Supply chain planning in the post-BEPS era: five questions for MNEs

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As governments around the world have established austerity measures to compensate for decreases in tax receipts, a new catch-phrase has emerged: double non-taxation.

Double non-taxation is the phrase used by governments to denote untaxed or lightly tax profits that result from effective, legal tax planning techniques. These techniques include application of well-established transfer pricing strategies, such as structuring certain functions, risks, and assets (including intangible assets) within a multinational enterprise (MNE) in tax-favored locations.

Transfer pricing issues have become a significant political issue as the G-20 nations focus on ways to combat double non-taxation. For instance, double non-taxation has increasingly been the subject of political agitation by non-governmental organizations (NGOs), resulting in reputational risk for MNEs that are the target of NGO actions, such as the Lux Leaks. In addition, the United States and other countries are demanding greater “transparency” in taxpayer disclosures.

Double non-taxation is the principal focus of a game-changing project at the Organization for Economic Cooperation and Development (OECD), referred to as Base Erosion and Profit Shifting (BEPS). At the heart of the BEPS project are efforts to align profits from controlled transactions with “commercial reality” and economic substance- concepts that appear sound, but that are ultimately in the eye of the beholder. The BEPS project has resulted in a crescendo of action item papers recommending changes to existing international norms, model tax treaty provisions, or domestic tax rules. Transfer pricing issues that are at the heart of BEPS project include revisions to the rules regarding risk shifting within an MNE group, limitations on intercompany payments for interest, insurance or royalties, and revisions to the treatment of intangibles. The OECD BEPS project encompasses efforts to revise the rules for defining and valuing intangibles and for redefining the concept of a permanent establishment, especially with regard to companies engaged in digital commerce.

BEPS IN THE CURRENT TAX ENVIRONMENT

The year 2016 is shaping up to be a watershed for bringing the multi-year BEPS efforts closer to fruition. In late 2015, the finance ministers of the G-20 reiterated their commitment to implementing key BEPS action items during 2016. In the offing are the following BEPS-related actions that will affect transfer-pricing based international tax planning:

- Enacting legislation or otherwise implementing country-by-country (CbC) reporting and establishment of procedures for automatic exchange of CbC templates among tax treaty or tax information exchange agreement partners. The first automatic exchanges are planned to take place in 2017 based on reporting by multinational companies for tax year 2016.

  - CbC reporting will enable countries to pinpoint double non-taxed or lightly taxed income reported in jurisdictions with few employees or low local brick and mortar investment.
  - Because changes to US rules are not proposed to be effective before tax years beginning in 2017, US based companies will need to decide where to file “surrogate parent” CbC schedules.

- Implementation of revised rules for evaluating returns to contractual assumption of risks related to developing intangible property, as well as rules for re-characterizing transactions that are based solely upon contractual assumptions of risks.
- Finalization of a multilateral instrument (treaty protocol) that will potentially amend hundreds of existing OECD-based treaties. Amended treaty provisions would impose limitation of benefits provisions, place restrictions on the deductibility of interest in one jurisdiction that does not result in an income inclusion in the payee jurisdiction, and adopt changes to long-standing Permanent Establishment rules.

One general theme of the changes being considered is that taxable (or non-taxable) profits should follow economic substance. In the case of risks, emphasis will be placed upon the actual management of the functions that give rise to the reward that is inherent in the risk being assumed. Current OECD BEPS proposals emphasize that a rigorous functional analysis should be undertaken to justify returns to a controlled transaction and that the returns being allocated should reflect commercial reality. In an environment that abounds with “nattering nabobs of negativism,” is tax planning possible to justify profits in tax-favored jurisdictions ?

POST-BEPS TAX PLANNING AND TAX-EFFICIENT SUPPLY CHAINS

After BEPS actions are incorporated into OECD documents and local legislation, tax planning opportunities will still exist, but realizing the benefits of tax planning will require a greater emphasis on economic substance supporting the profit generated around the world.

One often overlooked area of opportunity is tax-efficient supply chain planning. For many companies, particularly in the consumer products industry, an efficient supply chain is a critical value driver. The efficient management of a company’s supply chain allows it to bring to market innovative products of the right quality, at the right price, and at the right time. Failure to efficiently manage a supply chain can have drastic implications.

In the apparel and footwear industries, for instance, the inability to meet a production schedule can lead to a brand missing a fashion season. It has been well documented that inefficient management of a supply chain can even lead to the collapse of a brand. Conversely, an efficient supply chain enables the brand owner to market products in a timely manner, to increase number of product launches and offerings, to enhance the value of a brand through consistently high quality, to reduce costs, to better manage inventory levels, and to foster innovation. Efficient supply chains allow a company to react to consumers in a more agile way. In fact, fast-fashion brands such as H&M and Forever 21 have supply chains that enable them to bring trends to store shelves with unprecedented speed and efficiency, thereby driving less agile companies into bankruptcy or leading to sales declines for competitors.

Efficient supply chain management as a key value driver is not limited to fashion or similar consumer goods companies. For example, while technology companies are justly proud of having leading-edge, technology-driven products, their technological innovations need to be incorporated into products that are produced efficiently, at the right time, and at the right price. The world’s best leading-edge technology does not generate profits for the intangible property owner until that technology is incorporated into a product that is made, delivered, and sold to the consumer. In short, turning leading-edge IP into globally realized profits requires a well-managed supply chain.

TAX PLANNING OPPORTUNITIES

In the past, many consumer products companies have engaged in tax planning involving their supply chains. Typical, tax planning involved an intermediary entity located in a tax-efficient jurisdiction earning profit associated with supply chain transactions. In many cases, these entities lack sufficient economic substance to withstand scrutiny from a BEPS-type inquiry. With the implementation of BEPS-type provisions, these structures are no longer viable.

Opportunities exist, however, for companies to structure or restructure their supply chains in a tax-efficient manner. The fact remains that for most companies, a well-managed supply chain is a significant value driver. Particularly in the consumer products industry, companies have generally employed companies ("buying agents") located close to the factory base producing the company's products. Historically, these agents were predominantly located in Hong Kong, close to production sites in China. However, as Chinese labor rates rise and companies increasingly look to other countries for sourcing, opportunities exist to restructure the supply chain in order to centralize management of the production functions and enable efficient expansion of the supply base.

Because production involves company employees performing labor-intensive activities, supply chain management through buying agents contains the economic substance necessary to support tax planning in a post-BEPS era. Buying agents generally earn a commission as compensation for the services that they provide. The industry practice is that buying agent commissions are expressed as a percentage of the free-on-board (FOB) price of goods sourced through the buying agent. A buying agent's commission rate depends on a number of factors, including the variety of goods that the agent handles, the complexity of the manufacturing process, the functions provided by the agent, and the size of the territory that the agent covers.

Based on extensive industry experience, there is a direct relationship between the number, type, and intensity of functions performed by buying agents and the commission rates they earn, with agents that perform more specialized, high value-added functions earning higher commission rates.

According to US Customs, there are standard activities that buying agents characteristically engage in when acting as an intermediary between manufacturers and principals. These activities include (but are not limited to):

- Compiling market information
- Gathering samples
- Translating
- Informing the seller of the desires of the buyer
- Locating suppliers
- Placing orders based on the buyer's instructions
- Procuring the merchandise
- Assisting in factory negotiation
- Inspecting and packing merchandise and
- Arranging for shipment and payment.

As compensation for providing these standard buying agent activities, agents generally earn average arm's-length buying agent commission rates in the range of 5 percent to 10 percent. In some cases, there is either a separate commission paid, or a higher total commission rate charged, for additional services performed by a buying agent that are beyond the scope of services typically provided by a buying agent.

High-value-added services justifying higher or additional commissions include the following:

- Product design and pre-production engineering services
- Artwork
- Additional quality control procedures and
- Certain product testing.

Because of income sourcing rules that exist in many jurisdictions, high value-added services can be performed in a tax efficient manner using arm's-length transactions to support the fees charged. These types of transactions are not the type for which the BEPS proposals are designed. Rather, these types of transactions reflect the economic substance-based tax planning that should be acceptable in a post-BEPS environment.

WHAT CAN COMPANIES DO NOW? FIVE QUESTIONS

The authors recommend that companies review certain aspects of their supply chain, including the following:

1. Where are products sourced currently, and what are the plans for expansion of the supply base?
2. Are products sourced through company-owned facilities or unrelated manufacturers?

3. Which company employees are involved in performing supply chain activities close to the manufacturing source base, and where are these employees located?
4. Which headquarters employees are involved in performing supply chain activities?
5. Are internal or external buying agents utilized to assist with the sourcing of products?

This information can help determine whether opportunities exist to structure or restructure a the supply chain in a tax-efficient manner.

Learn more by contacting the authors.

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