

# Headquarters cost studies: time to review processes and procedures

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## The economic and political background

In today's economic environment, companies are reviewing all business activities as they search for potential cost savings. For US-based multinational corporations with significant US headquarters activities, a study of the costs and expenses associated with those activities can help achieve that goal. In addition, since 2007, Congress has discussed legislation that could affect the timing of the deductibility of expenses that are related to deferred foreign income. These rules could significantly limit certain headquarters cost deductions, and companies should understand the potential impact such legislation might have on them.

The Administration's budget for fiscal year 2010 includes proposals that would raise \$159 billion in revenue over ten years from international tax reforms, including a proposal under which certain "foreign-related deductions" would be allowed only to the extent that the applicable expenses and losses are properly allocable or apportionable to currently-taxed foreign income. Relevant foreign-related deductions allocable or apportionable to foreign income that is not currently taxed in the United States would be deferred. This deduction deferral proposal is similar to the new Code section 975 that was proposed by Chairman Charles Rangel (D-NY) of the House Ways and Means Committee in 2007.<sup>1</sup> Two of the most significant US deductions that could be deferred under these proposals are foreign-source interest expense and foreign-source headquarters (HQ) expenses.

## Why conduct headquarters cost studies?

An HQ cost study gives companies the ability to factually allocate and apportion their HQ expenses between important categories of income for US federal income tax purposes (e.g., US-source income, foreign-source income, income eligible for section 199 deductions, etc.). An HQ study can also help a company identify expenses that should be charged out to foreign subsidiaries under Code section 482. The amount of HQ expenses allocable to each category of income is often identified through the use of a functional analysis of activities, commonly called a time study. A time study is inherently more accurate than broad-brush apportionment methods, such as the gross income or gross sales methods, and can provide a fact-based analysis to document expense apportionment methodologies.

### *A. Increased foreign tax credit utilization*

Most US-based companies have substantial HQ costs. For foreign tax credit limitation purposes, companies need to know which of those expenses are allocated or apportioned to foreign-source income. This knowledge is particularly important for companies being challenged by the IRS on foreign tax credit issues or simply for companies that have excess foreign tax credits that could expire.

In the current economic downturn, using foreign tax credits has become more challenging. For many companies, foreign-source income is lower because export sales and royalty income are less vis-à-vis prior years. In addition, the strengthening of the US dollar during recent years may have affected a company's US federal income tax profile in unforeseen ways. For example, section 902 credits may now be higher than in recent years because foreign-source dividends can carry fixed amounts of foreign tax credits (translated each year based on the date paid) but may bring the US parent company lower dividend income in US dollars (translated into US dollars at the date of the dividend). Even more fundamentally, however, many companies are incurring US-source losses that may implicate the new overall domestic loss regime<sup>2</sup> or result in net operating losses. Any losses make it more difficult (or impossible) for companies to claim foreign tax credits.

### *B. Proper charge-outs to foreign subsidiaries*

As noted above, an HQ study can also identify expenses that benefit foreign affiliates<sup>3</sup> that should be charged out by the US group. Such charge outs allow for proper reimbursement of expenses incurred by the US group on behalf of the foreign affiliates. Furthermore, expenses that are appropriately charged out may not be subject to disallowance under the recent legislative proposals. Transfer pricing advisors are often part of the HQ study team because they can help to (i) identify which costs should be charged out; (ii) determine whether such costs should be marked up; and (iii) document the services provided as beneficial to the foreign affiliates, helping to satisfy section 6662. A properly documented analysis not only can be very helpful, but also is typically required in order to support the foreign deductibility of the charge-outs.

### *C. Financial statement support*

Headquarters cost studies can also be helpful with respect to significant financial accounting issues. For example, an HQ study can help a company prove that FTC carryforwards can be expected to be utilized within the ten-year carryforward period of section 904(c). This can help to justify the realization of a deferred tax asset (i.e., no valuation reserve). In addition, for purposes of FIN 48, a study can help demonstrate that a reserve is not required for deductions included in the US federal corporate income tax return that

actually benefit foreign subsidiaries. Instead, these US-performed services would be charged out to the applicable foreign subsidiaries.

#### *D. Enhanced quantification of the revenue streams impacted by HQ costs*

Section 861 requires that all expenses, including HQ costs, be allocated or apportioned to some income stream. Facts and circumstances will prioritize the various attributes that create the highest overall tax benefits within each organization (e.g., more foreign tax credit limitation, higher domestic production activity income, etc.). An HQ study will identify facts that allow specific allocation of HQ costs to the various income streams, moving companies away from broad apportionment methodologies that may inaccurately (and possibly detrimentally) burden the various tax attributes in a manner inconsistent with what may be optimal.

#### *E. To assess exposure for deferred foreign expenses*

As mentioned above, the Administration has proposed rules that would defer the deductibility of certain US expenses (such as stewardship) that relate to deferred foreign income. Although some companies have already made efforts to estimate the impact of this proposed legislation, many US companies have not historically quantified their stewardship expense because they have had excess FTC limitation, overall foreign losses, net operating losses or, simply, resource constraints. Even taxpayers in an excess credit position may need to refine their analysis of HQ expenses. By conducting an HQ study, companies can better quantify their exposure and may be able to reduce the amount of stewardship (and other foreign-related) expenses, which would reduce deductions that could be disallowed in whole or in part by future legislation.

#### **An integrated approach to HQ cost studies**

As the comments above suggest, HQ cost studies are most effective if they are conducted to achieve multiple business objectives. Specifically, an integrated approach brings together the considerations of expense allocation and apportionment, foreign tax credit planning, transfer pricing, potential section 199 domestic production issues, and so forth. Experienced practitioners in one area of international tax, such as section 861 expense allocation, may not be able to fully assess a company's section 482 posture. Accordingly, as mentioned above, an HQ study team should preferably include transfer pricing specialists who can help assess this issue.

Of equal importance, a company should assign a project leader who can help determine the overall approach to the study, who to interview, and how to obtain the right data. This individual should arrange, and participate in, all interviews.

An integrated approach means an optimal interview process that is minimally disruptive to a company's executives. For example, if a cost center is expected to have both stewardship and foreign-benefiting costs, then both transfer pricing and international tax advisors may be asked to participate in the interview, depending on the potential materiality of these two types of costs. This helps avoid situations in which the same executive is interviewed twice, once during a section 861 study and again during a section 482 study.

Working with the company, an HQ cost study team will help identify the appropriate people to interview at the outset of the project. Scheduling the right balance of interviews— not too many and not too few— is important to ensure adequate coverage with minimal cost and disruption. Once the study has begun, unplanned “ tiering” of interviews is often necessary to allow the interviewers to move down the organization to obtain the right information. For example, when Sally, the Director of Purchasing, is interviewed, it is discovered that Phil, her direct report, and his team were involved in a special project to purchase raw materials in Europe. The company and the transfer pricing team decide that an interview of Phil. is warranted so that sufficient documentation can be gathered to support charge-outs to European affiliates.

Knowing how to conduct an interview to elicit the necessary data requires both a strong technical understanding of sections 861 and 482 and a working knowledge of the company. In other words, the overall strategy of the HQ study should be understood before a single interview takes place. It is also necessary to understand how to analyze the data received in the interviews. For instance, a company treasurer may have time spent that benefits foreign subsidiaries, such as the time incurred to secure a European line of credit. However, the balance of time spent by the treasurer will often need to be carefully apportioned to various (or all) classes of gross income based on the actual activities she undertook.

### **The importance of accurate data**

A fundamental issue that an HQ cost study team faces is determining the proper data to use during the interviews. Company executives are typically only familiar with management reporting data, which often does not line up with general ledgers or other accounting data that is used to produce the US federal income tax return. It is also very likely that company interviewees do not have the same legal-entity orientation of their organization that the HQ cost study team (and tax department) has. For these reasons, most HQ study interviews should be conducted using management reporting data, and the team will need the ability to “bridge” this data to the relevant accounts in the general ledger (and then ultimately to the US tax return.)

The HQ cost study team also needs to view the organization from management's perspective. If the company CFO is being interviewed, for example, he may be responsible for 17 different “cost centers” that are scattered throughout the management reporting

system. In other words, not all companies conveniently prepare “profit and loss statements” for each of their executives. Also, there are often allocations of company overhead costs that show up in some or all cost centers. A description of the various overhead costs, and the method used for apportioning such costs to cost centers, should be understood to make sure that the appropriate costs are being analyzed in an accurate manner.

### **The role of quantitative tax specialists**

Quantitative tax specialists also play an important role in HQ studies, because those studies take place in the context of quantitative analyses such as foreign tax credit calculations or transfer pricing evaluations. Before starting interviews, the quantitative advisors can model the company’s tax footprint by income category, analyzing net taxable income related to dividend flows, royalty flows, US inventory sales, provision of technical services, and so forth. This step will largely rely on a Company’s existing expense allocation and apportionment methodologies used for tax purposes.

A determination of the company’s tax footprint at the outset of an HQ study will show a high-level snapshot of all categories of the company’s foreign-source and US-source income, taken down to Line 28 on the Form 1120. The tax footprint can help identify issues and trends that will impact the interviews. The resulting footprint might show, for example, that, based on a company’s cost allocation methodologies, domestic inventory sales are profitable but export sales inexplicably generated losses. This result might cause the HQ cost study team to focus on understanding whether domestic business activities of HQ employees were understated in the allocation of expenses (or for that matter, if the export business has identifiable costs that are not incurred in the domestic business). If the study finds export income should increase and domestic income should correspondingly decrease, it could have a potentially negative impact on section 199 deductions or other categories of income, but it will more accurately reflect the company’s business activities.

Quantitative specialists also work with a company’s data to ensure that management reports do not contain estimated expense allocations. These types of charges, which often originate from the company’s cost accountants, can skew the results of various cost centers. Even if the allocations seem appropriate at first, the HQ cost study team may determine, after further research, that a different apportionment methodology (e.g., headcount) is more factually correct than the methodology (e.g., gross sales) that was used by the company’s accountants.

Finally, an HQ cost study is most useful if the process can be utilized every year to update the results. Thus, companies should work to develop a well-documented bridge that connects management reporting cost centers to general ledger codes, and then to the tax return. For this reason, the initial-year HQ study should be planned, executed and documented with particular care.

## Allocating costs to categories of income

To determine the net income (or loss) from each category of income, companies need to allocate and apportion their US expenses, and two of the largest costs that must normally be analyzed are interest expense and R&D expense. The regulations under section 861 have mechanical rules for allocating and apportioning these two types of expenses. The other category of large, non-inventoriable expense that needs to be allocated and apportioned to various categories of income is HQ costs. Unlike interest and R&D expense, HQ expenses are allocated and apportioned to the categories of income to which they factually relate.

In some cases, companies may decide that HQ costs are not “definitely related” to any specific income stream and, following section 861 principles, are thus apportioned among all income categories, generally using gross income (or gross sales) as the apportionment factor. While easy to understand and apply, this approach has pitfalls. Headquarters expenses incurred during the year may not factually relate to the results of the business operations on a proportionate basis. For example, when applying gross income apportionment, the streams of income with the largest amount of gross income attract the largest amount of expense. However, the reality may be that top executives and their teams spent most of their time addressing problem areas in the business, which in fact were the least profitable parts of the business. Similarly, when using a gross income apportionment methodology, foreign-source royalty income may attract a disproportionately high amount of HQ expenses, especially in years where US earnings are depressed due to the economic environment. In fact, such royalty income may factually require little US management and oversight, except for some legal and accounting resources. The lesson is that a time study can often identify factual relationships that make it clear that certain categories of income (e.g., foreign-source income) deserve much less than a pro rata share of HQ expenses.

## Final deliverables of an hq study

An HQ cost study can generate a number of different deliverables that serve various purposes. The primary written output is a report summarizing the study, discussing the approach taken, the cost centers reviewed, memoranda for each of the interviews, and a summary of the sourcing results by income category. In addition, the study can generate supporting documentation that will serve as the underlying basis for detailed invoices (organized by foreign subsidiary) for benefiting costs being charged out under section 482.

## Conclusions

Most companies can benefit from having a more accurate calculation of the relationship between their HQ costs and their respective streams of income. For companies contemplating an HQ cost study, an integrated approach is often best to reduce both the costs of the study and the disruption to company executives. A study can also help companies document the methodologies used for calculating the foreign tax credit limitation; thus companies are more likely to apply those methodologies consistently year after year. An HQ study will also help identify which costs to charge out, section 199 domestic production income, etc.

An integrated HQ study team would include a project leader from the company's tax department and an international tax advisor with experience in analyzing section 861 issues, as well as transfer pricing and quantitative advisors. Headquarters cost studies can furnish support for tax and financial accounting audits, improve a company's foreign tax credit position (or income from other relevant categories), and allow for proper reimbursement of expenses incurred by the US group on behalf of foreign affiliates.

## Endnotes

<sup>1</sup> See H.R. 3970, "Tax Reduction and Reform Act of 2007," §3201 (2007).

<sup>2</sup> See section 904(g).

<sup>3</sup> See the new section 482 services regulations; Treas. Reg. §1.482-9.

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