

Integrated global structuring: Aligning global business models and tax planning

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Global markets, new business models, ever-changing operating and regulatory environments, competition, liquidity concerns, the impact of culture, the pace of change—and the influence of new information technologies on them all—have made the efficient management of a business on a global scale more complex than ever.

These dynamic factors cause tax planning and compliance for multinational companies (MNCs) to become more complex, with the need to address and manage multiple objectives on a global scale. Best-in-class MNCs recognize that to manage these complexities, and to achieve and sustain a competitive worldwide effective tax rate (ETR), they need global tax strategies that **fully align** with corporate strategy, business planning, and the operational footprint—rather than treat tax as an outcome of such strategies to be managed “down-stream.” Alignment creates the opportunity for financial efficiencies, improved liquidity, and long-term tax savings. Conversely, a lack of alignment between business strategies and tax planning can result in missed opportunities and can create unnecessary and potentially significant tax risks and costs.

This article explains some of the significant elements of an effective, aligned global tax strategy and analyzes the financial and tax drivers impacting an MNC’s ability to achieve a competitive and sustainable ETR.

Global trends—doing business and tax planning in the 21st century

Internal change. Businesses face constant change from within. Changes in a company’s business model or operating model, and new business initiatives, such as geographic expansion, cost reduction, changes in products, 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 recognize that such changes create both tax opportunities and tax risks.

External change. Now add these current global trends to the mix: the free movement of capital and labor, the shift of manufacturing base from high to low cost, the tightening of credit markets, and the gradual removal of trade barriers in connection with the integration of economic interests of nations into federations. Furthermore, there are subtle trends, such as the development of global brands, and the ever-increasing importance of developing, protecting and exploiting intangible property (IP).

Impacts of change. Increased globalization has enabled MNCs to reduce production costs and deliver their products and services to market in less time leading to increased profits and margins. In contrast, global competition, upward pressure on operating costs, and the escalating cost of research and development (R&D) typically create downward pressure on margins and profitability. To remain competitive, companies need to focus on increasing margins through innovation, improved quality, operational efficiency, and effective risk management.

MNCs are actively streamlining their operational structures and business models in response to these factors by managing central functions and risks on a regional or global basis, revising their geographic footprint, and re-aligning their operations.

Tax changes. On top of these global business trends, MNCs face unprecedented challenges in their global tax environment. There is an increased legislative focus on “avoidance,” arbitrage, and disclosure. Many “developed” countries are lowering their tax rates and broadening corporate tax bases to be competitive with the “developing” countries. This has led to aggressive, base-broadening audit challenges on debt structures and restructurings by revenue authorities around the world.

US political change. In the US, Congress has reinstated “pay-as-you-go” budget rules requiring tax legislation to be deficit-neutral and therefore requiring any tax cuts to be offset with either tax increases or reductions in spending. There is increased pressure on Congress to

consider revenue-raising tax provisions as offsets. This has resulted in renewed interest in economic substance codification and proposals to limit or repeal deferral of US tax on foreign earnings. A new administration and the changing face of Congress are likely to sharpen the focus on corporate taxpayers.

Administrative change. There has also been a steady increase in coordinated enforcement activity and exchange of information between national tax authorities. FIN 48, with its related disclosures, and the IRS interest in tax accrual work papers (and definition thereof) is a significant challenge. These developments, among others, have created a climate of uncertainty when, for tax risk management and financial statement reporting purposes, companies are seeking a high degree of “certainty.”

As the following sections demonstrate, successful implementation of global business strategies to manage today’s business challenges must also address the many facets and intricacies of global tax planning.

Effective tax planning and shareholder value

A key component of shareholder value is earnings per share (EPS). An important element of EPS is a company’s ETR. Any increase in earnings resulting from organic growth, acquisitions, or other corporate initiatives, is diluted by a company’s ETR. Thus, ETR significantly impacts EPS and, therefore, has a direct impact on shareholder value.

Effective tax planning requires a capability to react to situational opportunities as well as to plan for the future. Situational planning can be either opportunistic or necessary to achieve discrete objectives. Situational planning is generally not sustainable.

This strategic approach tends to increase the likelihood that tax savings are both significant and sustainable, and mitigates exposure to anti-avoidance legislation and tax controversy. Conversely, failure to seriously consider and successfully execute an integrated global tax strategy in the broader context of business transformation may result in tax planning that is sub-optimal, or, worse, not aligned with business operations, and therefore unable to produce sustainable results.

In order to have a long-term, positive impact on EPS tax savings should be sustainable. Best-in-class MNCs do not solely rely on one-off or situational tax planning ideas that tend to be more tactical than strategic. Such strategies may not be integrated with the business and generally do not result in a sustainable impact on ETR. Instead, these companies take steps to lower their worldwide ETR through a comprehensive and integrated approach to global tax strategy and planning that is aligned with the business strategy and operations and that, on balance, is more substantive in nature (i.e., is supported by operational substance and economic realities).

Benchmarking global tax efficiency

An important step in the process of devising an integrated global structure is: (a) to make an assessment of the MNC's ETR relative to its peers, or similar companies; and (b) evaluate the factors driving the enterprise's profit and related tax burden (the enterprise's Structural Tax Rate).

Benchmarking of global tax efficiency is an approach that can be used to determine whether tax expense can be reduced. This analysis involves determining the appropriate benchmark(s) and the appropriate companies against whom to benchmark. The appropriate benchmarks are typically ETR, cash tax rate and foreign rate differential. However, certain adjustments to ETR may be required to account for non-recurring or abnormal items to improve the reliability of the analysis. Furthermore, benchmark companies may or may not be competitors and may or may not 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 a MNC with valuable insight as to whether or not it is directionally well-positioned.

Both effective global tax planning and effective benchmarking require an understanding of the enterprises' 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 company's ETR. Tax rate drivers can be either positive or negative; i.e., those that reduce the tax rate (positive drivers) and those that increase it (negative drivers).

While many profit drivers are also tax rate drivers, and vice versa, this is not always the case. For example, a tax credit is a positive tax rate driver but not a profit driver, and earnings in a high-rate country is a profit driver but not necessarily a negative tax rate driver if only minimal profits are earned there.

While specific goals will vary among companies, MNCs should focus on tax planning techniques that impact their 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 risk, and foreign exchange risks) 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 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 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.

The functional and financial tax rate drivers with the most adverse impact on the ETR are: full-risk, high-tax manufacturing locations; full-risk, high-tax marketing and distribution locations; intangible profits in high-tax locations; inefficient use of tax-favored locations; tax incentives or special regimes; and inadequate use of internal leveraging. In such situations, significant functions and risk, and therefore the associated profit, reside in high-tax jurisdictions, resulting in a relatively high ETR.

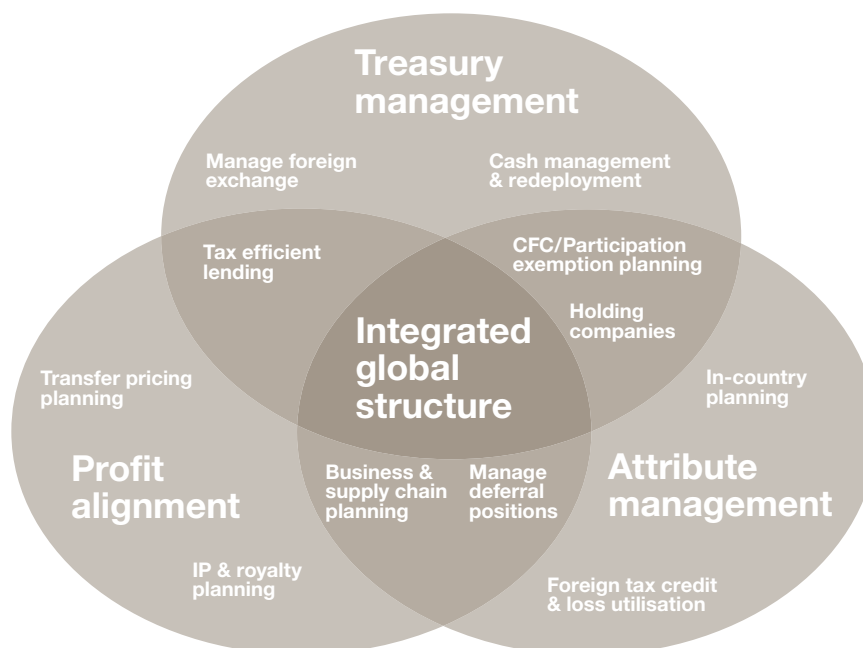
An integrated global structure

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

While there are numerous specific global tax-planning strategies, they can be grouped into three fundamental areas: profit alignment, attribute management, and treasury management. **Profit alignment** covers planning for the impact of the entities and jurisdictions 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. This third area has become even more critical to many companies due to the tightening of global credit markets.

As illustrated by the diagram below, there are considerable overlaps and interdependencies between the three components. The remainder of this article analyzes each of these three fundamental areas.

Purely tactical or ad hoc, one-off planning is not a sustainable approach to global tax planning and usually results in a constant search for the next tactical solution. Developing global tax strategies that produce long-term results requires a deliberate, broad, and quantitative process that incorporates elements beyond taxes. Such strategies should support the enterprise's strategic vision and goals, blend tax strategy with corporate strategy and structure, and should be consistent with the company's objectives across other functional areas (e.g., treasury policy and objectives).



Profit alignment

Profit alignment is at the heart of global tax planning and addresses both financial and functional profit drivers. Profit alignment should begin with a careful review of the company'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.

The most common techniques for profit alignment are 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, including the use of hybrid entities and instruments, dual-resident entities, and other tax-efficient lending techniques. Using these financing techniques and structures, MNCs can incur debt via inter-company asset or share sales (giving rise to interest deductions in the high-tax jurisdictions). This type of planning may also involve tax-efficient factoring of receivables and tax-efficient leasing. Although these financial techniques and structures may offer the simplest route to lower worldwide taxes, they are increasingly the target of specific anti-avoidance legislation in a number of jurisdictions.

If supported by the company's current or future operational model, more substantive profit alignment strategies involve the migration of assets, functions, risks, and/or IP to low-tax jurisdictions, often reducing the overall tax burden and ETR of the company on a more sustained basis. MNCs should identify profitable operations or assets currently located in high-tax jurisdictions that could, if supported by appropriate operational substance and within risk tolerances, be migrated to lower-tax jurisdictions and permanently deferred (or effectively permanently deferred) from taxation through acceptable tax-planning actions.

For example, a profit alignment strategy might involve the transition of an existing plant to a lower tax (and

typically lower cost) country or opening a new plant in a low-tax jurisdiction or a jurisdiction that may grant a tax holiday. In recent years, some MNCs have established manufacturing operations in countries like China, thereby accessing lower labor costs and a large domestic market. In most instances, under China's Foreign Invested Enterprise laws, these MNCs were granted tax holidays. A similar trend has been the movement of technology and service jobs to countries like India in order to take advantage of lower labor costs; another is the migration of manufacturing and technology to countries like Ireland and Singapore in order to take advantage of available tax holidays. These are examples of profit alignment and how management decisions can have a positive 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 centralized 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 centralized headquarters or principal company operations, IP companies, shared service companies, contract or consignment (toll) manufacturing arrangements, commissionaire arrangements, limited-risk distributors, or procurement companies. Examples of popular locations for centralized principal operating models include Switzerland, Hong Kong, Singapore and the Netherlands.

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 company's operational model.

Specific strategies exist for companies 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

There is no one best solution—corporate risk profile, personal experience, preference, and most importantly, alignment with business operations—drive the decisions to implement a specific strategy.

the potential legal implications of any IP migration strategy, special consideration should be given to IP in the development of an MNC's global tax strategy.

Often IP is owned and developed in the parent company jurisdiction or other high-tax jurisdictions. IP ownership may be dispersed and, depending on acquisition and development patterns, may or may not be well managed from a tax perspective. Further, legal ownership may or may not coincide with beneficial or economic ownership and inter-company transfer pricing policies may not properly reflect and reward the true economic or beneficial owner of key intangibles.

In conjunction with this operational planning, it may be possible to employ tax planning to enable the utilization of these key intangibles from a tax-favored location. In some cases, operational synergies can be achieved by centralizing ownership and management of intangible property 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 strategies, 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 realignment of intangible asset ownership and assumption of business risks to benefit from tax-favored locations and ownership. These planning ideas, if supported by arm's length transfer pricing, can have a substantial impact on lowering an enterprise's ETR.

Attribute management

Attribute management involves examining jurisdictional or in-country planning opportunities. One attribute to manage is corporate structure, which refers to an enterprise's operational model, capital structure, and tax and legal structure. An integrated global structure provides the platform and allows a company to meet the multiple goals and objectives of global tax planning. Corporate structure can significantly impact an MNC's ability to achieve its global tax planning goals and objectives. For example, a significant tax attribute for all MNCs is the domicile of the parent company, normally associated with the historical origins of the company. However, changes in domicile of the parent do occur, and indeed are becoming more common, especially during cross-border mergers or through purely self-directed actions.

Other attribute management 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 tax consolidations, R&D 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), foreign tax credit planning, income-into-capital planning, or the use of tax holidays or special tax zones.

This fundamental area also includes domestic legislative and regulatory initiatives whereby corporations and coalitions discuss their views, concerns, and issues directly with governmental and regulatory authorities. However, the results of legislative work may reach beyond national borders. For example, domestic lobbying may seek reductions in cross-border withholding taxes or more favorable double-tax treaties. Irrespective of the parent company location, in-country tax incentives (and disincentives) should influence the company's structure and activities across jurisdictions.

Treasury management

Treasury management relates to efficient offshore cash management, management of foreign exchange (book and tax), efficient redeployment of offshore cash for use offshore, and efficient redeployment of offshore cash for use onshore (i.e., repatriation). In today's environment of tight credit, an effective global strategy for treasury management is critical.

Treasury management is essential for sustaining a long-term reduction in ETR. For example, the migration of profitable operations to lower-tax jurisdictions or reductions in tax through in-country tax planning will be ineffective at reducing the ETR of a US-based MNC where deferral cannot be sustained in situations such as where earnings must be repatriated back to the parent, or result in deemed repatriations under the "anti-deferral" Subpart F rules, and are taxed at the higher rate in the US as a result. Given that the top corporate income tax rate in the US is 35%, if the migrated profits are repatriated, or deemed repatriated, to the US, then US tax of 35% would be due, with an offsetting foreign tax credit for the taxes incurred in the low-tax jurisdiction. This effectively eliminates the tax benefit of a migration strategy. To be effective for a US MNC, any migration strategy must be combined with a deferral strategy that relies on effective treasury management.

Holding companies, in conjunction with financing strategies, entrepreneur and limited-risk supply chain structures, and IP planning, can be utilized in an integrated global structure to effectively address the efficient redeployment of cash (both offshore and onshore). An integrated holding company structure is essential as it effectively helps to preserve the benefits of global tax planning by permitting the redeployment of cash throughout the organization and across borders to where it is needed in the business operations in the most tax-efficient manner.

Conclusion

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

An integrated global structure is aligned with the operations and objectives of the business and should address all three fundamental components:

- **Profit alignment**—factors that impact where the business profits of the MNC initially arise and are taxed.
- **Attribute management**—examining the particular characteristics of an MNC and the tax systems of the countries in which it operates.
- **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. In order to develop global tax strategies that produce long-term results, MNCs need to invest in a deliberate, broad, and quantitative process that incorporates elements beyond taxes. The final strategy should blend tax strategy with corporate strategy and structure in support of the enterprise's strategic vision and goals, benefiting the enterprise over the longer term.

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