



## Tax Efficient Supply Chains in Asia

TAX

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## Today's Presenters

- ◆ **Thomas Herr, Tax Principal, National Co-Leader for Tax Efficient Supply Chain Management (TESCM) Services**
- ◆ **John Tumelson, Advisory Managing Director, Business Performance Services**
- ◆ **Komal Dhall, Tax Principal, Global Transfer Pricing Services**
- ◆ **Stephen Bates, Tax Principal, Washington National Tax, International Corporate Services**



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# Overview

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## TESCM TaxWatch Audio Webcast Series

### ◆ Previous TESCM Webcasts

- Tax Efficient Supply Chain Management in an Evolving Global Landscape
  - Replay link:  
<http://www.visualwebcaster.com/event.asp?id=43412>
- Tax Efficient Supply Chain in the United States and Europe
  - Replay link:  
<http://www.visualwebcaster.com/event.asp?id=44338>
- Tax Efficient Supply Chains in the Latin America Region
  - Replay link:  
<http://www.visualwebcaster.com/event.asp?id=45819>



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## What Is TESCM?

- ◆ **Tax Effective Supply Chain Management is the integration of operational and tax planning to improve after-tax profitability.**
  - Benefits of operational-only restructurings can be eroded by tax costs and may create unexpected tax risk
  - Tax-only planning is often reactive and may lack necessary substance to create lasting benefit
  - Integrating the two enhances shareholder value by increasing after-tax profitability and reducing tax risk



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## Today's Agenda

- ◆ **Background**
- ◆ **Opportunities and Challenges in Asian Supply Chain Planning**
- ◆ **Contract Manufacturing in China**
- ◆ **Service Centers in India**



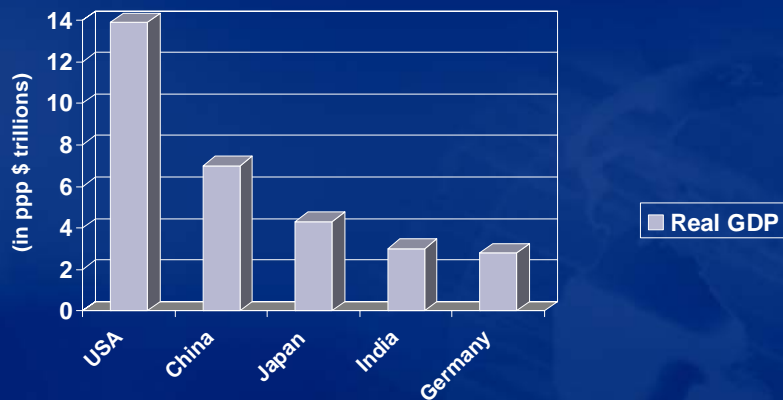
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## Three of the World's Five Largest Economies Are in Asia



Source: CIA World Factbook

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## Asia Has the World's Top Six Ports

Rank	Port	Country
1	Singapore	Singapore
2	Hong Kong	China
3	Shanghai	China
4	Shenzhen	China
5	Busan	South Korea
6	Kaohsiung	Taiwan
7	Rotterdam	Netherlands
8	Hamburg	Germany
9	Dubai	United Arab Emirates
10	Los Angeles	United States

Source: Shipping Statistics Yearbook 2006; Containerisation International Yearbook 2007; U.S. Army Corps of Engineers, Waterborne Commerce of the United States CY 2005; AAPA Surveys; various port authority internet sites



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## Asia Is Investing in Its Infrastructure

### China's Infrastructure Plan

Transport	By 2005	By 2010
Rail	75,000km of railway, including 25,000km of multi railway, 20,000km of electrical railway	80,000km of railway, including 35,000km of multi railway, 30,000km of electrical railway
Road	1,600,000km of road, including 26,000km of highway	1,800,000km of road, including 36,000km of highway
Seaport	800 deep water berths	850 deep water berths, 170 million tones of container handling capacity
River	110,000km river way, 8,800km for over 1000 ton vessel	15,000km main water transport way
Airport	150 airports	Build a complete main city centered air network

Source: U.S. Embassy in China



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## Economic Growth in Asia

Country	Gross Domestic Product, Current Prices U.S. Dollars (in Billions)			
	2005	2006	2007 (est)	2008 (est)
Cambodia	6.29	7.27	8.49	9.62
China	2243.69	2644.64	3248.52	3713.30
Hong Kong	177.78	189.80	202.96	216.27
India	778.67	873.66	1089.94	1249.44
Japan	4557.11	4366.46	4345.95	4552.20
Singapore	116.70	132.16	153.49	166.17
Vietnam	53.05	61.00	69.23	79.53

Source: International Monetary Fund, World Economic Outlook Database, October 2007



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## Inflation Rates in Asia

Country	Inflation, Average Consumer Prices (annual percent change)			
	2005	2006	2007 (est)	2008 (est)
Cambodia	5.9	4.7	6.5	5.5
China	1.8	1.5	4.5	3.9
Hong Kong	0.9	2	2	3.2
India	4.2	6.1	6.2	4.4
Japan	-0.3	0.3	0	0.5
Singapore	0.5	1	1.7	1.7
Vietnam	8.3	7.5	7.3	7.6

Source: International Monetary Fund, World Economic Outlook Database, October 2007

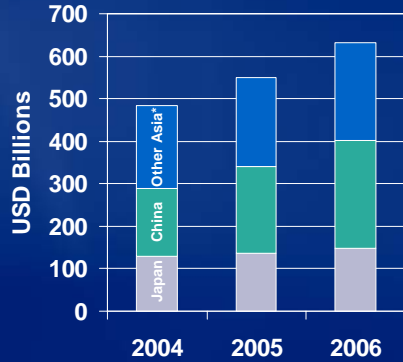


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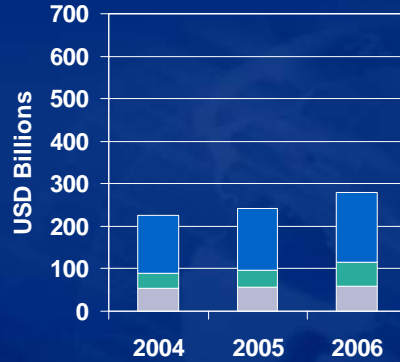
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# Intertwined Economies Further Highlights Importance of Supply Chain Planning

U.S. Imports from Asia



U.S. Exports to Asia



\* Includes India

Source: WTO, International Trade Statistics, 2007



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# Key Supply Chain Risks for Asia

Risks	Comments
Product/Supplier Quality	<ul style="list-style-type: none"> <li>– Lack of supplier quality controls</li> <li>– Communication barriers</li> </ul>
Regulatory Concerns	<ul style="list-style-type: none"> <li>– Lack of process standards and established practices</li> <li>– IP Protection</li> </ul>
Transportation Costs / Barriers	<ul style="list-style-type: none"> <li>– Increasing Oil Prices</li> <li>– Poor Infrastructure</li> </ul>
Ease of Doing Business	<ul style="list-style-type: none"> <li>– Cost of start-up and closure procedures, trading boarder costs</li> <li>– Complex Licensing Agreements</li> </ul>



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## Outlook

- ◆ **As a trading partner with Asia, North America will continue to source goods and services based on economics and risk**
  - Product sourcing locations will shift based on production economics and capacity
  - Services can include pushing value added activities to the supplier and /or off-shoring back off activities to gain operational economics
- ◆ **Changing economics and risks require a flexible supply chain plan that can adapt quickly to changing conditions**



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## CPE Question #1

- ◆ **Benefits and risk mitigation may be realized by integrating tax planning with operational supply chain restructurings.**

True or False?

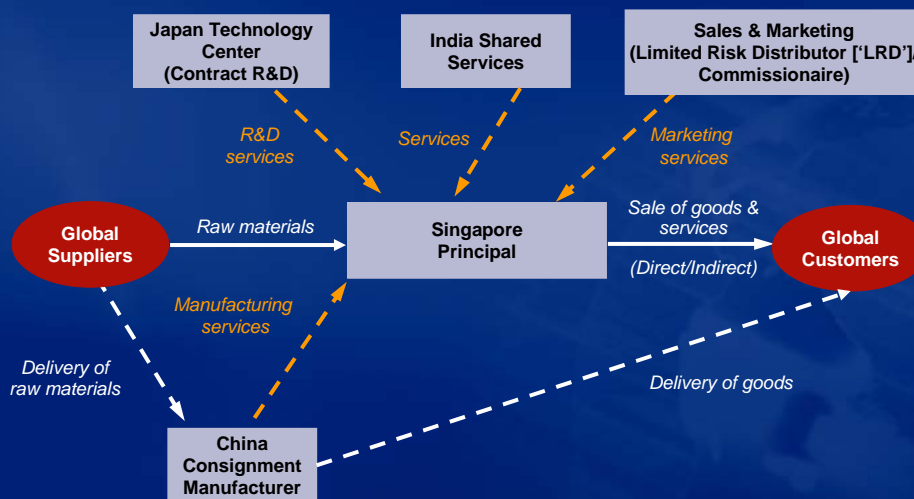


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# Tax Opportunities and Challenges

## Tax-Efficient Supply Chain



## Asia Offers a Number of Tax-Efficient Locations

### ◆ Singapore

- Corporate rate of 18 percent may be reduced by ruling
- Reduced rates (15 percent, 10 percent, 5 percent, or 0 percent) depend on the level of investment and nature of Singapore functions
- Incentives available for HQ or trading companies

### ◆ Hong Kong

- Corporate rate to be reduced to 16.5 percent
- Potential incentives for contract manufacturing in China (50 percent exemption)

### ◆ Local tax incentives

- Offered in India, China, and other countries for specific activities (e.g., high tech R&D)



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## Challenges in Implementing TESCM Structure

### Distances



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## Challenges in Implementing TESCM Structure

- ◆ **Lack of Economic Integration**
  - Duties and other trade barriers
  - Different currencies
- ◆ **Limited treaty network with United States (e.g., Singapore, Hong Kong, Taiwan)**
  - Inconsistent application of permanent establishment (taxable presence) standard
  - Substantial withholding tax burden for some industries
- ◆ **Rapidly changing regulatory environment**



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## CPE Question #2

- ◆ **Distances in Asia between major economies do not pose a significant challenge in centralizing certain functions.**

True or False?



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## ***Sourcing and Contract Manufacturing in Asia***

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## **Typical Development Stages**

- 1. Sourcing in United States**
- 2. Sourcing in Asia via middlemen**
- 3. Direct sourcing from Asian suppliers**
- 4. Contract manufacturing in Asia for U.S. market**
- 5. Contract manufacturing in Asia for global markets**



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## Direct Sourcing/Manufacturing Models

### ◆ Service model

- Deferral is possible, but limited fee potential
- Requires centralization of functions in single jurisdiction

### ◆ Commission model

- Deferral generally requires activities in manufacturing jurisdiction
- China business trust provides opportunities

### ◆ Buy-sell model

- Greatest potential for deferral due to offshore risk
- Deferral generally will require either purchases from and sales to third parties or substantial manufacturing oversight under the proposed “substantial contribution” test
- May be combined with trading or principal company structure



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## Substantial Contribution Test

### ◆ Principal will be regarded as manufacturer if it makes substantial contributions to the manufacture of the goods through its employees

#### ◆ Specific factors:

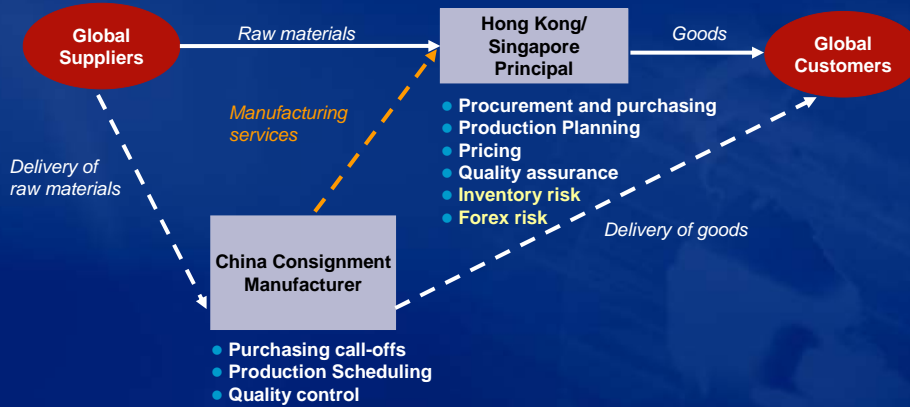
1. Oversight and direction of the activities or process (including management of the risk of loss)
2. Performance of some manufacturing activities
3. Control of raw materials, WIP, and finished goods
4. Management of the manufacturing profits
5. Material selection
6. Vendor selection
7. Control of logistics
8. Quality control
9. Direction of R&D and protection and use of IP



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## Hong Kong/Singapore Principal Model



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## Impact of New Chinese Tax Regime

- ◆ **Definition of Taxpayers**
  - = Resident vs. nonresident
  - = Place of effective management
- ◆ **CIT Rates**
  - = Standard: 25 percent
  - = Preferential: 15/20 percent
- ◆ **Tax Incentives**
- ◆ **Transfer Pricing Rules**



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## CPE Question #3

- ◆ **“Solicitation of customers” is one of nine factors to be considered in determining whether CFC satisfies the “substantial contribution” test.**

**True or False?**



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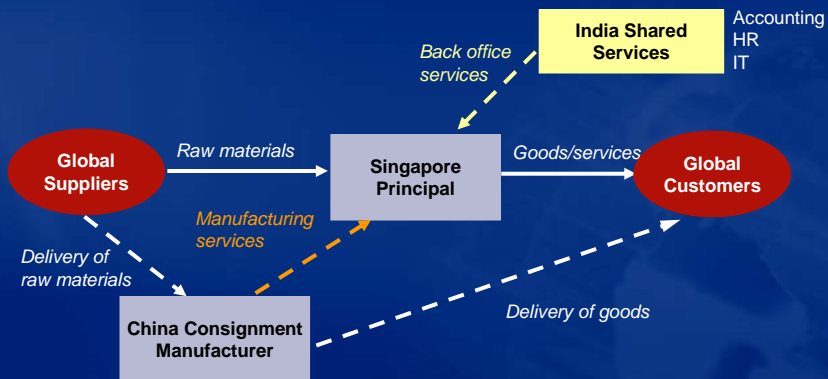
## *Service Centers in India*

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## Shared Service Center



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## India Service Centers

### ◆ Transfer Pricing

- High cost plus markups relative to other jurisdictions
- Location savings argument

### ◆ Permanent Establishment and Case Law

- Dependent agent
- Recent case law

### ◆ Status of Audit Cases



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## Transfer Pricing

### ◆ Mark ups on service centers

- BPO cost plus mark up can be as high as 25 percent
- KPO cost plus mark up can be as high as 35 percent
- Sales agent mark up can be as high as 20 percent
- R&D center returns will vary depending upon industry and activities

### ◆ High markup supported by comparable companies

- Acceptable to Indian tax authorities
- Uncertain how foreign jurisdictions will respond



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## Location Savings

### ◆ Location savings defined

- Savings as a result of moving from a high to a low cost jurisdiction; and, where the net savings is positive

### ◆ Formally introduced in U.S. transfer pricing regulations but not in OECD Guidelines

- U.S. case law exists
- Location savings not introduced in Indian transfer pricing regulations nor as a result of court cases
  - Justification for high markups can be found in underpinnings of location savings



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## Relevant Court Cases in India

### ◆ Morgan Stanley and Co (Supreme Court)

- Cost plus 29 percent payment to Indian subsidiary engaged in ITeS/BPO services considered adequate
- Deputation of employees to Indian subsidiary may result in service PE (however, stewardship activities do not result in PE)
- Robust functional analysis and documentation can mitigate risk

### ◆ Rolls Royce (Delhi Tribunal)

### ◆ Galileo (Delhi Tribunal)



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## *Practical Thinking ...*

- ◆ Starting point for attribution should be the PE's profits
- ◆ Analysis should lead to a proper Profit Split between the PE and the Head Office
- ◆ As a corollary – Profits of all PEs plus HO should not exceed global profit of the Enterprise
- ◆ Arm's length compensation to the PE should normally constitute sufficient discharge of nonresident's tax liability in India
- ◆ Functionally separate entity approach should be a better way to attribute profits than related business activity approach



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## Status of Transfer Pricing Audits in India

- ◆ **Threshold for taxpayers subject to review is taxpayers with international transaction of greater than INR 50 million, or approximately 1.2 million USD**
  - Results in a high number of cases being reviewed
  - Recently, Indian tax authorities have expanded resources devoted to conducting exams
  - Year ending March 31, 2005 currently under review
- ◆ **Many reviews result in adjustments and these adjustments are almost always appealed**
  - Option to proceed to Income Tax Appellate Tribunal (ITAT) if results of appeal unsatisfactory
  - Where a transfer pricing adjustment is upheld, the taxpayer will lose benefit of the tax holiday



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## CPE Question #4

- ◆ **The threshold for taxpayers subject to review in India are sales of greater than USD 50 million.**

**True or False?**



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# Q & A

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## Today's presenters

Name	E-mail	Telephone
Stephen Bates	srabates@kpmg.com	415-963-5422
Komal Dhall	kdhall@kpmg.com	212-954-2044
Thomas Herr	therr@kpmg.com	612-305-5532
John Tumelson	jtumelson@kpmg.com	678-778-4105

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