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Supply Chain Planning through the tax lens

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Introduction

In the year 2010 the global volume of goods traded amounted to 15,238 bn USD. The increase over 2009 was round 21%. For long years, Germany has been the largest exporter, but has been surpassed by China and is now the third largest exporting country. The strong increase in trade volumes is partly due to the segmentation of business processes into sub-processes and the decentralisation of business functions. The term 'supply chain' refers to the entire system of activities, people and resources involved in the creation, manufacturing, logistics, marketing and ultimate sale of a product or service. The multitude of sales and services is generated by different companies from different countries under different tax and regulatory systems.

There is a combination of trends that heavily impact supply chain planning and make it increasingly relevant also for tax management. Obviously, one key driver is the continuing growth in high-duty countries (e.g. BRIC and most of Asia). With the financial problems in the western countries, these developing economies will be even more in focus in the coming years and not only for sourcing, but also for distribution. Another trend is the globalisation of manufacturing networks. And there is on the one side a continuing growth of Free Trade Agreements while at the same time particularly western countries step up protectionist measures and compliance requirements.

In an ongoing drive to improve the bottom line, and in pace with global trends, companies in Asia are seeking opportunities to transform and integrate their supply chains in order to better leverage resources and achieve efficiency gains, cost reduction and revenue growth. In addition to the potentially very significant cost savings and revenue growth that can be enjoyed from restructuring of the supply chain, and which should always be the driver of any decision to restructure, any cost benefit analysis is heavily impacted by various direct and indirect tax considerations.

Why transform the supply chain?

Any supply chain restructuring requires a holistic and detailed review of the existing business model to identify the entire spectrum of activities, the value added by each and where the potential problems (opportunities) lie. For example, is it too expensive to continue manufacturing in Germany? Are there delays in getting products to market due to lack of control over inventory? Are support services such as IT being inefficiently duplicated in various locations?
Generally, the locations for manufacturing and distribution are pre-determined by operations and the markets. However, there are business functions, that are basically flexible and can be detached from the manufacturing or distribution locations.
With these types of questions in mind, potential aspects of a transformation could include:

Manufacturing Locations

- Low risk manufacturing in relatively low cost countries such as China, Indonesia, Malaysia, Thailand etc. This can involve a consolidation of existing smaller manufacturing facilities
- Are there business functions in a low cost country, which can be (easily) moved to a location that provides for example better qualified staff, lower taxes and less tax complexity/risk?

Distribution Locations

- Converting local distributors to commission agents, commissionaires or 'low risk distributors' in order to better manage inventory and potentially get products to customers in a more timely manner

Flexible functions

- Using a regional principal/headquarters in Hong Kong. This must not be a 'shell' company but one with genuine commercial substance driving the business, include senior decision makers on strategy, marketing or R&D. It can include centralised logistics, warehousing etc to the extent this is well positioned in locations of suppliers and customers in the region
- Utilising shared service centres to centralise back office functions such as IT, HR, marketing, treasury, accounting and any other activity that can be meaningfully centralised without the need for a significant local presence in each jurisdiction

The bottom line

Besides the expected reductions in the cost of doing business and potential competitive advantages that a restructure can provide, the direct and indirect tax costs and opportunities need to be managed carefully as they can provide a further impetus to the transformation, or alternatively render it unworkable. These must be considered in phase 1 of any supply chain planning project:

- **Customs duty** – Asia is estimated to be the region where the highest amount of customs duties are collected. Customs planning is therefore crucial in this part of the world.

- **Exit charges** – For German companies it is particularly difficult to from a tax angle to move functions from Germany to foreign locations, since the very restrictive exit taxation regulations have been introduced. Here, precise tax planning is required in order to avoid inverse consequences and a heavy tax bill in Germany.

- **Tax arbitrage/transfer pricing** – any decision to restructure must give careful consideration to the corporate tax and transfer pricing implications. Locations in Asia such as Hong Kong and Singapore, with 16.5% and 17% basic corporate income tax rates (and with access to lower rates under different regimes) respectively, are generally selected as the regional headquarters location for an MNC in Asia. However, it should be stressed that these locations are selected on their own merits for their excellent infrastructure, educated workforce and ease of doing business. The low tax rate is of course important, but should not be seen as the key driver of these decisions.

  Utilising a low tax regime such as that available in Hong Kong /Singapore for the regional entrepreneur and using low risk manufacturing plants in countries such as China, Indonesia and Malaysia where production costs are lower, can enable the group to earn a low but consistent profit in the manufacturing country and retain residual profits in Hong Kong or Singapore. At the same time, increasing the exposure to a larger number of countries also requires more effective compliance management systems to be in place.

- **Indirect tax** – Taxes such as VAT (leakage of up to 17% in China) can easily overshadow the customs duty and tax arbitrage impact on the P&L. And while VAT often is neutral (i.e. no tax cost, but always administrative burden as it is a high compliance tax) for transactions within the group, for example Business Tax on services provided to a Chinese group company is always a cost. Needless to say, they need to be addressed up front in the modelling process before a decision on the optimal model is made.

Altogether, while operations need to be the basic driver for a supply chain transformation, there are risks and opportunities that need to be managed from a regulatory side. Firstly, coming from a European – or German – background, more often than not transfer pricing is considered the priority planning tool in the tax field. In Asia, however, customs duties in many cases have the bigger impact. Customs duties and transfer pricing impacts are generally opposite sides of the same coin which has to be understood when trying to duplicate business models that may work well in Europe or other parts of the world, but may not work in Asia.
The difficulty in managing such processes is the often different responsibilities for customs duties and taxes. While customs duties impact EBIT (Earnings Before Interest and Taxes), income taxes and VAT only impact the bottom line result. Thus, customs cost may well be important for the regional operations teams, whereas tax cost is not. It is therefore necessary to take an integrated view on both customs and taxes when analysing the potential of customs and tax planning in the supply chain.

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