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Growing your business™

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GYB

is published by PwC's Private Company Services (PCS) practice. Here we discuss the challenges privately owned businesses face and where the opportunities lie, suggesting how you can effectively make the most of both.

Please visit the GYB website at www.pwc.com/gyb for archives and local contacts. Contact our editor at gybeditor@us.pwc.com.



Rich Stovsky
US Leader
Private Company Services

Today's business environment presents private companies with challenges and opportunities. Driving growth will require many companies to take calculated risks and to do things differently as they position themselves in an economy with intense competition and uncertainty. The key is to be well-informed and surrounded with the right talent to execute the company's strategy.

In addition, to grow, companies must have capital, and private companies have a variety of sources to tap. For creditworthy businesses, it's a matter of knowing what sources of capital are available, and which make the most sense for the company's particular growth objectives.

Increasingly, companies have been finding the biggest growth opportunities in markets abroad. As private businesses continue to expand activities beyond US borders, one of the things to keep in mind is international tax—and not just for compliance purposes.

Approached strategically, international tax planning can significantly increase a company's growth capital and improve its liquidity. This isn't true of just companies with subsidiaries or headquarters outside the United States. Strategic international tax planning can also benefit many companies that might not consider themselves international but nonetheless do a fair amount of business globally. The key is for businesses to integrate international tax planning with their operational and growth strategies rather than treat it as a bolt-on feature.

Other taxes to bear in mind are those resulting from the healthcare act, which ushers in higher rates for high-net-worth individuals, starting in 2013. Business owners, executives, and shareholders, among others, can start pursuing tax-planning strategies and other income-preserving opportunities now to mitigate the effect of the tax increases two years on.

In looking ahead, companies have also begun pursuing the twin benefits of the technological innovation known as "cloud computing"—its ability to cut costs and drive growth. Although corporate focus on this still relatively new technology tends to zero in on the cost-savings benefit, early adopters are already finding that cloud computing has the potential to do far more—accelerating time to market, improving customer responsiveness, redefining collaborative business networks, and even creating new revenue streams. For private companies that want to be nimble, shedding legacy IT systems in exchange for cloud alternatives could prove a competitive differentiator in today's rapidly changing environment.

I hope you find this issue of *GYB* helpful. It is the first I've had the pleasure of presenting in my role as US leader of PwC's Private Company Services (PCS). As during Richard Calzaretta's distinguished leadership tenure, those of us in PCS welcome your thoughts about the topics discussed in *GYB* and other issues your business faces. Please feel free to reach out to me, any of the authors, or your local team to start the discussion.

Sincerely,

A handwritten signature in dark ink, appearing to read "Rich". The signature is fluid and cursive, written in a professional style.



Volume 62

Growing your business in today's economy and beyond

04

Financing the future: Strategies for accessing capital

There are a range of funding options out there. The key is knowing which ones are best for your growth objectives and what different lenders expect of borrowers.



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**Growing globally:
Aligning your tax and business strategies**

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Cloud technology is becoming a competitive differentiator for leading private companies—driving growth and innovation while cutting costs.

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**Health reform:
Mitigating its impact
on personal income**

Tax-planning strategies pursued now can ease the impact of the healthcare act's tax increases when they take effect in 2013.

Financing the future: Strategies for accessing capital

There are a range of funding options out there. The key is knowing which ones are best for your growth objectives and what various lenders expect of borrowers.

Companies that want to grow, whether organically or by acquisition, need capital. Sometimes cash flow from operations can fund expansion. In other cases, business owners need to tap outside sources. In a quest for external funding, a private company often starts and ends with traditional bank loans. These days, however, bank credit is not as easy to come by as it once was.

One reason for this is that the number of traditional lenders actively participating in the market has diminished over the past few years, due to banking industry consolidation; and many of those lenders are focused primarily on their existing loan portfolios. Banks that continue to lend have made their loan underwriting standards more rigorous, their covenants for senior debt tighter, and their pricing higher. They've also stepped up their due diligence in assessing potential borrowers, including stress-testing borrowers' projections.

Despite these challenges, there's good news for solidly performing companies: "Many banks and other lenders have money to put to work," says Michael Milani, president of PwC Corporate Finance LLC.¹ "They're willing to lend to businesses that exhibit a strong balance sheet, predictable EBITDA, and a solid business plan. Creditworthy businesses should therefore have a variety of capital sources available to them. The trick is knowing what's out there. It can take a bit of homework."

Some funding sources may be better suited to a company's growth needs than others. With that in mind, businesses seeking funds should research a range of borrowing options, carefully consider which ones make the most sense for their particular growth objectives, and then devise a well-thought-out strategy for accessing the capital.

¹ PwC Corporate Finance LLC is owned by PricewaterhouseCoopers LLP, a member firm of PricewaterhouseCoopers International Limited, and is a member of FINRA and SIPC. PwC Corporate Finance LLC is not engaged in the practice of public accounting.



Alternative funding options are often overlooked. They are worth investigating.

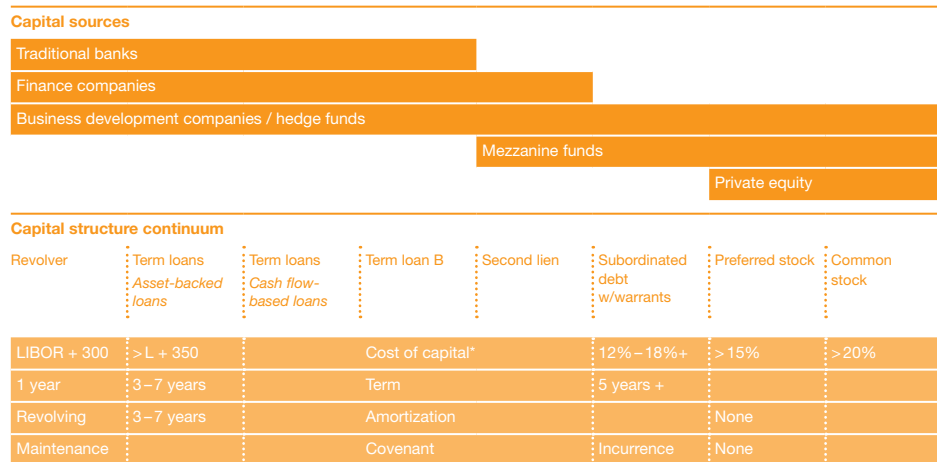
Know the range of capital sources

A traditional bank loan is just one among a number of potential funding sources. And yet alternative funding options are often overlooked. They are worth investigating, says Milani: “Not only does alternative financing reduce your dependence on your current lenders, but it can also increase your company’s ability to invest in long-term projects. Nontraditional lenders are often more willing to lend for longer periods than banks, or they may provide a tranche of capital that doesn’t amortize, with the principal payable upon maturity.”

Alternative sources of capital range from asset-based lenders to mezzanine funds. With each funding source, there are specific factors you should bear in mind. Certain capital sources may require you to relinquish some equity, while others may want you to offer them a seat on the board of directors.

“Take private equity firms, for instance,” says Avery Tuchman, managing director of the Mergers and Acquisitions group in PwC’s Private Company Services practice. “They demand a higher rate of return than commercial banks. But in exchange, private equity firms may offer more underwriting flexibility and provide less-rigid terms. They tend to place more emphasis on a company’s cash flow and future prospects than do traditional bank lenders, which focus more on balance sheets and leverage ratios.”

The pros and cons to each funding source are something companies will need to consider carefully as they assess their financing options. The chart below shows the types of capital sources available, ranging from traditional banks to private equity firms. It also shows where along the capital structure continuum those institutions provide capital—ranging from revolving lines of credit to common stock.



*Directional guidance based on approximate terms currently available in the marketplace as of July 2010.

Shop around

There are a variety of capital sources for private companies to tap.

Here are some of them:

Asset-based lenders

Many companies have significant amounts of capital locked within their organizations in the form of assets that have the potential to be securitized. Often such companies borrow against those assets via asset-based lending (ABL), reinvesting the capital in the business. Asset-based lenders make lending decisions according to the quality of the borrower's assets.

Finance companies

Finance companies are non-bank financial institutions that offer capital to businesses seeking senior debt, mezzanine debt, and equity capital. Finance companies can typically lend on somewhat more aggressive terms (higher leverage/pricing), as well as participate in tranches of capital beyond senior debt.

Mezzanine funds

Mezzanine funds comprise investors that provide companies with subordinated debt for three to seven years. This type of debt typically has no or low payments in the first few years, with either graduated payments in later years or a "bullet" payment upon maturity. Collateral (if required) generally consists of all assets, but claims are subordinated to senior lenders. Many subordinated debt loans have an equity "kicker" in the form of warrants. Usually, a mezzanine lender will want a seat on the company's board or some other method of interacting directly with management.

Private equity

Private equity firms commit equity capital for an extended time, either to purchase a minority/majority position in a company or to fund acquisitions or new technologies. Private equity investors also tend to focus more on long-term growth than on short-term profits.

Institutional investors

Pension funds and insurance companies, collectively known as institutional investors, can also be long-term sources of capital for privately held companies. Institutional investors can provide term debt, mezzanine debt, and equity capital.

Business development companies and hedge funds

Business development companies (BDCs) and hedge funds amass pools of capital (in the case of BDCs, the funds are often raised in the public markets) and then seek opportunities to invest or source capital. BDCs and hedge funds can provide different tranches along the capital structure continuum, depending on a company's needs.

Vendor and customer financing

Potential arrangements include direct loans, accelerated or delayed payment terms, equipment financing, direct equity investment, or financial assistance for new product development. Supplier/customer financing is most appropriate when there are certain synergies between the parties or if the company depends on the innovation of the other company—meaning that, without financing, both parties' businesses could be impacted.

Export-import banks

These government agencies lend money to companies to encourage production of goods for export to other markets. The US agency is the Export-Import Bank of the United States. Many governments outside the United States have similar banks and services.

Divestitures

As a company refines its strategy to adapt to an evolving marketplace, certain business units and subsidiaries can become less relevant to its long-range plans. Best-in-class companies actively monitor their businesses for strategic relevance and consider divesting noncore business units so that the proceeds can be invested more effectively.

Getting started

“Anticipate your funding needs early,” advises Milani. “Quick credit decisions from lenders are a rarity these days, so allow for sufficient lead time as your company searches for capital. Also, understand that the stronger your company and the more prepared you are, the greater your leverage in negotiating terms with capital providers.”

With those thoughts in mind, you should take the following preparatory actions before approaching prospective lenders:

- Assess your company’s creditworthiness.
- Foster strong relationships with current and prospective lenders.
- Make your information package compelling.

Do a self-assessment

“Regardless of whether a company is seeking capital from traditional lenders or from alternative sources, the first step is knowing the key areas that capital providers focus on when evaluating potential credit or investment risk,” says Tuchman. “That analysis will affect the availability of capital to your business, as well as the structure, pricing, covenants, and any other terms associated with the capital.”

In assessing prospective borrowers, lenders typically use the “five Cs of credit” as their main criteria: current capital structure, cash flow, collateral, conditions, and character (see our sidebar for more details). Businesses seeking capital should study these criteria and make sure their company measures up before approaching prospective lenders.

The five Cs of credit

1. Current capital structure

The availability, pricing, and other aspects of capital depend on the nature of the prospective borrower’s existing debt—for instance, the debt’s amount and maturity, the nature of any covenants, and the type of debt (e.g., senior or subordinated/mezzanine, revolving or term, secured or unsecured). In trying to grasp a prospective borrower’s total debt capacity, potential lenders will also assess the company’s ratio of total debt to earnings before interest, taxes, depreciation, and amortization (EBITDA), as well as total debt to equity.

2. Cash flow

In evaluating current and future cash flow, lenders will generally look at three years of past financial performance and five years of projected performance. That includes income statement and balance sheet trends, as well as financial ratio analysis. In scrutinizing projected financial performance, lenders will look at the reasonableness of assumptions and overall believability. They will also analyze debt and lease amortization/ payments, interest coverage, capital expenditures, and working-capital needs.

3. Collateral

Lenders consider current and fixed asset collateral, such as receivables and inventory, as well as the appraised asset values of property, plant, and equipment.

Cultivate lender relationships

To make itself attractive to lenders, your company will want to develop relationships with multiple potential funding sources. Your current team of advisors—attorneys, consultants, investment bankers, and accountants—can be instrumental in making introductions to new lenders, by leveraging their networks to identify appropriate funding sources for your particular needs. They can also help you cultivate and manage relationships with both your current providers of capital and prospective lenders, developing requests for proposals and negotiating terms, among other things.

Although you might end up tapping only one or two of the lending sources you cultivate, maintaining relationships with a good number of them is a sound strategy. Keep as many eggs in your basket as you reasonably can. It could end up being well worth the effort.

Make your package compelling

Once you have assessed your company via the “five Cs of credit,” as well as considered what a particular lender might be looking for, the next step is to create a comprehensive, well-organized package that’s tailored to each of your targeted funding sources.

The package should not only include your request for capital and what you intend to do with the funding, but also present a solid business plan—one mapping out a clear strategy and financial projections. Make sure your plan demonstrates that you have a good handle on your business, your cash flow, and your capital needs. All data should be presented accurately and clearly, and the package as a whole should have no significant information gaps. Be transparent about any concerns, past or present, and about your plans for the future.

4. Conditions

These comprise the company’s industry environment (including cyclical and seasonality); competition and barriers to entry; pricing power; gross profit margins and operating profit margins; product and technology risk; product life cycle; the company’s position in its industry; and comparable companies and transactions.

5. Character of borrower

This reflects the nature of the business itself, management’s strength, the company’s customer base (existing and potential, turnover, backlog), and the company’s suppliers (concentration and alternatives). In assessing a prospective borrower’s character, lenders may consider a variety of other factors as well, including contingent liabilities; legal and environmental issues; “intangible” assets such as goodwill and trademarks; and labor relations.

Quick credit decisions from lenders are a rarity these days, so allow for sufficient lead time as your company searches for capital.



Case study

How does a company find growth capital in a tight credit market?

Here's the way one company did it.

Looking to finance construction of a large new production facility, Company ABC² came up empty-handed after seeking funds from its usual lending sources. With guidance from PwC Corporate Finance LLC (PwC CF), the company tried again.

First, the company assessed its creditworthiness, based on the “five Cs of credit” criteria. Next, it sized up its financing alternatives—the potential transaction structures and the types of lenders that might work with the company. The company then considered the strategy it would use to negotiate lending terms with each prospective source of capital.

Having done the necessary homework, the company proceeded to prepare a solid information package for potential capital providers. The financial memorandum package included financial projections and other forward-looking statements, as well as a description of the envisioned transaction.

The company was then ready to go back into the market to seek capital. PwC CF introduced prospective lenders to the company, helped it assess their level of interest, assisted the company in preparing for due diligence visits, and advised the company as it negotiated the terms of the financing agreements.

The result? A failed attempt to access capital was revived as a successful \$45 million financing—one that included a construction loan, a revolving line of credit, and an equipment term loan.

² To protect the privacy of the company, we have used a fictional name in this example.

Conclusion

Regardless of whether your company wants to make an acquisition, launch a capital-intensive project, refinance, or find a way to bridge a lean period, it will benefit from looking at a range of capital sources beyond traditional bank loans. By studying those sources and maintaining your company's creditworthiness, your business can work more effectively with current and prospective capital sources and, as a result, better position itself for growth—in any type of economic environment.

More information

Want to learn more about strategies for accessing capital? Please contact someone on the PwC team, including:

Michael L. Milani
President
PwC Corporate Finance, LLC
312-298-2755
michael.milani@us.pwc.com

Avery Tuchman
Managing Director in Mergers and Acquisitions
Private Company Services
973-236-7652
avery.tuchman@us.pwc.com

Growing globally: Aligning your tax and business strategies

An integrated approach can increase a company's growth capital and improve its liquidity—sometimes substantially.

Private companies that scaled back in response to the economic crisis—through cost containment and greater organizational efficiency—are looking to grow again. Many of them are seeking opportunities abroad, where demand for goods and services is increasing, particularly in key foreign markets that are rebounding more quickly than the US economy.

As private US companies pursue such opportunities, it is important that they have a solid understanding of international tax laws. Too often, however, companies treat international tax planning as a compliance exercise rather than an integral component of their business and growth strategies.

“International tax planning is sometimes an afterthought rather than built into a company's corporate development strategy,” says Ken Esch, a partner with PwC's Private Company Services group. “That stems partly from a silo approach within organizations, but it's also due to a lack of awareness that your tax planning in China, for instance, may affect your planning in other countries—it's all interconnected. The good news is that you can develop an integrated global structure to manage all of these issues and drive a lower effective tax rate.”

A non-integrated structure, on the other hand, can result not only in inefficient tax structures, but also in missed opportunities—such as the chance to significantly increase a company's growth capital and improve its liquidity. To make the most of these opportunities, a company will want to view its international tax planning through a wide-angle lens—seeing the near-term benefits that an integrated global tax strategy can deliver while also eyeing that strategy within the broader context of the company's evolution. This approach is more likely to produce sustainable results.

Expansion abroad is just one reason for a company to take international tax planning into consideration. There's a host of other reasons as well, but US private companies sometimes overlook these, failing to realize how international they've become in recent years. As a result, they could be forfeiting the benefits that a well-conceived global tax strategy can deliver.



Expansion abroad is just one reason for a company to take international tax planning into consideration. There's a host of other reasons as well.

Are you more international than you think?

A common reason some businesses don't think strategically about international tax planning even though they should is that they consider themselves primarily domestic companies. Often the United States is home to their headquarters and the majority of their employees. But many of those same companies might be using service providers beyond US borders, such as international suppliers, or they might be selling products around the globe (e.g., through Internet sales)—and so quite possibly their activities are more international than they appear at first glance.

Take the case of a PwC client—a privately held company with \$1.5 billion in total revenue—which initially decided against developing an integrated global structure, since it considered itself a domestic business. “From an accounting perspective, everything was run through an S corporation here in the United States,” says Michael Urse, a partner with PwC's International Tax Services group. “As a result, the company's internal recordkeeping gave the impression that the business was more US-centric than it really was. However, when the company turned to PwC to streamline its operations and realign its tax structures, it found that it was able to reduce its annual tax cost by 25 percent.”

Choosing a globally tax-efficient business structure

Private companies often choose to take the form of a “flow-through” entity, such as an S corporation, because they want to manage their cash in the United States and pay one level of tax (at the shareholder level). If an S corporation operates abroad (either directly or through other flow-through entities), any foreign taxes paid can be claimed by the S corporation's shareholders (subject to the foreign tax credit limitation).

However, S corporation shareholders will bear an increased tax burden when the extension of the Bush-era tax cuts expires. At that time, the top tax rate for ordinary income, including qualified dividends, is due to rise to 39.6%, and the capital gains tax on the sale of S corporation stock would increase to 20 percent.

As Urse points out, “One of the biggest cash-flow drains for S corporations is the distribution of cash to pay the personal taxes of shareholders.” Given the significant effect of tax costs on corporate earnings, private companies may want to reevaluate their tax structures (along with their transfer-pricing arrangements—see sidebar on page 15) when contemplating international expansion. Some companies, for instance, could find it makes sense to change their status from an S corporation to a C corporation, particularly if they have significant international operations.

“While an S corporation is a tax-effective way to operate for domestic profits,” acknowledges Urse, “it can also be very costly for international profits. Use of a foreign holding company can lower a company's cost of capital by allowing the business to capture its foreign profits and reinvest them in working capital and growth strategies outside the United States.”

Setting up foreign entities

Increasingly, companies with foreign operations that had once focused primarily on manufacturing goods for US consumption are now selling to a growing customer base in or near where their foreign operations are located.

“It often makes sense to put the ownership of certain corporate assets where their market is,” says Yosef Barbut, a director with PwC's Global Accounting Services group. “If the main market for one of your core products is India, then setting up a foreign corporation there might be the most appropriate move, for a variety reasons, including operational ease, market penetration, and tax efficiency.”

This principle applies to more than just manufactured goods. Intangible assets such as intellectual property (IP) are also something that companies may decide to manage abroad if a substantial portion of the market for goods or services that use a company's IP is outside the United States. An effective IP migration strategy usually involves dividing economic ownership of a company's valuable intellectual asset between the company and a non-US entity. These arrangements may be subject to "cost-sharing" regulations. For example, a US technology company based in Silicon Valley could license its non-US IP rights to a Swiss company, with the understanding that the Swiss company will pay a portion of the cost of future R&D development.

Although there are clear tax benefits to such arrangements (if the foreign entity is in a country with relatively low tax rates), it's important that a company not make tax considerations the sole driver of its decision to migrate intellectual property. "IP migration is about aligning the way a company sources its revenue to how it owns its intellectual property," says Esch. "Tax objectives should certainly be taken into account, but in a way that's integrated with the company's overall global business strategy."

Other considerations

In considering tax objectives, companies will want to keep in mind that a key benefit of setting up a foreign entity is the opportunity to defer US taxation of foreign earnings. If a US business—either an S corporation or a C corporation—were to set up subsidiaries abroad, it could have considerably more working capital at its disposal if foreign earnings were kept offshore. While the owners of an S corporation or a C corporation can generally defer US taxation of foreign earnings if they use a foreign legal entity, there are certain US anti-deferral rules that need to be managed if a company is to avoid immediate US taxation of foreign earnings (i.e., before the earnings are repatriated as dividends). The decision to use either an S corporation or a C corporation in the United States requires careful analysis.

Setting up foreign entities can also be useful to private businesses that are seeking financing at a reasonable cost. "Ideally, a business will use intercompany debt structures to obtain capital in a tax-efficient way," says David Chen, a director in PwC's International Tax Services group. "Although this may seem like an obvious suggestion, doing it effectively can be complicated and requires careful planning." One approach is to create a tax-efficient debt structure by

Transfer pricing

US companies operating abroad should take note that the IRS has announced its intention to increase its focus on the use of transfer pricing.

Transfer pricing refers to the pricing for transactions between related firms, such as between a subsidiary and its parent company. Under the so-called "arm's length" principle of US tax law, the amount charged by one related party to another must be the same as it would be if the parties weren't related. In other words, one division of a company cannot sell its products to another division at artificially low prices to reduce the company's taxable income.

IP migration

Transfer pricing is an especially critical issue when a company determines the value of intellectual property (IP) before undertaking an IP migration. The value that a company decides on for its IP determines the price the company's foreign entity will set for the US entity. That price, in turn, determines the amount of taxes potentially owed. Determining the arm's-length price for IP can be quite complex.

US law requires that the "best method rule" be used to determine which transfer pricing methodology is best for deciding on the appropriate arm's-length price of a given transaction. The IRS defines this as "the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."

Given the inherent ambiguity in this language (the IRS does not define "most reliable"), a US private company doing business overseas may want to consider undertaking a formal transfer pricing study. This will provide contemporaneous documentation that supports the company's transfer pricing policies, with the goal of helping those policies withstand increased IRS scrutiny.

A photograph of a factory floor. In the foreground, a conveyor belt with yellow and black safety stripes runs across the frame. To the left, a large stack of materials, possibly wood or metal, is visible. In the background, there are various pieces of industrial equipment, including a green corrugated metal structure and a large grey metal component. The lighting is bright, typical of an industrial setting.

Redefining “manufacturing”

Improvements in areas such as IT and accounting systems have given US companies greater control over their remote manufacturing and supply-chain management. An additional advantage for certain companies manufacturing abroad is that in the past couple of years they’ve been able to treat certain foreign operations as manufacturing activities (for tax purposes) even if those operations haven’t been doing the physical manufacturing themselves. As a result, businesses that outsource their manufacturing to a foreign entity might be able to defer income that previously they could not defer.

This is due to a recent US tax-regulation change that broadens the range of activities that qualify for income deferral—as permitted under the exception to the “Subpart F” regulations of the Internal Revenue Code. These regulations deal with related-party transactions that are characterized as foreign-based sales income.

Under Subpart F, companies that manufacture goods have long been permitted to defer income on related-party sales transactions. Over time, however, the definition of “manufacture” has evolved as businesses have become more global in their operations.

“When these rules were originally developed some forty years ago, the notion was that the value in a manufactured product lay in the bending of the metal or the molding of the plastic, so to speak,” PwC’s Mike Urse explains. “Today, consistent with trends in international operations and global manufacturing, there’s increasing recognition that value isn’t limited to the bending of the metal, but rather, extends to the design, marketing, and distribution of the final product.”

Therefore, if a company essentially controls the outsourced product—including its quality and quantity—it can often claim to own the value of that product and therefore defer the related income. To do this, however, a company must have a tax structure that allows it to take advantage of this recent regulatory change. In some cases, that could require abandoning a flow-through model and becoming a C corporation (with foreign subsidiaries).

putting the lender in a low-tax jurisdiction and the borrower in a high-tax jurisdiction. The borrower can take a deduction on the interest paid on the loan, while the lender pays a comparably lower tax on the interest income (or no tax at all).

In creating a foreign entity, private companies will need to take care that they choose the right legal form for the country in which they're operating. Ideally, the form of entity they choose will allow the company to build a business structure that is sufficiently flexible to accommodate growth without undue tax consequences, as well as accommodate future changes in tax regulation. Often it may also be advantageous to own foreign subsidiaries through foreign holding companies or

even regional sub-holding companies. This is just one aspect of integrated global structuring that can improve cash redeployment between foreign entities and make it easier to implement tax-reduction strategies.

Conclusion

As the geographic footprint of US businesses continues to expand and international growth opportunities increase, there is a strong imperative for private companies to assess their tax structure from a global perspective. Quite likely they will find that integrated global structuring can help them achieve their growth objectives more efficiently, both at home and abroad.

More information

Want to learn more about aligning your global tax structure with your international growth strategy? Please contact someone on the PwC team, including:

Ken Esch
Partner
Private Company Services
312-298-3419
ken.esch@us.pwc.com

Michael Urse
Partner
International Tax Services
216-875-3358
michael.urse@us.pwc.com

Yosef Barbut
Director
Global Accounting Services
973-236-7305
yosef.barbut@us.pwc.com

David Chen
Director
International Tax Services
313-394-6436
david.s.chen@us.pwc.com

Taxing matters

Here are some other international tax issues companies need to keep in mind:

Withholding taxes

Certain business charges are subject to withholding taxes in foreign jurisdictions. These include taxes on interest, royalties, dividends, and some services.

Efficient capital structure or intercompany debt

If a US company uses debt to set up a foreign business (i.e., by loaning cash to the subsidiary), the subsidiary can take a deduction on interest expense. This reduces the amount of taxable income in that foreign jurisdiction.

Subpart F income

Normally, payment of US income tax on the earnings of a foreign

subsidiary is deferred until those earnings are repatriated in the form of a dividend. However, there are certain key exceptions, which include foreign passive income (e.g., interest, rents, royalties, and certain dividends) and earnings from certain types of intercompany transactions. These earnings must be immediately included in US taxable income.

Indirect taxes

Examples of these are the value-added tax (VAT) and customs duties. The VAT charges a sales tax at each stage that value is added to a given product or service. A US company that is the importer of record in a foreign jurisdiction is responsible for collecting and administering the VAT, although its cost is ultimately paid by the end-user (normally the consumer).

Cloud computing: Why it matters to your business

Cloud technology is becoming a competitive differentiator for leading private companies—driving growth and innovation while cutting costs.

Beyond the clever headlines, techie jargon—and considerable hype—cloud computing is a force business executives are beginning to take seriously. They understand that, like the Internet and e-commerce before it, this technology trend is changing the way companies of all sizes do business.

Just a year ago, however, talk of cloud computing was confined primarily to the IT department, with a focus on cost-cutting: Did this new technological approach make it possible to streamline operations and reduce maintenance costs? Could software-as-a-service provide top-tier applications without burdensome investment? Would a pay-as-you-go model shift technology spend from capital expenses to operational ones?

Today, this line of questioning is still valid. But it's not why corporate leaders are taking notice. What's grabbing their attention is the increasing evidence that cloud computing has the potential to be a game-changer by accelerating time to market, improving

customer responsiveness, redefining collaborative business networks, and even creating new revenue streams. Business leaders are also recognizing that the cloud model is part of a broader shift in corporate thinking—the emergence of a new mindset, one that's dispensing with old paradigms in pursuit of innovation and business growth.

While cloud computing is clearly ascendant, with some companies already reaping first-order benefits (e.g., technology cost-savings), it's still early days. Many companies are only just now seriously considering their cloud options. Regardless of your own organization's awareness/use of cloud, it makes sense to start understanding the role cloud computing might play in your business strategy—and in helping your company maintain a competitive advantage, both now and for the long term.



Private companies in particular are well positioned to take immediate advantage of cloud technology.

Immediate benefits: Cutting costs and increasing efficiency

From startups to Fortune-1000 heavyweights, companies are successfully adopting cloud computing. Private companies in particular are well positioned to take immediate advantage of cloud technology. One reason is that, compared with public companies, private companies are not as restricted from a regulatory perspective and therefore don't necessarily have to demonstrate the same level of rigor in their systems.

"Having that flexibility allows private companies to engage and leverage cloud services more readily than organizations that are hampered by regulations," explains Sarah Thompson, a manager in PwC's Risk Assurance Services practice. Also, private companies may be less wedded to legacy technology systems that are costly to maintain but central to conducting business.

For many private companies, so far the focus has mostly been on dollars and cents. Cloud computing provides their businesses with the solutions they need, with little or no capital investment, lower maintenance costs, and less reliance on internal resources to manage everything.

Take, for instance, Envoy Media Group, a direct-marketing firm that runs highly targeted media campaigns across multiple outlets, including TV, radio, the Internet, and direct video. The company's entire Web presence has moved to the cloud, where it is hosted by Amazon's Web Services (AWS). The cloud's "pay as you go" model allows Envoy to quickly and easily add servers as needed, but without making hardware investments. This saves the company time and manpower, which it can now devote more fully to the business. Using the cloud also frees up Envoy's human capital spend so that the company can hire programmers and fill positions that have a direct impact on the bottom line, rather than maintain a large team of server administrators.³

Despite these and other clear benefits of cloud computing, the new technology isn't something that most companies are jumping at—not yet, anyway. For the moment, cloud is just one among a variety of options that some companies are considering as they move forward with internal projects.

"Companies need a compelling business reason to make the change," says Joy Dualan, a principal in the Risk Assurance Services practice. "For example, if they're already planning to replace a legacy application system, then a cloud solution might make obvious sense for them at this stage." Likewise, companies might consider integrating cloud into a current technology strategy. "Rather than purchasing new hardware and network resources to support a new ERP," explains Dualan, "a company may instead choose to transition to platform-as-a-service and/or infrastructure-as-a-service."⁴

A company might also decide to use a cloud-based application when an internally managed application doesn't meet the needs of employees. Such was the case with Zagat Survey, the company behind the eponymous dining, travel, and leisure guides and website. Earlier this year, Zagat migrated from an in-house customer-relationship management (CRM) system to Salesforce.com's cloud application. The move was driven by the sales leader and team, who had previously used—and were comfortable with—Salesforce.com.

The sales leader liked the idea of a simpler tool that required no maintenance on Zagat's part. He also appreciated the ability to acquire the CRM application and conduct a pilot in just a couple of weeks, before transitioning it to the full sales team.

³ <http://aws.amazon.com/solutions/case-studies/envoy/>

⁴ Platform-as-a-service (PaaS) is a cloud-based application that is custom-built for a company. For a fuller description of this and other cloud-related terminology, please see page twenty four.

Cloud computing 101

Why the term *cloud*? And what makes cloud computing different from other Internet-based approaches? Here are the short answers:

The cloud is a commonly used metaphor for the Internet, which is where cloud computing resides (rather than residing in a server that's physically located at one of the company's facilities). Cloud computing services—from complete business applications to raw computing resources—are provided to users via the Internet on an as-needed basis.

Companies, of course, already use the Internet as part of their IT operations, such as for corporate intranets, for Web-based applications that don't require special software on each employee's machine, or as a way to integrate with an outsourced service provider. What makes cloud computing's use of the Internet different are the following key characteristics:

- Cloud services are shared, often by multiple companies or business units (making the services *multi-tenancy*).
- The services are *elastic*—provided in an on-demand manner and scalable up to as many users as necessary—because the underlying infrastructure is flexible.
- Customers pay based on their consumption (as they would with a utility like electricity).

- Cloud hardware and software can reside anywhere:

At a provider:

- either a provider of a *public cloud* that's shared by other users, or
- a provider that creates and maintains a dedicated *private cloud* tailored to a single organization

At a company's data center, as in the case of a

- *private cloud*
- *hybrid cloud*—a combination of a private cloud and public cloud—which augments a private cloud with public resources when needed

Even if cloud is not on your company's shortlist, it's still likely to play a role in your technology and business strategy indirectly. That's because many vendors and service providers are incorporating the approach.

Case in point? Consider ADP, the outsourcing provider of business services, including human resources, payroll, tax, and benefits administration. "ADP was arguably one of the early providers of services using cloud computing architectures," posits Vinod Baya, research director at PwC's Center for Technology and Innovation (CTI). "The concept of private cloud is something they embraced a long time ago, to build flexibility and agility into their IT infrastructure. When we recently sat down with ADP's management team to talk about the future of cloud computing, they emphasized its importance to their ability to grow and meet customer needs."⁵

Next level: Agility and innovation

Reduced costs are a compelling proposition, but, increasingly, forward-looking companies are beginning to put equal weight on how cloud can help them be more agile and innovative. With cloud's ability to deliver on-demand resources, businesses can quickly try new ideas or keep pace with rapidly changing needs. A stretched IT department, for instance, might be hard-pressed to quickly set up the infrastructure required to develop and test a new product or service, requiring weeks or months to put it in place. By using cloud, the company's project could be up and running in days.

What it means for business executives

Cloud computing means different things depending on where you sit in a company.

Division/department managers: It's about better access to technology to meet a business objective. Managers can get the desired applications or services quickly and cost-effectively, for exactly the desired amount of time.

CFOs and controllers: The appeal is the ability to pay as you go and the elimination of intensive capital-investment in technology.

Chief information/technology officers: Cloud offers a new delivery model that lets CIOs/CTOs provide more technology services while drawing on fewer resources.

CEOs: All of the above, with a focus on how cloud can support growth by making the business more agile and efficient—e.g., using cloud infrastructures to create instant environments for trying out new ideas.

⁵ For PwC's interviews with ADP executives and an in-depth look at where cloud computing is heading, see PwC's *Technology Forecast Quarterly* at www.pwc.com/techforecast.

“In outsourcing the management of an application to a software developer, a company has immediate access to the most up-to-date technological innovations, without the capital spend of an internal system upgrade,” explains Fred Eisenhart, a partner in PwC’s Private Company Services practice.

For example, when Zagat began rebuilding the Web platform for its Zagat.com subscription service—one of its most strategic and fast-growing businesses—it determined that using Amazon’s Elastic Compute Cloud (EC2) infrastructure was a better choice than managing the hardware in-house. With EC2, Zagat could test different configurations of components to best meet its needs. Using a cloud infrastructure also gave Zagat the ability to experiment and deploy smaller-scale applications quickly.

Other companies have used cloud-based resources to propel innovation efforts, particularly those with a customer focus—for instance, by taking advantage of cloud-based storage to market product-pilot programs that generate considerable data, or by using cloud-based analytics to get a better handle on customer engagement and loyalty. Take healthcare distributor McKesson, which is using the cloud to help it centralize its data on customer loyalty.⁶ This has freed up McKesson’s analysts so that they spend less time on preparing data extracts and more time on creative analysis. Still other companies have turned to the cloud to meet short-term needs (e.g., Web promotion) for which an investment in infrastructure or dedication of in-house resources wouldn’t make sense.

As cloud technology matures and businesses get more comfortable with it, cloud computing’s potential to drive business growth will only increase. Cloud could also be the engine for a new *kind* of business growth: “We are focused on what companies will be

doing with cloud computing three to five years out,” says PwC’s Baya. “In our research with cloud pioneers, on both the user and provider sides, we find that cloud is a new strategic option for growth. Once you take some key capabilities to the cloud, a massive network of partners can help you grow by linking to your cloud-available services at marginal cost to you. We call this new kind of company the *extensible enterprise*.”

In this futuristic ecosystem, every company has the ability to be a cloud service provider. How? By offering Web-based processes, or specific sub-processes, to other companies that might then combine several such processes to create their own unique offering. While this idea is a stretch for most private companies today, the notion of well-defined, modular processes and seamless partner integration is certainly relevant to effectively running and growing a business.⁷

Due diligence: Risks and challenges

As with other novel—and therefore disruptive—technologies, cloud computing presents new challenges. Chief among these is security: What controls are in place to ensure appropriate access to customer data and other sensitive information? How is the data segregated from the data of other companies that are using the same provider? What security-breach guards has the provider put in place? Are relevant data regulations being met? Careful discussion of these issues with a cloud provider is essential.

Right now, the items that companies are typically moving onto the cloud are non-differentiating business functions, such as human resources, CRM, and email. But, for the most part, they’re keeping in-house those systems that contain mission-critical data or intellectual property.

⁶ *10Minutes on the Cloud*, PwC, June 2010.

⁷ For an in-depth look at the extensible enterprise and examples of how companies are moving toward this future, see PwC’s *Technology Forecast Quarterly* at www.pwc.com/techforecast.

Cloud terminology

Here are some key tech terms to know when talking about cloud computing:

Virtualization: A software technology that's key to making cloud computing possible, virtualization allows service providers to create a pool of standardized, shared resources that can be drawn upon and redeployed as needed. For a conventional software application—even one that is a Web-based service—dedicated resources are required, including a processor, memory, an operating system, storage, networking, and power. Virtualization does away with these application stacks, unlocking the application from specific underlying software or hardware.

Software-as-a-service (SaaS): An application and its supporting environment (hardware, network, operating system, database, etc.) are managed centrally by a service provider. Users typically access the application through a Web browser. Examples include Google Apps, Salesforce.com, and ADP.

Platform-as-a-service (PaaS): This enables companies to build custom cloud-based applications. Everything but the specific application code is hosted remotely by a service provider—hardware, network, operating system, and database. Examples include Amazon Elastic Compute Cloud, Google App Engine, and Windows Azure.

Infrastructure-as-a-service (IaaS): Hardware and network resources are available on-demand from the service provider, while the customer company manages any applications and their operating systems in-house. Examples include Amazon Web Services, GoGrid, and Rackspace Cloud.

Beyond security concerns, a number of other issues are apt to prompt questions from companies that are contemplating cloud computing:

What type of availability can we expect? What kind of disaster recovery plans does the provider have in place? Are the data and application interoperable with my internal systems and those of my other service providers? How can we be assured of the integrity of usage metering and billing? Are we indemnified against loss of data, including confidential information? How financially stable is the provider? These questions would need to be adequately addressed in a service-level agreement (SLA) with the cloud provider.

That cloud providers can and do adequately address these questions appears evident in the recent move by New York City and California to enlist Microsoft's cloud computing services.⁸ In New York's case, the move is meant to help the city centralize its IT infrastructure, as well as trim 50 municipal data centers down to one. California is turning to Microsoft's cloud capability to help the state consolidate more than 100 email systems. The public sector's confidence in the cloud could be a bellwether, as entities in general, both private and public, grow less leery of this new technology.

To allay that leering, cloud providers are increasingly relying on third-party assurance—similar to how more-traditional outsourcers undergo a SAS 70⁹ examination of their controls and then provide the resultant report to customers and other stakeholders. While assurance standards are still evolving for cloud computing, providers realize that a report from an independent entity can ease customers' concern about security, privacy, and availability. It's also important that the service-level agreement specify an exit strategy in the event that the provider fails to deliver on the SLA, goes out of business, is acquired, or lags behind the capabilities of its competitors. Addressing these issues upfront is the key to having a good initial experience with cloud computing rather than a discouraging one.

Conclusion

Cloud computing is an important trend, one that will have a considerable effect on how business is conducted over the next decade and beyond. That is why it's crucial for private company leaders—not just their IT managers—to understand the potential of cloud computing, raise the right questions with their management team, and begin contemplating a cloud approach in their company's growth strategies, starting today.

More information

Want to learn more about cloud computing? Please contact someone on the PwC team, including:

Joy Dualan
Principal
Risk Assurance Services
415-498-7436
joy.dualan@us.pwc.com

Fred Eisenhart
Partner
Private Company Services
415-498-7446
frederick.eisenhart@us.pwc.com

Sarah E. Thompson
Manager
Risk Assurance Services
415-498-7128
s.e.thompson@us.pwc.com

⁸ *Microsoft Signs NYC to Cloud Computing Deal*, October 20, 2010, www.informationweek.com/cloud-computing/article.

⁹ Statement on Auditing Standards 70, *Service Organizations*.

Health reform: Mitigating its impact on personal income

Tax-planning strategies pursued now can ease the impact of the healthcare act's tax increases when they take effect in 2013.

The new federal healthcare reform legislation—the Patient Protection and Affordable Care Act (the “Act”)—will affect individuals in a variety of ways as its provisions continue to roll out between now and 2018. One of those provisions is the requirement that top earners pay higher taxes to help fund the Act's initiatives—specifically, a 0.9% increase in the Medicare hospital insurance (HI) tax on both wages and self-employment income above a certain threshold, and a 3.8% tax on certain net investment income. These tax changes, which take effect in 2013, have nuances that taxpayers will want to consider carefully.

The Act also imposes new restrictions on the use of health savings accounts (HSAs), flexible spending accounts (FSAs), and Archer medical savings accounts (MSAs). It also eliminates the tax-favored reimbursement from these accounts for over-the-counter drugs that are not prescribed by a doctor.

Individuals should start assessing the impact that these changes will have on them and, in particular, determine what actions they can take now to preserve their income once the new tax provisions go into effect.

Tax increases: Who's affected and how

Both the 0.9% increase in the Medicare HI tax on wage income (or self-employment earnings) and the new 3.8% tax on certain net investment income apply to individuals earning above \$200,000 (\$250,000 for jointly filing couples, and \$125,000 for separately filing married persons). These income levels are not indexed for inflation.

While the employer's share of the Medicare HI tax will remain 1.45%, the 0.9% that employees will start paying in 2013 will boost their tax rate from 1.45% to 2.35% for earnings (i.e., wages or self-employment income). Together, the employee's and employer's Medicare HI tax rates will total 3.8 percent.¹⁰

¹⁰ This is distinct from the new 3.8% tax on net investment income.



Individuals should determine what actions they can take now to preserve their income once the new tax provisions go into effect.

Beware of potential under-withholding

The additional 0.9% Medicare HI tax is on *household* income. Because an employer is not expected to know an employee's household income, its only obligation in this case is to withhold the Medicare HI tax of an individual who earns over \$200,000. So although an employee who earns \$200,000 or under might nonetheless have a household income above \$250,000 (i.e., when factoring in wages earned by a spouse or partner), his or her employer is under no obligation to withhold the additional Medicare HI tax. This could result in under-withholding by the employer.

Therefore, if you think your combined household earnings might exceed \$250,000, bear in mind the potential for under-withholding when assessing your tax liability for 2013 and subsequent years. Likewise, in households where one or both spouses/partners are self-employed, the tax assessment should be based on combined earnings, since the 0.9% Medicare HI tax applies to self-employment income too.

Net investment income

Like the Medicare HI tax, the new 3.8% tax on net investment income will take effect in 2013. Net investment income is defined as investment income less any deductions properly allocated to such income. It includes gross income from interest, dividends, annuities, rents, and royalties (other than such income derived in the ordinary course of a trade or business that isn't a passive activity), as well as net capital gain and working capital interest. Net investment income does not include distributions from qualified retirement plans or amounts subject to self-employment taxes.

The 3.8% tax will also apply to income from limited partnerships and pass-through entities in which the taxpayer does not materially participate. For example, if a family-owned business has been set up as a pass-through entity, family members who do not materially participate in the running of the business but earn investment income from it will be subject to the net investment income tax.

Similarly, in the disposition of a partnership interest or S corporation stock, investment income will include only the net gain from property held by the entity, not the net gain attributable to an active trade or business. However, the 3.8% tax *will* apply to gains from the sale of a partnership interest attributable to passive property. Presumably, if the shareholder holds such stock or interest as a passive interest, the entire net gain will be subject to the new tax.

Tax-planning strategies

Because the 3.8% tax on net investment income is imposed on passive activities but not on income derived from an active trade or business, individuals should consult with their tax advisors to analyze their participation in a business, assess whether they are active or passive vis-à-vis the activity, and, where appropriate, explore potential ways of becoming active in the business.

Also, individuals might want to accelerate some investment income into periods predating the tax's effective date (January 1, 2013). For example, if selling a stock and realizing a capital gain makes sense from an investment standpoint, then doing so before January 1, 2013 would ensure that the gain is not subject to the new tax. Conversely, where individuals can defer deductions, such as investment management fees and investment interest expenses, it would be beneficial to pay those expenses after January 1, 2013, thereby reducing net investment income.

"This presumes that your income remains relatively consistent from year to year," notes Jim Medeiros, a partner in PwC's Personal Financial Services group. "As for accelerating investment income by selling stock before 2013, that makes economic sense only if it's likely that any rise in the stock price won't offset the higher tax rate. Individuals will want to think carefully about these and other tax-planning options before pursuing them."

Other income-preserving strategies include placing earnings in a variable life insurance policy or shifting capital gains to earned income. “Making these tax-planning decisions now can lead to substantial savings down the line,” says Medeiros.

“Cadillac” plans and health-related savings accounts

In 2018, high-cost benefit plans may face a 40% excise tax if the aggregate value of the coverage for a participant is over a certain amount: \$10,200 for individuals and \$27,500 for family coverage. Affected coverage includes health and supplemental benefits, as well as contributions to flexible spending accounts (FSAs) and health reimbursement accounts (HRAs).

Employers are responsible for calculating and paying the amount that is subject to the excise tax. If companies underreport the value of coverage, they could be liable for the unpaid tax and for underpayment of interest charges. The excise tax is not deductible for purposes of federal income tax.

“Employers will need to actively manage their benefit plans so that their value does not inadvertently exceed the specified limits,” says Aron Minken, a director in PwC’s Human Resource Services practice. He also

points out that HSAs can be a useful tool in helping companies adapt to the future tax: “Because HSA contributions are made pre-tax and aren’t subject to the 40% excise tax that takes effect in 2018, they’re not only a good means of deferring taxation for the next seven years, but can also be used in conjunction with high-deductible health plans to hold down costs for medical plans, thereby allowing a company to avoid the 40% excise tax on Cadillac plans.”¹¹

A recent PwC survey¹² of private-company CEOs and CFOs shows that 32% of them expect the Cadillac excise tax to have an impact on their business (20% expect a moderate-to-significant impact), with 60% saying their companies expect to change their health benefit plans to comply with the Act.

Conclusion

Although the funding of federal health reform has a direct effect on high-net-worth individuals, careful planning can mitigate the impact. By considering tax-planning strategies and other income-preserving opportunities now, individuals will be better equipped to deal with the Act’s tax increases and other changes as they occur.

More information

Want to learn more about health reform’s impact on personal income? Please contact someone on the PwC team, including:

James Medeiros
Partner
Personal Financial Services
617-530-7353
james.m.medeiros@us.pwc.com

Aron Minken
Director
Human Resource Services
646-471-3364
aron.minken@us.pwc.com

Health savings and spending accounts

Additional changes

Starting in 2011, individuals will see an increase in the penalty for distributions from HSAs and Archer MSAs that are not used for qualified medical expenses—up from 10% to 20% for HSAs, and up from 15% to 20% for MSAs. As for the maximum contribution to an FSA, that will be \$2,500, beginning in 2013. This amount will be indexed annually for inflation. Come 2011, individuals will also see the elimination of tax-favored reimbursement from these accounts for over-the-counter drugs that are not prescribed by a doctor.

¹¹ Note that a company’s contribution to HSAs could be subject to the excise tax.

¹² PwC’s Trendsetter Barometer survey incorporates the views of private-company CEOs and CFOs interviewed between May 7, 2010 and August 5, 2010.

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1 2009 Forbes America's Largest Private Companies List

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