

INTEGRATED GLOBAL STRUCTURING

Global and regional markets, new business models, ever-changing operating and regulatory environments, competition, impact of culture, pace of change and influence of new information technology have made the efficient management of businesses on a global and regional scale more complex than ever. This is particularly true with respect to Asia where business growth has outpaced the rest of the world in recent years.

As a result, tax planning and compliance for multinational companies (MNCs) in the Asia region has become more complex. The best-in-class MNCs recognise that to manage these complexities, and to achieve and sustain a lower global and regional effective tax rate (ETR), they need global and regional tax strategies that are aligned with corporate strategy, planning and operations. Such strategies create opportunities for both financial efficiencies and long-term tax savings. Conversely, a lack of adequate planning can result in missed opportunities and can create unnecessary and potentially significant tax risks and costs. This is most evident where an inefficient structure is required to be undone and replaced.

This article explains some of the significant elements of an effective global and regional tax strategy and analyses the financial and tax drivers impacting an MNC's ability to achieve a sustainable reduction in their ETR.

Global and Regional Trends: Doing Business and Tax Planning in the 21st Century

Changes in a company's business or operating model and new business initiatives such as geographic expansion, cost reduction, changes in products and services or supply chains can result in changes to existing (or the creation of new) value chains, transaction flows, cash flows, contractual rights and distribution patterns. Senior executives and tax planners must recognise that such changes create both tax opportunities and risks.

On top of these business changes, MNCs face unprecedented challenges in their global and regional tax environment. Many Asian countries are lowering their tax rates (more recently Hong Kong and Singapore) to attract business capital.

MNCs are actively streamlining their operational structures and business models by managing central functions and risks on a global and regional basis, revising their geographic footprint and re-aligning their operations to both their core competencies and expectations for growth.

For an organisation to optimise the benefits it realises from its global and regional business strategies, it must also address its many tax challenges in an integrated manner.

Effective Tax Planning and Shareholder Value

A key determinant of shareholder value is earnings per share (EPS). An important element of EPS, or the bottom line, is a group's ETR. Any increase in earnings resulting from organic growth, acquisitions or other corporate initiatives is diluted by a group's ETR and therefore has a direct impact on shareholder value.

In order to have a long-term, positive impact on EPS, tax savings should be sustainable. The best-in class MNCs do not rely purely on one-off or ad hoc tax planning ideas that tend to be more tactical than strategic. Such strategies may not be integrated with the business and generally may not sustain the ETR impact. Instead, these groups take steps to lower their ETR through a comprehensive and integrated approach to global and regional tax strategies and planning that is aligned with the business strategy and operations. This approach tends to increase the likelihood that tax savings are both significant and sustainable.

Benchmarking Global Tax Efficiency

An important first step in devising an integrated tax structure is to make an assessment of the MNC's ETR relative to its peers, or similar companies, and evaluate the factors driving the enterprise's profit and related tax burden. In other words, it is important to understand the MNC's profit and tax drivers and whether (and why) the enterprise compares favourably or unfavourably to similar companies.

Benchmarking of tax efficiency is the best way to determine whether tax expense can or should be reduced. This analysis involves determining the appropriate benchmark(s) and the right groups to benchmark against. The appropriate benchmarks are typically ETR and cash tax rate. However, certain adjustments to ETR may be required to account for non-recurring or abnormal items and to improve the reliability of the analysis. Further, benchmark groups may or may not be competitors or be within the MNC's same industry. A careful determination of the peer group is essential. While in practice, this exercise may not yield precise results, it should provide an MNC with valuable insight as to whether or not it is directionally well-positioned.

Both effective tax planning and effective benchmarking require an understanding of the group's profit drivers and identifying and ranking the corresponding tax-rate drivers. A tax rate driver can be defined as any major financial or operational influence on a group's ETR. Tax rate drivers can be either positive or negative, i.e., those that reduce the tax rate (positive drivers) or those that increase it (negative drivers).

While specific goals will vary among groups, MNCs should focus on tax planning techniques which impact the significant profit and tax rate drivers. Profit and tax rate drivers generally fall into two categories: financial drivers and functional drivers.

Financial profit drivers relate to financial risk. Financial profits represent the return on capital investments, intangible assets, and external and internal business risks (such as the return on inventory risk, accounts receivable risk, warranty risk, product liability and foreign-exchange risk) as well as the return from internal deployment of capital and other income-producing assets (e.g., intangibles). Negative tax rate drivers common to this category include intangible profits in high tax jurisdictions and capital deployed in high tax jurisdictions. These negative drivers may be exacerbated by inefficient transfer pricing policies. Conversely, the migration of inventory and other risks (along with the related operational "substance") to a low-taxed principal company is a positive tax rate driver that can result in a sustained reduction in ETR.

Functional profit drivers relate to the critical business functions of the company and where those functions take place. Functional profits accrue from the core business functions of the company such as manufacturing, distribution, marketing, sales, services and research and development (R&D). The location where such functions are performed and the level of risk borne (e.g., market risk and economic risk) can have a significant impact on where profits arise and thus on ETR. For example, the presence of core functions and the related risk in high tax jurisdictions is a negative tax rate driver. Conversely, migrating core business functions (e.g., business unit/regional directors, procurement, production planning, inventory management, logistics, and marketing) and the risk associated with such functions to low tax jurisdictions (Hong Kong or Singapore) can result in a sustained reduction in ETR, provided the migration of income is supported by operational substance and arm's length transfer pricing principles.

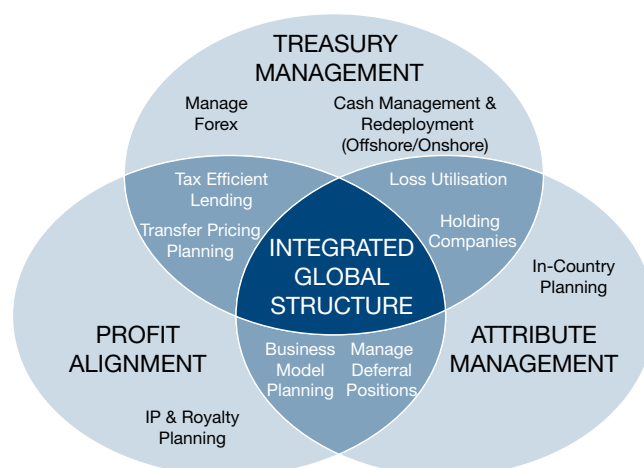
An Integrated Structure

Developing tax strategies that produce long-term results requires a deliberate, broad and quantitative process that incorporates elements beyond taxes. Such strategies should support the group's strategic vision and goals, blend tax strategy with corporate strategy and structure, and should be consistent with the group's objectives across other functional areas (e.g., treasury policy and objectives).

Developing and implementing a comprehensive tax structure involves multiple steps: studying the global and regional profit and tax rate drivers, setting goals, identifying strategies and planning techniques, weighing and choosing alternatives, implementing the plan and periodically reviewing the plan's performance.

While there can be many discrete tax planning strategies making up an integrated global strategy, they can be grouped into three fundamental areas: profit alignment, attribute management and treasury management. Profit alignment covers planning for the impact of where the business profits of the MNC initially arise and are taxed. Attribute management involves examining the opportunities available given the particular characteristics of an MNC and the tax systems of the countries in which it operates. Treasury management addresses all issues arising from situations in which cash is located in a different jurisdiction from where it is needed, whether for reinvestment or return to shareholders.

There are considerable overlaps and interdependencies between the three components. For example, a financing strategy designed to utilise interest deductions in a particular territory is optimised if it provides deferral of home country taxation on the associated interest receipt, manages the foreign exchange exposures arising in the treasury center and allows for the income to be reinvested tax effectively. The following diagram provides a pictorial summary of the position.



Lead Article

The remainder of this article analyses each of the three fundamental areas.

Profit Alignment

Profit alignment is at the heart of tax planning and addresses both financial and functional profit drivers. Profit alignment should begin with a careful review of the group's transfer pricing policy and practices to confirm that profits are reported by the appropriate legal entities and jurisdictions in accordance with arm's length principles. This review may uncover planning opportunities and should assist the company in managing its tax risks.

Next, MNCs should identify profitable operations or assets located in high tax jurisdictions that could, if driven by appropriate operational substance and commercial considerations and risk tolerances, be migrated to lower tax jurisdictions and permanently deferred (or effectively permanently deferred) from taxation through acceptable tax planning actions.

Common techniques for profit alignment include financing and leveraging strategies, using capital deployment and financial risk-shifting (or sharing) strategies. Finance and risk management involve effective placement or leveraging of capital.

Alternatively, if supported by a group's current or future operational model, more substantive profit alignment strategies involve the migration of assets, functions, risks and/or intellectual property (IP) to low tax jurisdictions, often reducing the overall tax burden and ETR of the company on a more sustained basis. For example, a profit alignment strategy might involve the transition of an existing plant to a lower tax country or opening a new plant in a low tax jurisdiction or a jurisdiction that may grant a tax holiday or tax incentives. In recent years, some MNCs have established manufacturing operations in countries like China, thereby accessing lower labour costs and a large domestic market. In most instances, under China's Foreign Enterprises Income Tax laws, these MNCs have been granted tax holidays, although based on recent changes most of these have now ceased or have been grandfathered under China's new Corporate Income Tax law which came into effect on 1 January 2008. A similar trend has been the movement of technology and service jobs to countries like India in order to take advantage of lower labour costs; another is the migration of manufacturing and technology to countries like Singapore in order to take advantage of lower labour and operating costs and available tax incentives. These are all examples of profit alignment techniques and how management decisions can have an impact on taxes, and vice-versa.

A trend in the way certain companies conduct their business is the movement from country-specific operating models to models with centralised functions and risks at either a regional or global level. These models are associated with streamlined operations and business processes (internal and external), regional or global hubs, shared services, and outsourcing. Such business transformations can sometimes create an opportunity to relocate functions to low tax jurisdictions for centralised headquarters or principal company operations, IP companies, shared service companies, contract or consignment (toll) manufacturing arrangements, commissionaire arrangements, limited (stripped)-risk distributors, or procurement companies. Examples of popular locations for centralised principal operating models in the region include Hong Kong and Singapore.

The use of these strategies depends on an MNC's level of profitability, the profit drivers, the character of income and most importantly, whether the strategy is supported by the group's operating model.

Specific strategies exist for groups whose IP, technology, or brand assets are major profit drivers and therefore major tax drivers. Given the increasing importance of IP as a valuable profit driver, and given the potential legal implications of any IP migration strategy, special consideration should be given to IP in the development of an MNC's tax strategy.

In conjunction with operational planning, it may be possible to employ tax planning to enable the utilisation of these key intangibles from a tax-favoured location. In some cases, operational synergies can be achieved by centralising ownership and management of intangible properties in a single location. This can be accomplished through cost-sharing of intangible asset development costs, licensing arrangements (i.e., licensing of intangibles among affiliated companies) or by revising transaction flows to coincide with the beneficial ownership of intangibles.

Thus, profit alignment applies to various techniques, whether through the effective use of transfer pricing, financial techniques or more substantive operational approaches that may involve a physical relocation of people, plants and equipment, or a retooling and realignment of intangible asset ownership and assumption of business risks to benefit from tax-favoured locations and ownership. These planning ideas, if supported by arm's length transfer pricing, can have a substantial impact on lowering a group's ETR. There is no one best solution. Corporate risk profile, personal experience, preference, and most importantly, alignment with business operations, will drive the decision to implement a specific strategy.



Attribute Management

Attribute management involves examining jurisdictional or in-country planning opportunities. One attribute to manage is corporate structure, which refers to a group's operational model, capital structure, and tax and legal structure. Many features of an MNC's corporate structure including the domicile of the ultimate parent company, can significantly impact its ability to achieve its global and regional tax planning goals and objectives.

Other strategies are often domestic rather than cross-border, and are often referred to as local or "in-country" planning. Depending on the country, planning opportunities to reduce direct and indirect taxes may include the use of local-country consolidations, research & development tax credits or similar incentives, the use of tax loss carry-forwards and loss-refreshing transactions, tax-free asset step-ups and revaluations (e.g., intangibles) or the use of tax holidays or special tax zones.

Treasury Management

Treasury management relates to efficient offshore cash management/cash pooling, management of foreign exchange risks (book and tax), efficient redeployment of offshore cash for use offshore and efficient redeployment of offshore cash for use onshore (i.e., repatriation). Treasury management is essential for sustaining a long-term reduction in ETR. Quite possibly, the migration of profitable operations to lower tax jurisdictions or reductions in tax through in-country tax planning will be ineffective at reducing a group's ETR if the parent is located in a jurisdiction that taxes on a worldwide basis and does not have an exemption system, if such earnings must be repatriated back to the parent or result in deemed repatriations under the parent company jurisdiction's "anti-deferral" (i.e., CFC) rules, and are taxed at a higher rate in the jurisdiction of the parent.

If the parent jurisdiction taxes on a territorial basis (e.g., Hong Kong or Singapore), the repatriation of earnings in the form of a dividend should not give rise to tax considerations beyond local country withholding taxes. In this case, repatriation planning will be limited to avoiding or reducing withholding taxes. The use of a holding company or holding company structure can play a significant role in reducing or eliminating dividend withholding taxes. Alternatively, if the parent country taxes worldwide income and uses a foreign tax credit system as opposed to an exemption system to mitigate double taxation (e.g., China, the U.S. or the U.K.), the reduction in tax achieved through tax planning strategies will generally be eliminated upon the repatriation of the low-taxed earnings to the parent jurisdiction in the form of a taxable dividend.

Conclusion

Today, as never before, integrated and comprehensive tax planning by MNCs is required to achieve sustained reduction in their ETR. MNCs should focus on tax strategies and planning techniques that have an impact on the most significant tax rate drivers and can produce a sustainable reduction in ETR.

An integrated global and regional structure should address all three fundamental components:

1. Profit alignment—factors that impact where the business profits of the MNC initially arise and are taxed.
2. Attribute management—examining the particular characteristics of an MNC and the tax systems of the countries in which it operates.
3. Treasury management—all the issues arising from cash being located in a different jurisdiction from where it is needed, be that for reinvestment or return to shareholders.

Solutions related to each of these planning or impact areas are not independent of one another, but overlap, and therefore should be developed and implemented as part of an integrated and comprehensive plan.