Value chain transformation in the BRICs

What works in evolving economies?

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What lies beneath the overall growth story for BRIC (Brazil, Russia, India, China) countries? Not only have BRIC countries made strides as manufacturing and services countries, they are now developing into significant end markets for multinationals. What's more, they frequently represent the fastest growing (as with Apple) or biggest (as with General Motors) markets. Large multinationals now find large portions of their supply chains focused on the BRIC countries. Not surprisingly, this will add extra strains on existing operational and tax structures.

Meanwhile, tax authorities from emerging countries are also establishing themselves as among the most aggressive in the world, so that tax and customs issues have become a priority for even the highest corporate leadership when it comes to BRIC countries. Falling on the wrong side of these issues can lead to significant competitive disadvantages or challenges from tax authorities. As a result, multinationals in BRICs are forced to take a more proactive approach, including direct engagement with local tax authorities, to ensure they employ sustainable operating models.

Implementing new models is hard work. It involves considerable change and requires strong support from all levels of the organisation. But there are major benefits to be gained – especially when tax, financial, and operational considerations are aligned to provide benefits in all three areas. A holistic, systematic approach is essential, in particular the need to map out potential models so that each can be analysed from key perspectives, as illustrated in the country specific sections below.

Brazil

Brazil and Latin America present special opportunities, but also challenges. Brazil is now the sixth largest economy in the world, with the fifth largest population. In recent years, Brazil has made important strides in providing economic opportunities to its expanding middle class of consumers. Domestic and foreign investment is strong, especially with the upcoming 2014 World Cup and the 2016 Olympics.

Brazil has a complex tax structure, with a high tax burden, complex layers of taxation, frequent changes in laws and regulations, and a lack of incentives for foreign investment. Nevertheless several value chain transformation (VCT) solutions have been developed for companies to adapt to Brazil's challenges and to make use of growth opportunities. There are special regimes for relief of customs duties and other indirect taxes for products manufactured for export, or for targeted industries (including automotive, aerospace, and information technology). There are also incentives available for infrastructure projects and for manufacturing in the Manaus Free Trade Zone.

Companies may also utilise "in-country principal" entities in Brazil with proper substance, which can benefit from a lower rate of taxation (presumed profit method) and can remit dividends free of withholding taxes. These entities could effectively serve as a Brazilian affiliate of a regional principal company in a more traditional VCT structure. Brazil's transfer pricing regime has recently (2012) been modified to improve the application of the resale price method for importation, and to recognise a commodity price method.

Apart from Brazil, other countries in Latin America generally have transfer pricing regimes that are more OECD-compliant, however their sometimes spotty Double Taxation Treaty (DTT) network and incomplete Permanent Establishment (PE) definitions add complexity. Companies in Mexico have utilised its maquiladora (toll manufacturing for export) regime and DTT network to align Mexican manufacturing with a global principal structure. Other companies have utilised regional headquarter companies in Panama, Uruguay, and Costa Rica as shared service centers or procurement hubs, often as a branch of an EU principal company.

Russia

Despite the impact of the global financial crisis, the Russian economy has recovered at a satisfactory pace in 2011-2012, as demonstrated by stable GDP growth (4.3% in 2011), a falling inflation rate and a year-on-year rise in real disposable income. Together with the overall size of its market, these positive indicators continue to make Russia one of the top-tier countries for many multinational corporations (MNCs).

In 2012, Russia finally became a member of the World Trade Organisation (WTO). As a result, customs rules will eventually be brought into line with those of other WTO members while the remaining preferences available to local

50%

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manufacturers will gradually be removed, yet some will remain. This may significantly impact the business case for setting up local production in Russia. Also in 2012, Russia introduced new transfer pricing (TP) rules. Compared to the previous rules, the new TP regime is considerably more sophisticated and better aligned with OECD principles. This should help multinationals to apply VCT solutions in Russia that have been proven in other OECD territories. Although Advance Pricing Agreements (APAs) are allowed under the new TP legislation, actual practice is still in its infancy. In fact, no APAs had been obtained as of the time of writing.

With all that, however, the Russian tax authorities continue to see maximising collections as their primary task. In 2011, more than 90% of field tax audits resulted in additional tax assessments, which was largely due to the numerous, and at times rather rigid compliance and documentation requirements. The percentage of tax disputes won by taxpayers through litigation still remains comfortably above 50%. But, this figure has been declining from year to year due to the increasing complexity of disputes. While taxation in Russia has traditionally been a form-based system (which requires a different approach and mindset than at home), it is clear that substance is becoming increasingly important. Thus, it is critical to make sure that operating models encompass both form and substance.

In summary, MNCs now enjoy significant opportunities to build efficient value chains for the Russian market. However, these must be robust and defendable, both in form and substance, in view of the Russian tax authorities' traditional focus on maximising collections and their increasing sophistication in pursuing that goal.

Incredible, (Un)certain India!

Despite short-term reverses, India's GDP growth continues to be robust at a little over 6% per annum and is expected to continue that way for the foreseeable future. For multinationals, this means opportunities for resource deployment as more sectors open up to enhanced investment, including multi-brand retail, aviation, pharmaceuticals and insurance.

Foreign Direct Investment (FDI) is for the most part liberalised; however, there are exceptions such as retail, and while political change may be coming, so far there are very few success stories in large-format retail for several reasons. In short, partnerships and alliances may be the way to go in this sector, just as in the case of insurance – MNC retailers will have to place a long term bet on India.

India continues to provide new developments on the tax front, including introduction of a "negative list" of tax exempt services and place of

performance rules which mean that companies will have to consider input credits for services and their linkage in the supply chain to goods or services for local consumption or export.
By introducing the APA to India, certainty on transactions which are typically vulnerable to adjustment in India is now more likely. Such transactions include royalties, compensation for sourcing, imports of goods and export of services. APA rules, recently notified, are consistent with the practices in other jurisdictions and contemplate, among other things, pre-filing meetings and the possibility to obtain bilateral and multilateral APAs. PE issues also consume tax directors' mind-space and a possibility now exists to structure more complex transaction models (toll manufacturing or commission structures through profit attribution).

Although India's tax rate is relatively high at approximately 32.5%, India offers the opportunity to achieve lower effective rates through investment linked incentives - including Special Economic Zones, Free Trade and Warehousing Zones and priority sector projects. The possibility of entering into cost sharing arrangements for research and development (R&D) also entitles companies to get a weighted deduction.

The demographic advantage that India offers, coupled with rising income levels coming from sustained GDP growth over the last two decades, has resulted in the country emerging as a major market of products and services such as telecommunications, automobiles, consumer goods and healthcare. Multinationals therefore have to deal with domestic production and consumption, which requires development of India-oriented products. This in turn, often calls for a transfer of platform technology for upscale improvisation. In addition, there is a fine balance to be maintained between gravitating towards indigenous production, and retaining import content, which has to be evaluated in the context of capital investments and operating efficiencies. It is acknowledged over time that India is a sub-continent by itself with its unique preferences and modus operandi. Therefore, even as regional headquarter structures thrive in places such as Singapore or Hong Kong, from which strategic decisions can be taken, it is imperative for there to be a strong local operating and management connect at the Indian sub-continent level. In many cases, Indian MNC executives are tasked with overseeing the South Asian Association for Regional Cooperation (SAARC) region that includes Bangladesh and Sri Lanka, given their proximity and similarity to India, making India a sub-regional South Asian territory.

In summary, with changing landscapes, multinationals with operations in India should proactively and continually consider various alternatives to build efficiency and certainty in their tax structures and business models.

32.5%

At approximately 32.5%, India's tax rate is relatively high

China

China has undergone dramatic change over the past years. Where multinationals once viewed China as a low-cost producer of exports, they are rapidly shifting their focus. They now see China as a consuming nation with a growing middle class and increasing cost of doing business. Changing economic pressures and the regulatory landscape are prompting some businesses to move their production out of China, while others are expanding existing operations or moving production to different locations within China.

A particular challenge to multinationals is in regards to China's foreign exchange and other financial controls, which have the potential to cause trapped cash or otherwise prevent the proper allocation of capital through outbound remittance, an issue that has grown in importance as China's growth begins to slow and change focus. As achieving appropriate levels of outbound remittance can require significant time and effort for each case, and at the same time multinationals have developed quite complex cross-border flows, PwC is helping them to simplify these flows to develop a more streamlined process for achieving outbound remittance. As China does not have consolidation on an intra-China level, some form of "virtual consolidation" as well as tax authority engagement may be necessary to achieve the desired results.

However, even as new ways to simplify transactional flows in China are developed, new complexities emerge. For example, the large numbers of companies expanding R&D and services activities in China has heightened the importance of the valuation of intangibles, an area where opinions differ, especially when it comes to the concept of local intangibles. Developing understandings of valuation techniques in China can lead to different conclusions on the allocation of profit in comparison with tax authorities of other countries. At the same time, proactive engagement with the tax authorities at the local and national level within China - as well as with those of the counterparty country – may be necessary to produce sustainable results.

Conclusion

Given the complex economic and regulatory environment multinationals face in BRIC countries, multinationals will likely face a variety of challenges and opportunities as outlined above. PwC has established a network of VCT specialists and practitioners (international tax, transfer pricing and consulting) in all key BRIC and Latin American countries and we have a strong history of successful teaming with clients to align their emerging markets footprint with their global structure.

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