Building Tax Efficient Resilience Into Supply Chains

Impact Of Supply Chain Disruptions On Transfer Pricing

5 January 2024, Friday

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Key Takeaways

- The magnitude of supply chain disruptions in recent years has compelled companies to carry out comprehensive analyses of the financial impact on system profits and existing TP models.
- The key is to proactively assess if existing TP policies continue to be relevant and adequate in the face of supply chain disruptions, and actively monitor implemented TP policies alongside changes to the business.
- To identify the economic owner of intangible property, taxpayers need to first identify the entity which undertakes the "DEMPE" functions.

The world has witnessed major supply chain disruptions in recent years. Global events like the COVID-19 pandemic, the US-China trade war and, more recently, the Red Sea blockade, have time and again exposed the vulnerabilities of the highly interdependent international trade network and, simultaneously, demonstrated the importance of a resilient supply chain.

"While these supply chain disruptions have adversely impacted many companies, they have also spelled opportunities for some," shared Accredited Tax Advisor (Income Tax) Elis Tan, Executive Director and Transfer Pricing Leader, and Tom Ewigleben, Executive Director and APAC Global Value Chain Leader, BDO Singapore, at a webinar organised by the Singapore Chartered Tax Professionals.

"Companies that have pivoted and recalibrated their supply chains and TP models amid the disruptions have been rewarded with new business opportunities."

The Future of Supply Chain Management: Major Trends

Supply Chain as a Board-Level Priority

As consumers become more environmentally conscious, more companies are making ambitious sustainability pledges to connect with their audiences. To meet these lofty goals, these companies will need to make a drastic reduction to their carbon footprints. As the average supply chain emits more than five times more greenhouse gases than the company's operations, it will be crucial for the board to take the lead to relook the entire supply chain to drive these green initiatives.

Technology-Driven Resilience

The adoption of digital technologies and artificial intelligence (AI) in supply chains has surged significantly in recent years. In addition to its pivotal role in enhancing human intelligence, AI is also vital in automating tasks as well as improving visibility and responsiveness.

Time Compression in Planning and Execution

Digital technologies, such as the supply chain digital twin (which utilises real-time data and snapshots to forecast supply chain dynamics) and supply chain command and control centre (which provides automated control over the company's operations), are being put in place to improve a company's supply chain agility.

This has greatly accelerated the pace of supply chain planning and execution, from what used to be biannual planning cycles to monthly (or even daily) planning cycles.

Impact of Supply Chain Disruptions on TP Models

The magnitude of supply chain disruptions in recent years has compelled companies to carry out comprehensive analyses of the financial impact on system profits and existing TP models. In addition, the evolving roles of transacting entities and operational changes trigger shifts in value chain drivers, thus requiring adjustments to TP policies based on the existing TP models.

Limited Risk Model

In a Limited Risk Model, the limited risk distributor would generally be guaranteed a routine profit for its functions. If, due to supply chain disruptions, the limited risk distributor takes on a more substantial role (such as to lead supply chain initiatives) and/or assumes additional non-routine operational risks, its characterisation as a "limited risk distributor" may no longer be appropriate. Accordingly, its characterisation and remuneration should be reassessed to reflect the changes in the risk profile and functions performed.

Principal Model

In a Principal Model, the principal entity would typically receive the residual profit after the routine entities are remunerated for their respective functions. If the routine entities take on additional roles or assume additional risks arising from supply chain disruptions (such that the relative importance of the principal entity's role declines), the TP policy should be updated to reflect the changes, and the remuneration of the respective entities should be reviewed based on their new roles and risks assumed.

Centralised Supply Chain Model

In a Centralised Supply Chain Model, supply chain functions are centralised in a specific entity for synergies and bargaining power. While cost savings arising from the centralised supply chain may have been the main driver for remuneration in the past, the ability of the centralised supply chain to reduce supply risks may be increasingly important amid regular and severe supply chain disruptions. In this regard, companies should update their TP policies to reflect these changes.

What Does This Mean for TP?

Migration towards a Multi-Hub Model

After the series of supply chain disruptions including the COVID-19 lockdown, some multinational enterprise (MNE) groups have migrated from a Centralised Supply Chain Model to a Multi-Hub Model to enhance their supply chain diversity and resilience.

Such a shift from a Centralised Supply Chain Model to a Multi-Hub Model may comprise a business restructuring. From a TP perspective, the MNE group should reassess the functional and risk profile of the group entities before and after the business transfer and update its TP policies.

This shift may also involve moving from a single intangible ownership to a shared intangible ownership via a cost-sharing agreement between hub entities located in different countries. Taxpayers may need to perform detailed TP analyses to allocate the profits using the appropriate method, and the profit-split method may be considered in this case.

Adoption of Technology

More companies are integrating sophisticated technologies into their supply chains to enhance efficiency across the various stages.

For the purpose of TP, one question is whether the technology is recognised as Intangible Property (IP), and if so, who the economic owner of the IP is. It should be noted that the economic owner is not necessarily the same as the legal owner of the IP.

To identify the economic owner of the IP, taxpayers need to first identify the entity which undertakes the "DEMPE" functions, that is, the development, enhancement, maintenance, protection and exploitation of the IP. Depending on the economic ownership and other factors, the arm's length remuneration for the right to use the technology (for example, licence fee or cost-plus platform fee) may then be determined.

Managing Tax Authorities

Ultimately, taxpayers would have to manage the tax authorities and demonstrate that they remain TP-compliant despite supply chain disruptions.

The key is to proactively assess if existing TP policies continue to be relevant and adequate in the face of supply chain disruptions, and actively monitor implemented TP policies alongside changes to the business.

Conclusion

As businesses grapple with supply chain disruptions, the need to pivot and recalibrate their supply chains and TP models has never been more pressing. Having said that, those that stay proactive in managing their supply chain and TP positions will be poised to overcome the challenges and position for sustainable growth.

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