

Taxing issues in strategic sourcing decisions



Today's economic environment is forcing companies to assess their core competencies and identify more efficient operating modes. This analysis encompasses strategic sourcing options such as relocation and consolidation to use shared services, insourcing, outsourcing and co-sourcing. The precise tax implications of each option should be a key part of the cost/benefit analysis, because in some cases the tax impact is very significant. In some instances, the decision process advances before the full tax impact is understood and measured.

The best sourcing decisions are those made with a full appreciation of the comprehensive impact on the company's "tax footprint." Companies are required to allocate taxable income to the various jurisdictions, based on varying factors as a function of very specific rules. Similar rules apply for the imposition of provincial capital taxes. How an organization sources labor, capital and assets, and earns revenues will influence the cost outcome for a range of income, capital, payroll and sales taxes at the federal, provincial and municipal levels.

A sourcing decision that is not made on a fully tax informed basis can be very costly and some of these costs may not be directly visible. As an example, centralization of functions migrated from overseas subsidiaries may trigger a disposition of intangible assets, bringing tax implications in both jurisdictions, along with transfer pricing issues arising from the resulting intercompany charges. Documentation to sustain the appropriateness of the new charge and the cost of satisfying the authorities on value, are all part of the cost of the new model. In many cases, an examination of the foreign affiliate rules will be in order.

The particular sourcing decision will also affect the company's aggregate federal and provincial income and capital taxes since it will impact on the allocation of its taxable income as well as its payroll taxes. The impact of income taxes needs to be carefully considered and may involve more than an assessment of the future impact. Accumulated future income tax assets and liabilities may need to be recalculated to calibrate the effect of a changed provincial allocation.

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In the financial services sector, the recent announcement by the Ontario government to replace its existing 8% retail sales tax effective July 1, 2010 with a 13% tax harmonized with the federal goods and services tax (“GST”) will have a dramatic impact on existing and future outsourcing, co-sourcing and shared service decisions. All financial institutions that provide GST exempt supplies will experience a significant cost increase, as much of the new provincial component is not recoverable.

Existing outsourcing contracts currently bear 5% GST, the recoverability of which was evaluated in the original outsourcing decision as a “cost of business”. It is unlikely that the potential cost of future harmonization was factored into that original decision. Existing outsourcing arrangements need to be evaluated against the increased cost as does pricing of the company’s supplies to its customers.

Future outsourcing decisions will need to evaluate an incremental 13% cost in assessing the financial merits of that

strategic sourcing decision, as compared to self-servicing where the sales tax is not incurred on the internal labor component. Typically, a high proportion of the pricing in an outsourcing arrangement is labor related.

A careful review of existing outsourcing arrangements is warranted to determine whether the contracts will need to be amended to address the requirement of the vendor to charge (and the recipient pay) a harmonized sales tax. In addition, since the supplier will realize Ontario retail sales tax savings, the recipient will want to ensure that any such savings realized by the supplier translates into reduced pricing.

Strategic sourcing decisions have a complex impact on the drivers affecting the company’s tax footprint. A harmonized sales tax in Ontario adds one more dimension, and the potential for the remaining “PST provinces” to join should also be factored, as this is a real possibility within the often lengthy lifetime of outsourcing contracts.

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