The great tax offshoring debate (and how stakeholders can move beyond it)
The potential for debate

Once reserved largely for transactional support processes, offshoring\(^1\) is now climbing steadily up the value chain – but not always without challenges. Continuing economic pressures, along with greater confidence in the offshoring model and its enabling technologies, are prompting some leaders today to consider offshoring any activity that entails significant labor costs, even in areas some may still consider off-limits. One frequent focus of debate: Tax – specifically, U.S. federal and state income tax compliance and provision work. At first glance, the labor-intensive nature of this work\(^2\) appears to be a logical source of wage arbitrage-driven savings. Yet even at many companies that have embraced offshoring for other functions, the question of offshoring U.S. income tax\(^3\) remains controversial.

The lines of the debate are often drawn between a company’s CFO and its tax director – the main stakeholders charged with reaching a decision and moving the company forward. A CFO, interested in offshoring mainly to reduce costs, may see U.S. income tax as a natural next step in the company’s offshoring progression. He or she may assert that the hours U.S. tax personnel spend on compliance alone, let alone provision, would present an attractive wage arbitrage opportunity. A tax director, on the other hand, may counter that the relatively low tax headcount involved would limit the extent of the savings, especially compared with the savings the company could realize (or may already have realized) by offshoring larger groups. Moreover, the tax director may maintain that the highly technical, knowledge-based, and collaborative nature of the work makes offshoring U.S. income tax an unacceptable risk regardless of the savings potential.

To this, the CFO might respond that the risks should be evaluated in light of the many instances where companies have successfully offshored other complex business processes, such as budgeting and forecasting, legal services, and business intelligence, using virtual working technologies to support the necessary collaboration.

Luckily, in the matter of offshoring U.S. income tax, CFOs and tax directors have many more interests in common than their differences on offshoring might suggest. To begin a constructive dialogue, a CFO and tax director should clearly articulate their respective business objectives related to the tax offshoring effort, focusing on shared elements in the desired outcomes rather than on the specific approaches each believes should be employed. Equally important, the CFO and tax director should also seek a fact-based understanding of the potential benefits, challenges, and options in order to ground their discussions in information that is both accurate and mutually consistent. By thus establishing a basis for dialogue, a CFO and tax director can start the process of moving their company toward a more effective tax service delivery model ... whether or not it looks like the model either initially had in mind.

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\(^1\) This article uses the terms “offshore” and “offshoring” to refer to the movement of work to lower-labor-cost markets in order to pursue savings through wage arbitrage.

\(^2\) Although U.S. income tax compliance and provision make up only part of a multinational company’s tax responsibilities, they often drive a disproportionate share of the tax department’s workload, leading many companies to focus their initial discussions about offshoring tax on these areas. Accordingly, this article discusses offshoring specifically with respect to U.S. income tax compliance and provision. Future publications will explore issues related to offshoring other U.S. and global tax work (e.g., U.S. indirect tax, value-added tax, transfer pricing, etc.).

\(^3\) For convenience, we will refer to U.S. income tax compliance and provision work simply as “U.S. income tax” in the rest of this article.
Business leaders throughout any organization share a fundamental interest in pursuing enterprise value. Beyond this, CFOs and tax directors also share a finance-centric perspective that tends to further align their general views on what enterprise value entails (if not always on how to pursue it). As stewards of the company, both are interested in improving operational efficiency, enhancing organizational effectiveness, and managing compliance risk. Likewise, both are interested in pursuing long-term value as well as immediate gains. And both understand the probable need for compromise in order to balance various priorities.

Furthermore, CFOs and tax directors may find that they are surprisingly well aligned, not just in their views on what goals should be pursued, but also on what issues might stand in the way. In particular, most CFOs and tax directors are well aware of the extent to which burgeoning U.S. compliance obligations are overloading many tax departments — at the same time that budget constraints, hiring freezes, and shrinking talent pools are making it difficult to hire additional U.S. personnel. This combination of factors can drive a disproportionate amount of cost and risk, including risks associated with errors in execution, operational costs of paying U.S. tax professionals’ salaries, and potential opportunity costs driven by lack of time and resources for tax planning.
Broadening the scope of inquiry

While recognizing common interests can help jump-start dialogue between a CFO and tax director, exploring the reasons behind their divergent positions on offshoring – and the assumptions that may underlie those reasons – can help them work toward resolution. Often, a deeper dive into the drivers of each party’s position may reveal that at least some of their differences are based less on “reality” than on their perceptions of the issue.

To ground their discussions in a shared fact base, the CFO and tax director should not only strive to learn what the other “knows,” but also broaden the scope of their inquiry to consider matters that neither may initially consider relevant or be aware of. In particular, a fresh look at two areas – the kind of work to be offshored and the offshore operating model itself – may help CFOs and tax directors avoid making assumptions that can needlessly restrict the range of acceptable alternatives.
Pre-tax data preparation: A sampling of activities

Tax professionals typically perform many activities in the course of income tax preparation that are driven from financial accounting data and processes. Given appropriate design and supervision, many of these “non-core” tasks could be executed by general accounting resources. Examples of such activities include:

- Producing detailed legal-entity profit and loss statements and balance sheet reports
- Reconciling intercompany transactions at the legal-entity level at an appropriate level of detail
- Capturing data used to support research and development credit and transactions
- Capturing data used to support transfer pricing
- Supporting allocations and “top-down” adjustments
- Performing fixed asset tax depreciation calculations and reports
- Supporting other common U.S. book-to-tax adjustments (e.g., meals and entertainment, business gifts, contributions)
- Tracking tax-sensitive balance-sheet reserve items
- Developing state/city income tax apportionment factors (sales/property/payroll by legal entity jurisdiction)

Our experience shows that reducing such activities to 25 percent or less of a tax department’s workload often enables an increase in tax capacity. Any excess capacity can then be applied toward a variety of goals, such as improving tax-related risk management, redeploying tax personnel to more strategic activities, and/or reducing total tax department costs.

For accounting work, go to an accountant

Can a company use offshoring to reduce tax function costs and/or increase the tax department’s focus on tax planning — without using any offshore tax personnel? The likely answer is yes. The reason: At many companies, it takes as much effort to obtain, reconcile, and prepare the legal entity-specific financial information needed to prepare tax returns as it does to complete the actual returns. Because the tax department is the only group that needs the information at that level of granularity, it often falls to a company’s tax professionals to find and/or produce that information themselves. In fact, several studies suggest that the time tax professionals spend collecting, manipulating, and reconciling financial accounting and management data can easily account for half of a tax department’s total budget. Yet many might view this kind of work as more suitable for accounting than for tax. And accounting work is something that many companies have already partly or fully offshored, whether to an internal captive or an offshore external provider.

In light of this circumstance, a company may be able to substantially reduce the tax function’s operating costs and/or increase its strategic focus simply by having its offshore finance capability take over the preliminary data collection and entity-specific financial accounting work that its U.S. tax professionals have historically performed. The opportunity can be especially compelling for companies where such “pre-tax data preparation” clearly represents a substantial portion of the U.S. tax department’s workload, where leaders have concerns about the potential risk associated with offshoring work that requires knowledge of U.S. tax law, or where the company’s financial information is itself managed offshore. In the last case, moving pre-tax data preparation closer to the offshore repository of financial information might not only help reduce the tax department’s workload, but also help improve the accuracy and timeliness of the data collected.

Nor does the entire potential benefit necessarily accrue to the tax department. Making finance responsible for pre-tax data preparation may help speed the financial close process by giving finance professionals a head start on finding and organizing the data required for quarterly and year-end tax provision preparation. It may also help drive organizations toward a single source of financial information, which can help manage tax-related financial reporting risk.

Regardless of what they decide to do with pre-tax data preparation work, a CFO and tax director may still need to resolve the issue of whether to offshore U.S. income tax work itself. Here, the crucial difference between them often lies in the CFO’s more optimistic view of the chances of “success.” That’s where a tax director’s practical experience in the field can be a great asset in helping to establish realistic expectations. The most likely concern? Talent.

**Teaching U.S. tax from the ground up**

Tax directors are well placed to appreciate how much the complexity of tax work and the frequent challenges in execution can amplify the difficulties of managing talent in an offshore captive. The need for professionals experienced in U.S. tax law, coupled with a limited pool of qualified offshore talent with U.S. tax law knowledge, means that a company would either need to teach its offshore personnel U.S. tax law from scratch or attempt to hire experienced U.S. tax professionals from another company in the same location – assuming any exist. Each approach would take significant time, and the cost could offset a portion of the savings from wage arbitrage.

In fact, developing U.S. tax competence among offshore personnel may be difficult regardless of the time and money a company is prepared to spend. Outside the U.S. itself, U.S. tax training programs are virtually nonexistent (except for those offered by professional services firms, mainly to their own employees). This raises the question of exactly who would deliver U.S. tax training to a company’s offshore staff. Moreover, the traditional “apprenticeship” model for developing tax skills, which supplements classroom training with on-the-job mentoring by more senior professionals, would be challenging for an offshore tax organization to maintain. Compared with their finance, information technology (IT), or human resources (HR) captives, most companies would need only a handful of offshore professionals to handle U.S. income tax, and such a small group would likely have little extra time or senior-level talent to spend on junior staff. Remote supervision by U.S. staff, while technically feasible, is often less effective than on-site tutoring. Sending senior U.S. tax professionals to the offshore facility – provided the U.S. tax department is able to do so – might be one way to give offshore tax resources an apprenticeship experience, but the resulting expatriate management expenses would represent a substantial cost.

Then there’s attrition, which may have a bigger impact on an offshore tax captive than on most offshore finance, IT, and HR captives. A larger group, all other things being equal, can absorb a given attrition rate more easily than a smaller one – and while many finance, IT, and HR captives employ hundreds of people, a captive tax group would probably be substantially smaller. In addition, the immaturity of the marketplace for offshore U.S. tax services may make the field less attractive as a long-term career choice than functions with more plentiful job opportunities. Tax personnel deployed to deadline-driven work, including U.S. income tax filings, may experience high-pressure crunch periods alternating with slower seasons, which could contribute to job dissatisfaction and related turnover. And for all but very large companies, the probable small size of a captive tax group may limit the potential for staff to advance into supervisory positions – a critical element in retaining highly talented professionals.

These considerations, a tax director might say, are very likely more than enough to sink the business case for offshoring U.S. income tax. Outside the U.S.’ large market for U.S. tax professionals, and without its extensive formal and informal educational infrastructure for U.S. tax training, a company may find it next to impossible to find, develop, and retain the people it would need for an effective offshore tax group.

Or would it?

**The value of scale**

If managing offshore U.S. tax talent can create such problems, how can professional services firms, including the one authoring this article, maintain the offshore U.S. tax capabilities that they are known to possess? In a word, the answer is scale.

Scale, on the order of some 50-plus people, may arguably be the single most important factor in the ability to effectively manage offshore tax talent. A larger team, for instance, can more easily find the capacity to mentor junior staff than a smaller one. With a deeper “bench” of professionals to absorb work until replacements are found and trained, a larger group would be less susceptible to disruption through attrition. Further, a larger group could support more supervisory roles, which would increase the number of upward career paths available to employees. From a return-on-investment perspective, scale may reduce...
per-capita training and management costs, including those related to expatriate assignments and visits in both directions.

In principle, the potential advantages of scale could be available to any company with enough U.S. income tax work to support a critical mass of offshore tax professionals. Such a company might well consider an offshore tax captive to be a viable option, especially if it has already experienced positive results with captives in other functions and can apply the lessons learned to building its offshore tax capability.

That said, many companies may not have enough U.S. income tax work to support 50-plus full-time professionals. Does this mean that they should abandon the idea of offshoring U.S. income tax? Not necessarily. It just means that they may need to further explore the available options.

From captive to outsourced and everything in between
The unspoken assumption underlying many of the above-mentioned talent concerns is that an offshore U.S. income tax capability would necessarily be set up as an internal captive organization. This assumption may be so ingrained, in fact, that the suggestion of hiring an offshore external service provider may not even arise. Yet the possibility of offshoring U.S. tax by outsourcing it to an offshore provider opens up a vast range of options that can change the entire tenor of the discussion.

Arrangements with tax service providers fall into two general categories: the contract personnel model (also known as “loan staffing” or “resource augmentation”), and outsourcing (often termed “cosourcing”). Table 1 gives a side-by-side summary of the key characteristics of each.

The contract personnel model, in which the provider’s professionals work under corporate tax’s direct supervision, essentially allows a tax department to retain additional professionals on an as-needed basis. The company has the same level of control over and visibility into the activities of the provider’s professionals as it does with its own employees. The provider’s professionals, for all intents and purposes, are part of the company’s tax department for the duration of the contract.

An outsourcing arrangement, in contrast, is characterized by the service provider’s assumption of responsibility for the work done by its professionals, over whom the company’s tax department exercises a correspondingly lower level of control and supervision. Unlike the contract personnel model, outsourcing relationships can offer a great deal of flexibility to accommodate a wide variety of operational and contractual needs. For instance, corporate tax personnel may review some, most, or all work done by the provider; the provider may prepare all of the company’s tax returns or only a select few; and, of more relevance to offshoring, provider staff may work at the company’s offices, at the provider’s own facilities, or both.

Both of these external service delivery models may allow U.S. income tax to be performed offshore at less cost than a U.S.-based operating model, even factoring in a provider’s margin in addition to offshore labor rates. In effect, the cost of the margin gives companies access to an offshore tax talent pool without the need to manage and maintain that talent themselves, as well as the potential benefits of gaining access to the provider’s tax knowledge base. When comparing the offshore operating models – captive, contract personnel, and outsourcing – it is important to take a realistic view of the probable expenses of recruiting, training, supervising, and retaining appropriately skilled tax professionals in an offshore captive. Careful financial modeling can help leaders understand the magnitude and timing of each alternative’s expected return on investment.
<table>
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<tr>
<th>In-house service delivery</th>
<th>Contract personnel (&quot;loan staffing,&quot; &quot;resource augmentation&quot;)</th>
<th>Outsourcing (&quot;cosourcing&quot;)</th>
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| **Characteristics**      | • Work is performed by the company's own employees  
                           • Company takes full responsibility for filings |
|                          | • Provider professionals work under corporate tax’s direct supervision  
                           • Provider personnel are typically used to fill a specific staffing need on a temporary basis  
                           • Company has complete control and visibility over the preparation process  
                           • The company takes full responsibility for all filings  
                           • Provider personnel do not sign returns |
|                          | • Provider professionals work under varying levels of corporate tax supervision  
                           • Company has varying levels of control and visibility over the preparation process, as specified in agreed-upon statements of work and service-level agreements  
                           • Each party takes responsibility for work performed by its professionals  
                           • Provider is typically considered a paid preparer with respect to its work product  
                           • Provider personnel often sign returns as a paid preparer to represent the provider  
                           • Contracts are typically longer-term than in most contract personnel agreements |

| **Considerations**       | • Company retains full control over process and outcomes  
                           • Greater potential for long-term savings than external service delivery models (due to the absence of provider margin cost)  
                           • Typically requires greater initial investment and longer time to return on investment (ROI) than external service delivery arrangements  
                           • Talent-related costs may erode wage arbitrage savings  
                           • Requires a significant amount of support from the U.S. tax department |
|                          | • Company gains access to resources while retaining full control over process and outcomes  
                           • Generally costs less than many outsourcing arrangements  
                           • Company must provide supervisory professionals  
                           • Provider personnel typically must remain offshore to drive the desired savings, requiring proficiency in virtual work practices and/or the presence of corporate supervisors in the offshore location  
                           • If used only during busy seasons, a provider may be unable to guarantee year-to-year continuity of personnel  
                           • Limited availability of service providers with capable offshore resources that offer a contract personnel model |
|                          | • Company can choose its level of control over process  
                           • Company gains access to provider’s tax knowledge base  
                           • Requires less corporate tax supervision than a captive or contract personnel model |

| **Under what circumstances might this option be appropriate?** | • Leaders are not comfortable with outsourcing tax  
                                                               • Company has an extremely large volume of U.S. income tax work (enough for approximately 50 or more full-time employees)  
                                                               • Company has extensive experience in managing offshore captive operations  
                                                               • Leaders are willing to accept a relatively large up-front investment as well as a relatively long time to ROI |
|                                                               | • Company needs to quickly increase capacity for a non-recurring project  
                                                               • Company has operation(s) in the preferred offshore location that can accommodate U.S. tax professionals to provide on-site supervision  
                                                               • The company and the provider are both highly proficient in remote collaboration  
                                                               • Company has few in-house tax resources to supervise offshore staff  
                                                               • Company looking for a smaller initial investment and/or a shorter time to ROI than would be feasible with a captive  
                                                               • Company lacks the volume of U.S. income tax work to support approximately 50 full-time offshore tax professionals  
                                                               • Company plans to outsource as an interim approach while developing a captive tax capability |
Leading practices in offshoring U.S. tax

Across the board:

• **Proceed only if key stakeholders are supportive and engaged.** In theory, a CFO may have the authority to offshore U.S. tax over a tax director’s objections. In practice, an offshoring effort is far more likely to deliver the desired results if the key stakeholder(s), in this case the tax director, actively lead and support it. It’s important to encourage people to keep an open mind about the desirability and feasibility of offshoring U.S. tax relative to the status quo.

• **Standardize processes.** The greater the variation in a company’s tax-related processes, the more difficult it is for tax professionals to master them. Accordingly, standardizing processes may help control training costs, improve accuracy, and decrease turnaround time, as well as diminish the need for offshore tax personnel to seek clarification from U.S. tax professionals.

• **Document, document, document.** Like process standardization, effective documentation of tax processes, requirements, and other vital information can help offshore tax professionals work more independently of U.S. guidance. By reducing the need for queries on non-substantive issues, effective documentation can speed execution, improve consistency, and potentially increase the scope of work that the company feels comfortable sending offshore.

• **Start with the basics.** Even with effective documentation, the residual challenges of working remotely can make it difficult to properly execute tax procedures that require involvement from both the U.S. and offshore entities. In addition, particularly with a captive model, offshore tax personnel may be relatively new to the field and therefore less prepared for complex tax work than the (typically more experienced) tax professionals in the U.S.

• **Measure results and periodically reevaluate the effort.** A company should define and track metrics for offshore tax performance and regularly compare actual with desired results to help determine the offshoring effort’s future direction. Changes in the internal and external business environment may call for changes to the offshore operating model, ranging from simply moving more processes offshore, to outsourcing work previously done by a captive, to bringing U.S. income tax back to the U.S. entirely.

If establishing a captive:

• **Foster a culture of collaboration.** A tax department that views its offshore arm as an integral part of the team, and whose U.S. and captive professionals are committed to helping each other get the job done, is more likely to experience positive results than one that does not. Mechanisms such as site visits and joint projects can help build a collaborative culture by promoting cross-cultural understanding and enabling personal connections.

• **Run processes in parallel until comfortable with the captive’s competence.** Performing the same work in the U.S. and at a captive may add to startup costs, but it may also be a valuable investment in risk management.

• **Drive continuous improvement.** As with any service organization, an ongoing effort to simplify, standardize, automate, and improve a tax captive’s processes can increase both its efficiency and its effectiveness. A strong control framework around the captive’s activities is essential, as are training and education for its personnel.

If using an external service provider:

• **Follow good outsourcing practices.** The standard “leading practices” for outsourcing other functional processes apply to tax as well. These include establishing and monitoring key performance indicators (KPIs), requesting regular status reports, defining service levels and crafting a strong service-level agreement, developing effective governance mechanisms such as issue notification and escalation procedures, and so on.

• **Customize the service delivery relationship to fit your needs.** Some companies want their tax service provider to offer in-depth tax advice; others, perhaps with stronger in-house tax planning capabilities, want their provider to concentrate on compliance. Companies should clearly define their service preferences and needs, and they should look for a provider that is willing and able to work with leadership to deliver the desired fit.

• **Remember that process improvement cuts both ways.** Many outsourcing clients reason that process improvements should drive cost reductions that the provider should pass along to the company. However, with outsourced tax processes, the company may bear a greater part of the responsibility for improvement than may be the case for other outsourced functions. Pre-tax data collection and preparation, for instance, may be a clear opportunity for improvement where the bulk of the work must be done by the client.
A collaborative journey to a more effective model

In the matter of offshoring U.S. income tax, the differences between many CFOs and tax directors are usually much more perceived than real. We encourage CFOs and tax directors to begin the conversation, not by debating the pros and cons of offshoring, but by identifying the business outcomes they want to achieve. Having identified their goals, they can then work hand in hand to learn more about the issues, understand each other’s perspectives, and – ultimately – select and pursue a course of action that both believe can benefit the organization. In this way, they can transform the debate about offshoring U.S. income tax into a dialogue about getting the work done at a sustainable cost. And that’s a goal that everyone can agree on.
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