Taxing complex global supply chains in a post-BEPS world

Getting down to business with indirect tax

KPMG International

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The global project to address base erosion and profit shifting (BEPS) is primarily directed at taxing international profits, causing few companies to examine the potential impact of BEPS changes on companies' indirect tax positions in detail. But for global companies with complex supply chains and high volumes of transactions, the interlocking implications of BEPS for transfer pricing, value added taxes (VAT) and customs will be substantial.

In fact, the need to manage the impact of the anti-BEPS proposals across the company's supply chain can provide the impetus to drive interaction and collaboration among these three often-isolated disciplines. Starting from the premise that intercompany pricing is: 1) a major element in managing transfer pricing policy, 2) used to calculate import duties and 3) the basis for indirect tax calculations, analyzing and planning the company's responses to BEPS in concert, stands to generate more ideas, efficiencies and value than are likely to be produced when transfer pricing is considered on its own. The resulting collaboration and integration of a company's transfer pricing, VAT and customs teams could continue producing benefits for the company for years to come.

Transfer pricing, indirect tax and customs rules in flux

As governments work to implement the BEPS proposals, all forms of taxation will be affected. For corporate taxes, the key outcome of the process will be to consolidate and widen the tax base as well as to increase disclosure and reporting obligations.

Transfer pricing is a special focus of the Organisation for Economic Co-operation and Development's (OECD) Action Plan on BEPS. The proposals attempt to recalibrate transfer pricing principles to better allocate profits among locations where economic activity is carried out and where value is created. Country-by-country reporting and enhanced transfer pricing documentation rules require companies to collect more extensive data and make more detailed disclosures.

Meanwhile, as the BEPS project progresses, the widespread adoption of VATs and goods and services taxes (GST) continues. Malaysia and the Bahamas have both introduced VAT in the last couple of years. China has expanded its VAT rollout to cover industries not already included, India is looking to replace most of its indirect taxes with a GST, and the Gulf States are well advanced in their plans to introduce a common VAT in the region. Except for the United States, the global adoption of VAT will effectively be complete by 2018.

With new systems, changing VAT rates and bases, and rising tax authority scrutiny of VAT transactions worldwide, businesses need to process ever more data to ensure they collect and pay the right amounts of indirect tax on all their purchases and sales wherever they operate.

Customs regulations and procedures are also undergoing change at a rapid pace. New free trade agreements continue to be negotiated and fiercely debated. The European Commission's Union Customs Code (UCC), which took force on 1 May 2016, completely redesigned the customs environment for EU member states. The UCC's new rules and procedures — and its aim to shift to a paperless, fully electronic and interoperable customs environment — has wide-ranging consequences for international supply chains and high transaction volumes.

In addition, the UK's impending withdrawal from the European Union as a result of the Brexit referendum will likely have dramatic implications on customs, transfer pricing and indirect tax for essentially all multinationals doing business in Europe.

How will BEPS affect indirect taxes and customs?

While one of BEPS' primary goals is to address aggressive transfer pricing, which many believe is used by multinational companies to avoid paying their "fair share" of taxes, its impact will be felt beyond the transfer pricing landscape. For indirect taxes, the most immediate impact of BEPS will stem from the OECD proposals to address transactions in the digital domain. The proposals would change the charging structure for VAT on services and intangibles by requiring a business selling to consumers in another jurisdiction to collect and pay VAT in the consumer's country, rather than their own. These proposals aim to prevent companies from reducing their VAT bills by locating sales operations in low-rate jurisdictions. Expanded concepts of permanent establishment might also trigger new VAT obligations. Many companies may need to register for VAT and meet VAT reporting obligations in more jurisdictions as a result. These changes will also then impact indirect taxes on tangible good transactions. (For a more detailed discussion, see a related article from KPMG's Global Indirect Tax Services, "Don't underestimate BEPS' impact on indirect tax").

From a customs perspective, the impact will stem primarily from two elements. First there will be greater transparency of company activities and information to the tax authorities as a result of the new reporting requirements under BEPS. As such, importers should be prepared for increased transparency under the BEPS reporting standards to highlight customs related party pricing issues.

Second, there will be customs implications as companies assess and change their business structures in ways that impact compliance with customs import valuation laws. Some of these include: changes in agent and commissionaire structures, insertion of a foreign related middleman, shifting of intellectual property, including changes on where it's performed, who owns it and how it's paid. For a more detailed discussion, see a related article written by KPMG member firm professionals from Journal of International Taxation called *BEPS from a Customs Perspective.*[1]

[1] http://www.kpmg-institutes.com/content/dam/kpmg/taxwatch/pdf/2016/beps-and-customs-joit-0716.pdf

Domino effect of intercompany pricing

As countries bring their transfer pricing rules in line with the anti-BEPS proposals and tax authorities gain more information about and devote more resources to transfer pricing issues, companies can expect to see their transfer prices come under more frequent challenges. Add to that the fact that more information may be shared with customs authorities for auditing purposes, the consequences of adjustments to transfer prices across the supply chain pose considerable uncertainty and risk.

Case Study

For example, consider a global manufacturing company that ships goods from Spain (ES) to its subsidiary distributor in Mexico (MX).

Legacy Transfer Pricing

ES (HQ) → MX (Sub) → considered limited risk

— Resulting in a specific profit target for MX

Post BEPS Transfer Pricing

ES (HQ) → MX (Sub) → No longer limited risk (distributor)

— Requiring higher profit targets in MX.

Impact:

— EU-MX FTA eligibility or local content percentage goes down (when transaction value is used for calculation)

— Certain products may no longer be eligible for zero-reduced import duty payments

— Increase in import VAT payments impacting the overall value of the goods and subsequent cash flow.

Although intercompany prices were actually reduced as a result of BEPS driven change, this change unexpectedly triggered negative outcomes for customs and indirect tax and resulted in an unnecessary loss for the company as a whole, which could have been avoided with better planning.

Although a transfer pricing adjustment may trigger an adjustment to the (factual and commercial) consideration paid in that transaction, countries treat transfer pricing adjustments differently. Monitoring and following these inconsistent approaches can be difficult. Some jurisdictions consider transfer pricing adjustments as VAT-relevant adjustments to the prices agreed between the parties. Others may disregard transfer pricing adjustments if only the corporate tax returns were amended (not the commercial pricing) and no actual payment was made.

In turn, transfer pricing and VAT adjustments may have a number of knock-on effects:

— Taxpayers would need to disclose the amendment either on an amended VAT return for the period of the original payment or in the period of the adjustment.

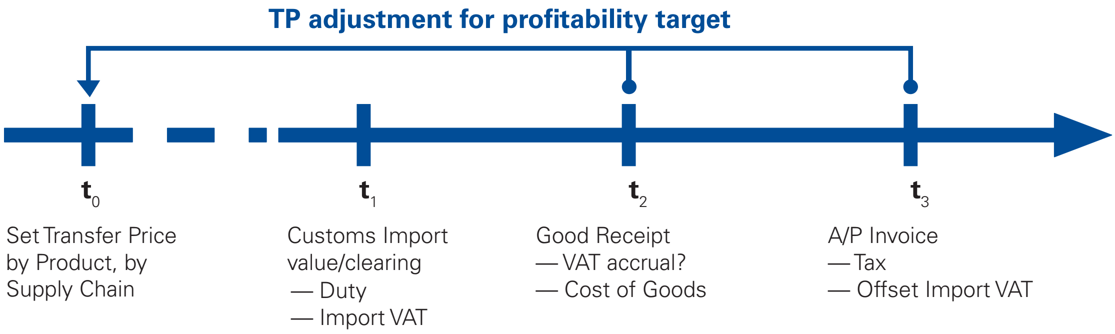
— New invoices or credit/debit notes would be needed to reflect the adjustment.

— Adjustments impacting imported or exported tangible goods would need to be disclosed to tax authorities.

— Correlative transfer pricing adjustments to, for example, interest, dividends and services may create additional VAT issues.

— Changes relating to intellectual property valuation could affect custom valuations and thus any import VAT paid.

Also bear in mind that customs authorities scrutinize the value of related-party transactions more closely than transactions between unrelated parties. Like transfer prices, values for related-party transactions for customs purposes are expected to meet customs own set of arm's length rules[2] and red flags are raised when they don't. As transfer pricing adjustments are typically retroactive, managing the ripple effects through amended VAT returns, customs declarations and invoices can complicate the company's compliance burden, impede recoveries and cash flows, and create unnecessary extra costs.



Source: KPMG International, 2016

2 Tests used to validate the acceptability of prices in related party transactions may differ significantly to those used for transfer pricing purposes.

Organizational barriers block cooperation

Despite the interplay between transfer prices, indirect tax and customs, a number of factors work to discourage cross-functional collaboration:

— The three disciplines are highly specialized, with different terminologies and perspectives, even in respect of the same subject matter.

— Reporting lines can differ, for example, with transfer pricing teams reporting through to tax while customs and VAT teams reporting to logistics and finance, respectively.

— Each team often relies on independent data streams and people, and even though their information needs sometimes overlap, data management systems and processes are often separate.

— Formal processes for communication among the three groups are rarely in place, and there is little recognition that communication is even needed.

Nevertheless, all three disciplines are greatly impacted by intercompany prices and share common goals: to ensure accurate compliance, to generate accurate documentation for compliance and audit, and to identify opportunities to reduce costs and add value. A more integrated approach to meeting these goals can help reduce costs, mitigate risk and identify opportunities for each discipline to drive more value.

Connecting the dots

While BEPS will have unforeseen impact over customs and indirect tax, it could also be used as a catalyst for better processes around intercompany price setting.

As a first step toward a more holistic approach, each team needs to develop a better awareness of the needs and objectives of the three disciplines and how they are interconnected. This common understanding will lay the foundation for a more collaborative working environment.

One way to build greater mutual understanding is for members of three groups to analyze the 'trigger points' of each discipline across the company's supply chain. Trigger points are those 'day to day' critical facts, events, data and policies in the value chain of one discipline that could give rise to potential compliance and operational impact within another discipline. Some may be obvious, for instance retroactive transfer pricing adjustments will have a direct impact on import value and indirect tax payments of tangible goods, and others not so much, such as the impact of shipment incoterms and existence of bonafide sale for indirect tax obligations. Common trigger points for transfer pricing, customs and indirect tax are as follows.

Transfer pricing	Customs	Indirect tax
Method/desired profit benchmark	Customs value	VAT calculations
Cost of goods sold	Classification	Registration
Profit results	Duty payments	Invoicing
Royalties/licensing	Free trade agreements	Cash flow
Retroactive adjustments	International commercial terms	Reporting
Function and risk	Circumstances of sale	VAT grouping
Permanent establishment	Importer/exporter of record	Title transfer
Tax structure	Country of export and import	Formalities
Value chain	Bona fide sale	Vendor contracts
Commissionaire structures	Import/export declarations (documentation)	
	Product descriptions	
	Exchange rate	

Source: KPMG International, 2016

Having determined the trigger points for each discipline, the next step is to analyze each trigger in terms of its impact and actions required by asking these questions:

- Is the trigger point's impact internal or external?
- Does it affect the balance sheet or P&L?
- Is there an associated reporting obligation?
- Is it applicable locally, regionally or globally?
- Is it driven by regulatory requirements or operational necessity?
- Which parts of the value chain does it affect: business strategy, business development, buying, selling, processes and/or inventory?

An important element of this exercise entails a detailed, cross-functional analysis of the company's information flows.

Questions to ask include:

- What data elements are required for each discipline?
- Are these data points currently collected and reported separately?
- Are there opportunities to set up common data gathering systems to feed the required data to each function's compliance?
- Are there opportunities to leverage this data through analytics for use in making strategic decisions?

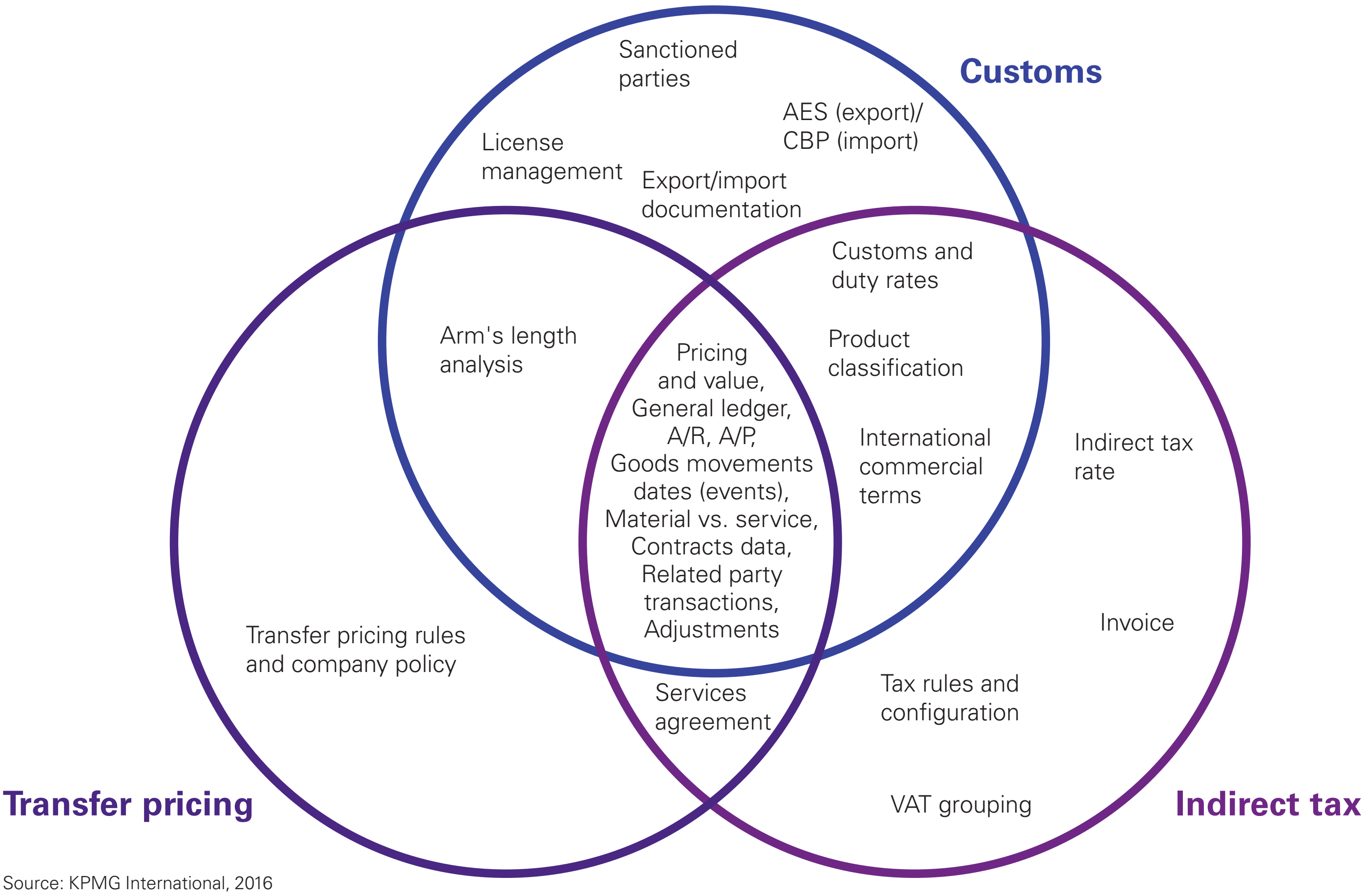
As with trigger points, an integrated analysis of data elements, sources and uses can point the way to more streamlined processes and systems for gathering, extracting and mining common data elements.

Once the teams have connected all the dots, they can begin to build their business case for investments that bring people, processes and systems together to meet each functions needs while generating efficiencies and value for the business overall.

Common data, different uses

Customs, transfer pricing and indirect tax functions all extract and utilize data for compliance and various forms of analytics. On initial review, the data each function gathers is very similar with a lot of overlap — as indicated by the VENN diagram below. Yet more often than not, data strategies are not integrated among the three functions.

The interdependence of data highlights the need for a common strategy across the various functions facilitating faster and more efficient consumption.



Source: KPMG International, 2016

Benefits of collective, forward-looking planning

Proactively managing the interaction of indirect taxes, customs duties, and transfer pricing in supply chains is key to maximizing efficiency and reducing cost, particularly in an era of value-driven tax management. Leveraging mutual understanding and available data across the supply chain can help ensure compliance, manage risk and unlock tax and non-tax value for the organization. As illustrated by the previous example, the cost of non-coordination is more than simple inefficiency and can add up to actual above the line costs.

The benefits of collective, forward-looking planning for transfer pricing, indirect tax and customs teams include:

- reduced risk
- less duplication and overlap of activities and processes among the three disciplines
- real-time communication of pricing and valuation adjustments
- greater efficiency and improved compliance
- improved cash flow planning
- more consistent platforms for data collection and analytics
- improved ability to influence outcomes
- heightened profile for all teams as strategic business partners.

Going back to our example, had the decision to change intercompany pricing been evaluated from all perspectives, the company could have found a way to change its prices in such a way as to not impact its preferential agreement eligibility.

What if the domino effect of intercompany pricing could be handled through an integrated cross functional technology solution for transfer pricing, customs and indirect tax?

There is a vision. Stay tuned...

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