Deloitte.

Paradigm shift

Using Business Model Optimization to reshape your operating model and tax strategies to the modern business landscape

October 2018

A global tax reset is underway. Is your business positioned to thrive?

The challenge

The alignment of a multinational company's operating model and its global tax objectives is an important step in enhancing corporate profitability and shareholder value.

This is easier said than done. Ownership of these two business objectives frequently rests with different leaders and shifts in one area can have cascading impacts on the other.

Business leaders often have to make tough choices when faced with competing priorities such as competitive pressure in the market and the internal desire for growth, regulatory constraints, and increased public scrutiny.

Currently these challenges are compounded by the uncertainty of a changing landscape. This is partially the result of the OECD's Base Erosion Profit Shift (BEPS) project which is bringing widespread regulatory and treaty changes across many jurisdictions. Some actions will be introduced in a coordinated fashion while others are already being introduced unilaterally. For companies who currently operate centralized business models that result
in the majority of profit (or loss) being concentrated into a single entity, such as a Principal Company or an IP Company, the impact of the BEPS project will be significant.

Increased public transparency and new compliance obligations present fundamentally new challenges for multinationals operating across multiple jurisdictions. Businesses need to evaluate the impact of these changes and respond appropriately or the result may be an unexpected increase in the group effective tax rate and compliance costs.

The solution

Value Chain Alignment (VCA) is the process of integrating the operating model and global tax structures into the way a business operates. Value Chain Alignment (VCA) is all about creating value through business transformation.

Even if your business has undertaken a Value Chain Alignment (VCA) project in the past, now is the time to reevaluate your strategy and choices to confirm you will have a sustainable model, that still makes sense in the new reset tax world.

Building a structure that presents the right balance between operational and tax needs and that can be sustained over time takes commitment from senior management. This can require transformation of key functions embedded within the operating model, and in some cases, the wholesale transformation of the organization on a regional or global basis. Changes need to be substantive and real, and it's seldom an easy road. But the opportunities for a more efficient business model and sustainable and scalable tax positions should create shareholder value and enhanced cash flow.

Developing a tax model that is not based on operations runs the risk of curtailing the bottom line, and a business model that does not take tax into account may end up surrendering some or all of the profit it creates.

The approach

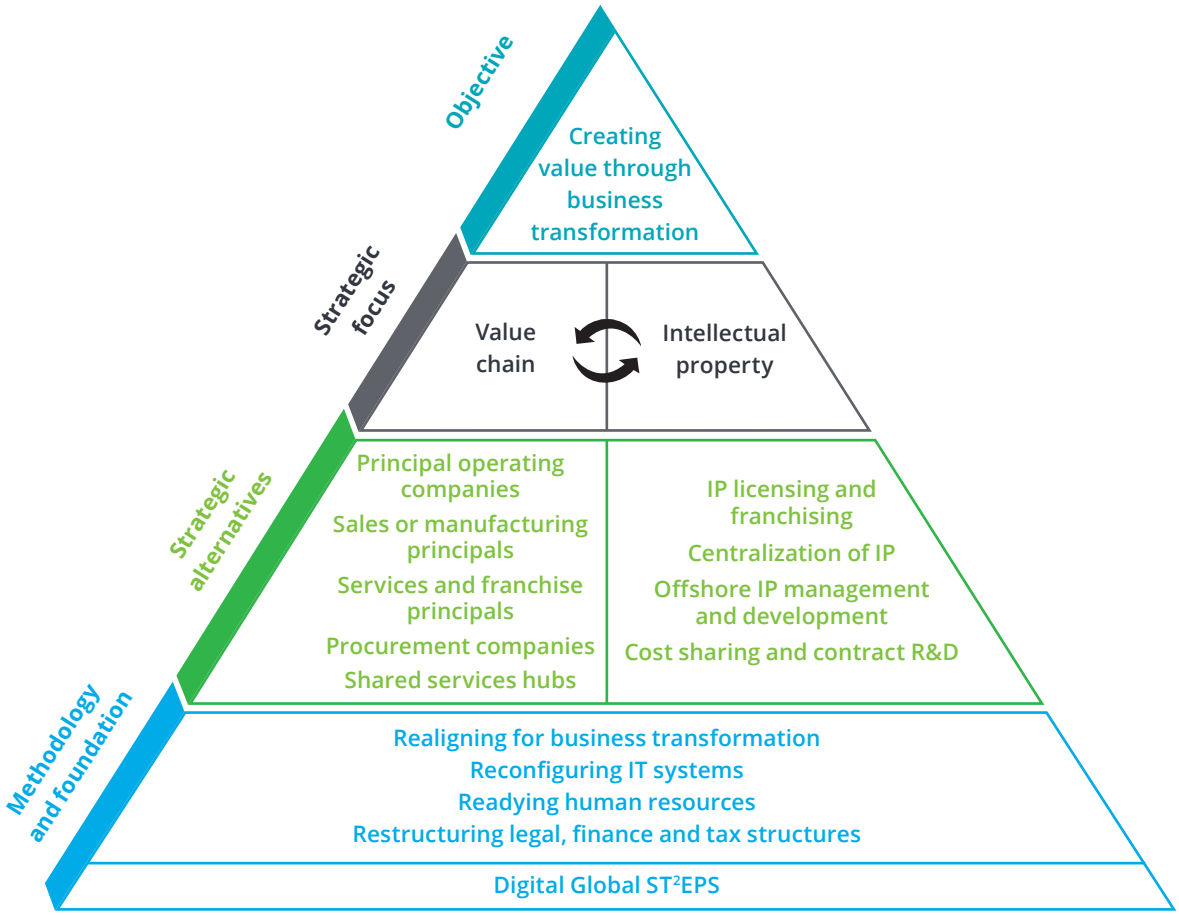
- Designing a Value Chain Alignment (VCA) structure involves careful consideration of business strategy and initiatives.
- This iterative process aligns the tax requirements with the business requirements to provide stakeholders with insight for transformational decisions.
- An integral part of the process is analyzing risks to achieving the tax objectives and developing responses to manage the tax risks effectively.

The business strategy forms the framework for the development of the operating model and identification of tax opportunities

Tax assessments impact the development of the operating model

The operating model and tax structure form an integral part of future planning developments

The methodology



Time to remodel?

Following a major transformation

Many companies find that it's a logical next step when they're already engaged in other large-scale transformations, such as supply chain restructuring or ERP implementations. However, forces outside an organization's direct control are just as likely to determine the Value Chain Alignment (VCA) timetable.

Significant shifts in the regulatory landscape

Initiatives like the OECD's BEPS project are triggering a need for businesses to reevaluate their current strategies. The wave of regulatory changes resulting from the BEPS initiatives are transforming the rules governing multinational operations in fundamental ways. Complying with new reporting requirements coupled with increased transparency is forcing businesses to take action sooner, rather than later.

Outgrowing the status quo

Many companies have a static approach to tax, and as a result the tax benefits that arise for example from investments or interest deductions do not necessarily keep pace with the business. As a company's pre-tax profits grow, the resulting global tax rate can increase disproportionately. A realigned business model and tax structure can result in tax consequences that align with the business instead of lagging behind.

Changes in the economy

A short-term focus on any single financial activity can create shortcomings in tax savings. For example, faced with a challenging economic environment, many companies focus on cost reduction by moving supply chain components around without regard to tax or trade jurisdiction. In this case, the value of the supply chain savings may be eroded by incremental tax and duty costs.

Merger and acquisition integration

When two organizations become one, it's quite unusual to result in a new entity where operational strategies and tax planning are in perfect harmony unless deliberate action is taken.

More common is that the legacy company has achieved such harmony, but the target company had not, or that each of the companies had been aligned with different goals in mind. Without a new, unified Value Chain Alignment (VCA) strategy, integration is unlikely to generate the anticipated synergies and after-tax returns.

Centralization vs. Decentralization

Enhanced connectivity and changing social conditions have encouraged the virtualization of the work environment with physical location becoming far less significant.

Yet, Value Chain Alignment (VCA) includes powerful reasons to move in the other direction—to physically centralize resources and people. Finding balance between both imperatives takes a big-picture view and skill at change management.

Nailing down the four R's

Value Chain Alignment (VCA) seldom alters the fundamental value proposition a company offers to its customers. But almost everything else is on the table. And while there are no standard solutions, Value Chain Alignment (VCA) projects typically focus on four specific areas.

Realigning for business transformation

Operational changes are usually required to move the business model and the tax plan into harmony. Defining a new operating model to improve operating margins and grow revenues in a tax compliant manner can generate increased after-tax earnings and enhanced cash flows. Physical location of components of the value chain and of intellectual property continue to have a part to play in determining the appropriate operating model and
legal structure.

Reconfiguring Information Technology (IT) systems

As governance structures, supply chains, and other parts of an enterprise realign to capture more value, the information systems that support those functions must evolve as well. As
a result, the IT systems should be reconfigured to support the new operating model. In addition, the IT function is itself a source of potential new efficiency through centralization, shared service centers, and economies of scale.

Readying human resources

Value Chain Alignment (VCA) initiatives have human capital implications across the organization. After all, moving functions and risks means moving people, and that can trigger leadership challenges, potential disruption to the business, and loss of talent. These challenges, which can also create opportunities, need to be managed carefully with a command and control project management structure, strong communication plans, and dynamic change management. Managing the consultation and negotiation process with Employee Representative groups is a critical challenge but one that must be done with vigor and consistency to be successful.

Reorganizing legal, finance, and tax structures

Value Chain Alignment (VCA) goes beyond narrowly defined tax questions—but those questions remain at the heart of any worthwhile solution. Any new legal structure and transaction flows that often result from a Value Chain Alignment (VCA) transformation are also a means of managing tax and trade risks in local countries as the legal entity structure aligns with the target operating model. Finance aspects, cash flows, and customs duties and other indirect tax implications of the new business model need to be considered within the new management and reporting structure.

Supply chain: Global feng shui

A basic principle of Value Chain Alignment (VCA) is that functions and risks should reside where they legitimately make the most of both tax savings and value creation.

Value Chain Alignment (VCA) uses arm's-length transfer pricing guidelines, applied to a center-led business model (i.e., the Principal Operating Company (POC)), as well as customs and other indirect tax planning to embed tax efficiency into a company's operating model. The result is a business with an organically competitive effective tax rate. Equally, it is critical that the structure reflects substance over form, and decision-making and those roles that substantially contribute to the decision making process actually and properly take place in the location of the POC. As the BEPS initiatives further underline these requirements, companies need to decide if they are ready to move firmly to a center-led business model, with physical centralization of critical members of its workforce to result in a sustainable business and tax model. And making the new supply chain structure work takes an integrated team that focuses on the integration of business, tax, human resources (HR), and systems requirements through effective program and change management.

The POC should bear responsibility for business strategies, business plans, and innovations, as well as the risks and benefits that accompany these responsibilities. The POC's portfolio typically include strategic direction, manufacturing, procurement, marketing, logistics, capital expenditure, strategic finance, product costing, foreign exchange risk, and other areas commonly associated with an independent enterprise. In reality, the POC should be a full- fledged operating company and not a headquarter company.

Locally, the operational entities need to be aligned with the new operating model to focus on excellence in execution. This is often accomplished by splitting the operations into a production company (e.g., a contract manufacturer), whose responsibility is to convert raw materials into finished goods, and a limited risk distributor whose responsibility is to focus on the customer and the local market. A service company is often utilized as well to employ shared service functions that are not directly tied to a limited risk/functionality production company or distributor. Such functions may include, for example, finance, HR, legal, corporate affairs, and local marketing support roles.

Such a radical transformation brings challenges. One is governance. It is important to create and document operating protocols that determine how these newly independent entities work together.

Indirect Tax consequences: Know the terrain

When a company transforms its supply chain, the cost reduction will generally create not only direct tax savings but also have an impact on the company's indirect tax position. Such impact can sometimes invite incremental, unforeseen customs duty and VAT* costs or increase overall compliance and administrative requirements associated with these taxes. In Latin America and Asia in particular, such potential costs can rival the expected income and operating savings. A supply chain realignment that does not take into account customs duties, trade regulations, and VAT could actually create additional costs rather than achieve anticipated benefit.

To achieve harmonious business transformation, organizations should remember that a Value Chain Alignment (VCA) strategy is more balanced when customs, VAT, and other trade requirements are taken into account. The objective is a future model that can manage transaction tax costs and allow for unimpeded cross-border transactions while pursuing overall tax efficiencies.

Indirect Tax	Considerations
VAT/GST	• Irrecoverable VAT costs created by the anticipated new structure • Whether the POC can act as a non-resident importer without creating a permanent establishment • Need for updating systems to reflect transactional tax changes • Variations to the operational model needed to accommodate differences in the relevant countries • Need to carefully manage cash flow on asset and inventory transfers, and identify available opportunities or simplification measures • Likely increase in compliance obligations (e.g., Additional VAT registrations may need to be applied)
Customs Duty and Trade Regulations	• Customs valuation structures that can be implemented to alleviate any incremental duty • License and/or registration needed to import and export products • Countries that allow non-resident importers/exporters • Existence of free trade agreements and/or bonded facilities

* For ease of reading, VAT in this document refers to any transaction based tax applied by jurisdictions globally, including but not limited to Value Added Tax (VAT), Goods & Services Tax (GST), Consumption Tax, Service Tax, Business Tax, etc.

Intellectual property: Securing proprietary assets

Intellectual property (IP) may not weigh anything or occupy an office, but it does have a physical location and is one of the areas under increased scrutiny from the OECD's BEPS project. Forward thinking companies are taking the time to reevaluate past decisions to determine whether they are still sound and make sense in a post-BEPS environment.

The location of the management and control of IP, including the IP itself, determines which jurisdiction(s) will have taxing authority over the present and future value of the IP. Equally, transferring the IP can risk losing value as part of the migration.

Analyzing IP unfolds in a series of questions. If IP is moving from one country to another, how much does the receiving entity in one country pay the originating entity in another country for the asset? How is the reduction in the value of the IP assessed over time? Should compensation take place all at once, or in installments? Should compensation be made in equal payments or a declining schedule? What about royalties paid to the new owner of the
IP—or should the IP value be embedded in the product costing? A company's commitment to innovation, marketing and competitiveness can affect how quickly the IP depreciates.

A site determination for IP seldom has the large-scale capital and labor ramifications that go along with locating a plant or a POC. Nevertheless, it can be just as critical to the bottom line.

Sweat equity

There are times when a company can identify a need, engage a consultant, and expect results in a tidy, pain-free package. Value Chain Alignment (VCA) is not one of those times.

Value Chain Alignment (VCA) is an iterative, labor-intensive process. The business being transformed must take ownership of that process, no matter what outside help it engages for strategic planning and execution assistance.

One reason for this focus is the depth and breadth of the change involved. Value Chain Alignment (VCA) has the potential to realign an organization's footprint, alter its supply chain, and move its people around the globe. The necessary steps can take months or years to bring to fruition. That is not the kind of change you place in someone else's hands for a turnkey solution.

Culture is another reason for a company to participate in managing its own transformation. Carrying out the process requires buy-in from many people in many roles, and winning that trust is easier when the lines of communication originate inside the company.

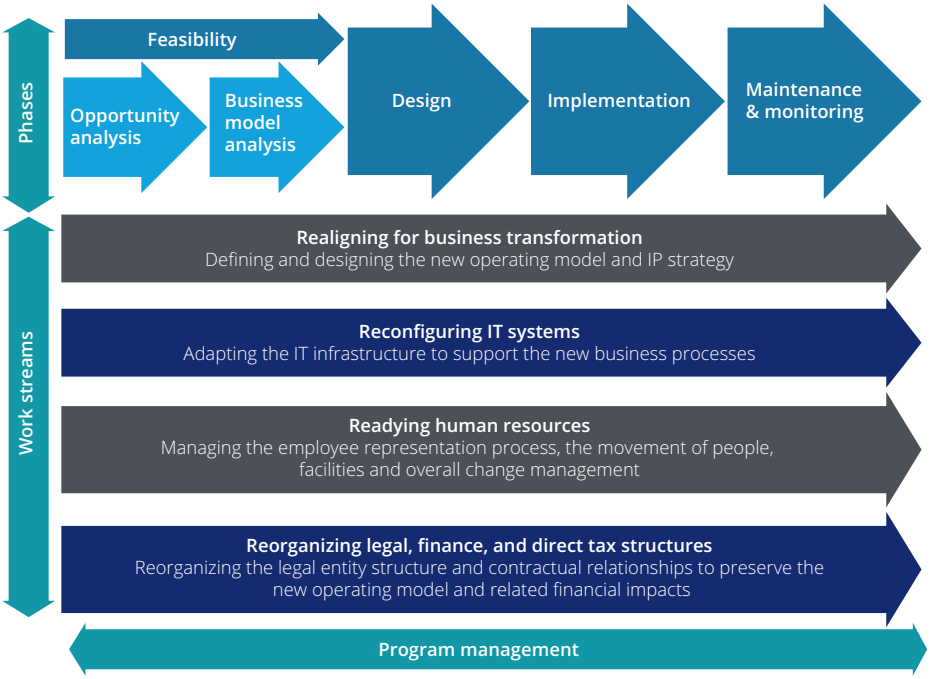
Externally, the transformation process creates change that investors, customers, suppliers, regulators, and other stakeholders will need to accept. A consultant can help manage those relationships, but the company itself must be responsible for them.

For these and other reasons, the typical Value Chain Alignment (VCA) project is governed by an internal Project Management Organization, led by a senior level company employee serving as Program Director. It is for the Program Director to then choose an experienced consultant to help guide and position them, to look ahead, prepare for the challenges, and grasp the opportunities.

Inside Value Chain Alignment (VCA)

What can a company expect as part of a full-scale commitment to Value Chain Alignment (VCA)? There is no typical duration for a Value Chain Alignment (VCA) project, but most take between 12 and 24 months from design through to implementation. A company may choose to move toward Value Chain Alignment (VCA) in phases, or all at once in a "big bang" transformation.

The typical process involves four phases:



Feasibility

This phase can be broken into an opportunity analysis and a business model analysis to provide for "stage gate" decisions and to limit the company's investment in time and resources upfront until it is determined whether a viable business case exists for the Value Chain Alignment (VCA) project.

- Opportunity analysis: A first-level opportunity analysis determines the potential savings opportunities that may result from Value Chain Alignment (VCA).
- Business model analysis: If the goals appear worth the effort, the next step is a deeper dive that identifies and prioritizes goals, weighs potential costs and benefits, and begins to analyze the operational and tax implications that go with putting certain functions into a center-led operating model. The key question at this stage is can the company operate within a Value Chain Alignment (VCA) model? At the conclusion of this phase, the company should also have a fully costed business case so it can make an educated go/no go decision.

Design

If the feasibility study provides a green light for the Value Chain Alignment (VCA) project, the next stage is the development of a detailed operational model using the "four "R" methodology"—Realigning for business transformation, Reconfiguring IT systems, Readying human resources, and Reorganizing legal, finance, and direct tax structures. It is here that the transforming company makes decisions about the operations, systems, people and financial, and tax implications of each planned change.

Implementation

This is the time to move Value Chain Alignment (VCA) from the blueprint to reality, by creating the new operating model and legal structure. Throughout this stage, the design must come to life during the implementation to ensure that every function is efficient, ready for the change, and tax compliant.

Maintenance and monitoring

The Value Chain Alignment (VCA) structure is complex and cross-functional. Once it is in place, ongoing monitoring and building a detailed rationale file can help facilitate compliance and identify potential enhancements.

Planning the blueprint

When preparing to undertake a Value Chain Alignment (VCA) project, consider the following common challenges and how you would address them:

- Shifting regulatory landscape, Country-by-Country reporting requirements and increased public transparency
- Collaboration and communication among units such as sales and marketing, operations, IT, legal, HR, finance, and tax
- Potential effects on external and contractual relationships, and how to manage them
- Harmonization of different IT systems and standardization of master data
- Trends in hiring, attrition, and change resistance among the workforce
- Collective bargaining agreements, works council or other forms of employee representation that may constrain necessary change if not properly consulted
- Managing the direct and indirect tax risks that accompany the business transformation
- Opportunities for reducing costs and increasing the top line through standardization and harmonization of processes and implementation of business process improvements

Putting thought into how you would tackle these issues will leave you better prepared to manage the work of outside resources that may assist you in the process.

Gathering the right resources

Think about your blueprint. Do you have the right people on your team today to successfully implement your plan? If not, consider your options. Distinguish between your need for specialized short-term expertise to help some aspects of your plan and longer-term needs that indicate a need to rethink your future hiring profile.

For example, if you plan to automate operations and integrate data flows then adding professionals to your team permanently who have strong technology skills may be important. Alternatively, if you are undertaking a reorganization or entity simplification project, you may need short-term, specialized legal support from both corporate and employment law aspects. If you want to pursue a process automation project, in addition to tax technical expertise you will likely want a strong tax technology architect to help with the strategic planning and design aspects.

For each component of your plan, assess the skills you need to reshape and reengineer your operations.

Case studies

Consumer Products Manufacturer—A company was struggling to implement a successful change program throughout its European, Middle East, and African (EMEA) operations. Deloitte reviewed various operating models, emphasizing the need to look at the model from a holistic perspective, including business issues, systems, people, and tax. Based on the review, the company decided to implement the European Principal Company (EPC) Model for its EMEA operations.

HR Outsourcing Services Company—Deloitte performed an opportunity analysis to help this company evaluate its global business strategy and identify tax planning opportunities, including the potential establishment of an offshore principal company structure for its services business. In addition to international tax and transfer pricing, this project involved state tax, management consulting, and information systems considerations.

Software Developer—A US multinational experienced significant growth through acquisitions, which led to a geographically distributed EMEA management team and back-office processes. Deloitte helped the company evaluate a centralized operating model, which included the creation of an EPC and commissionaires in over 20 countries in EMEA. Deloitte provided advice and assistance related to economic modeling, consulted on potential strawman structures, and assisted the company in evaluating the operational costs and benefits of each scenario. In the design phase, Deloitte worked with the company to refine the proposed structure. Transfer pricing, federal tax, state tax, VAT, and customs professionals, among others, were an integral part of the team that delivered an overall solution for the company.

Diversified Technology and Manufacturing Company—A company requested assistance in connection with two Value Chain Alignment (VCA) projects, one of which enhanced the work from an earlier engagement, while the second involved a new structure in a different region. Both new projects involved designing and implementing Value Chain Alignment (VCA) structures.

Oil and Gas Manufacturing and Services Company—Working with the company's VP of Tax, a Deloitte engagement team used Value Chain Alignment (VCA) resources to identify efficiencies related to the global use of IP requiring analysis of intercompany licensing, allocation of development costs, and transfer pricing. The integrated team also communicated with the legal and valuation consultants that assisted the IP Company. The benefits included globally centralized IP management to prioritize spend, enhance return on investment, and manage global cash flow.

Living in the new structure

Value Chain Alignment (VCA) is not a half measure. There are no pilot studies, no test beds, because the decisions involve the entire organization. That makes it a large commitment—in many cases a "life event" in the history of the company.

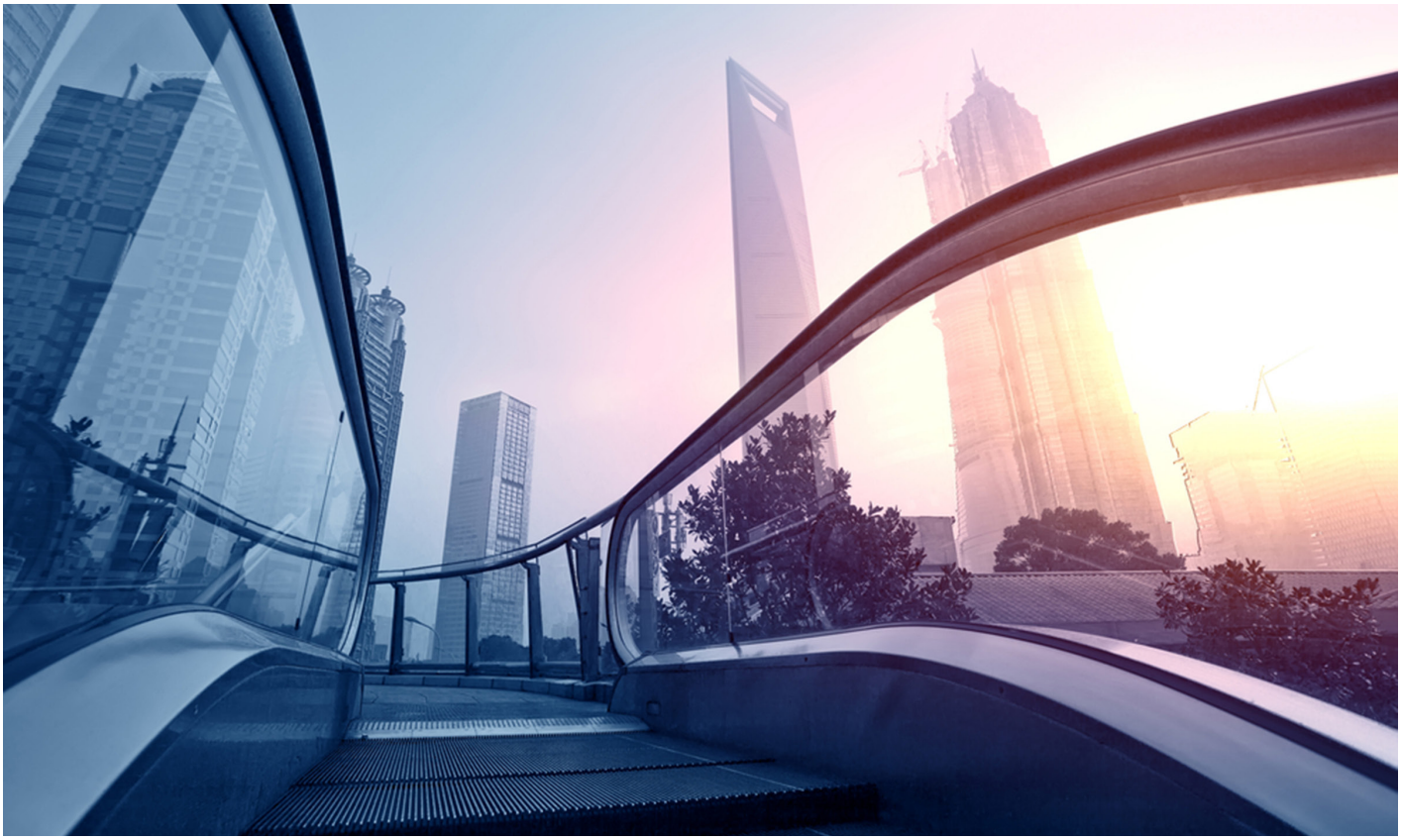
Only lasting value is worth the effort that goes into Value Chain Alignment (VCA). This is not a process a company wants to go through for only a few quarters' advantage, and it certainly is not one to start over every few years. Built-in sustainability is the hallmark of a worthwhile Value Chain Alignment (VCA) project.

Getting started is a big step. Determining whether it is worth the investment requires brutal honesty. There are likely new competencies and specialized skills which you will need in supporting your new structure going forward. In addition, the process will result in some level of business disruption for a period of time, which needs to be managed closely.

But once the dust settles, the benefits should spread throughout the organization.

If successful, the structure Value Chain Alignment (VCA) leaves behind should be easier to control, easier to live in, and more profitable—both before and after taxes.

And finally, in today's climate of international tax transformation and transparency, multinationals are seeing Value Chain Alignment (VCA) as a necessity to sustain value for shareholders.



The world of global tax is transforming. Is your business on solid ground to create value through business transformation?

Contacts

Raoul Stocker
Partner Tax & Legal
Deloitte Switzerland
rstocker@deloitte.ch
+41 58 279 6271

Deloitte.