



The BEPS ripple effect.

**Multinationals are reevaluating how
and where they do business**



BEPS and the business

On its face, the global initiative to address base erosion and profit shifting—commonly referred to as BEPS—is about taxes. That is, national tax authorities around the world are trying to prevent multinationals from structuring their affairs in a manner that results in stateless income or income subject to very little tax.

But the reality is that reforms proposed to address BEPS impact far more than a company's tax situation. These reforms are causing multinationals to reevaluate their entire operating model—where they are going to operate, who they will do business with, and how they will run the business.

Indeed, BEPS raises a waterfall of complex questions for multinationals, including the following:

- Is our current operating model compliant with anticipated BEPS outcomes? Do we need additional substance to support profit allocation? Or should we consider an alternative model that better aligns with existing value chain contributions?
- How will potential modifications to our operating model to make it BEPS-compliant affect our overall business costs (e.g., costs incurred to add or relocate employees or assets), including our talent management, recruitment, and training strategies?
- How will modifying our operating model affect our transactional and tax costs? For example, will we be subject to new taxes in locations where we previously claimed no profits? What will be the impact on our tax liabilities beyond corporate income tax, such as import duties, tariffs, and indirect tax/value added tax (VAT)?
- What additional IT system changes will be necessary to adopt the required operating model changes, such as transaction flows, interfaces, and reporting requirements, etc.?
- Should we change our outsourcing and supplier relationships to preserve tax benefits or mitigate tax risks, and if so, how will those changes affect business costs and impact customer experience?
- What impact do the political or cultural environments in a country have on decisions regarding changes to our operating model?
- How will our customers react to these changes?

Given all of these uncertainties, it is not easy for multinationals to assess what the right move is—or whether to make any move at all. Managing BEPS risk is further complicated in light of looming U.S. tax reform. For some businesses, BEPS reforms will converge with other business drivers, and the changes decided upon will be transformative. For others, it will be a significant project, but not a major disruption.

In this paper, KPMG LLP (KPMG) provides insights to help businesses:

- Understand the potential ripple effects of BEPS reforms beyond tax issues
- Take steps to respond to and cope with the new BEPS-driven global landscape.

Background

By now, multinationals are well aware of the global initiative led by the Organisation for Economic Cooperation and Development (OECD), at the behest of the G20, to address BEPS. Driven by slow growth and declining tax revenues, rising sentiments of economic nationalism, and a perception that many multinationals were not paying their “fair share” of tax, the OECD set out 15 “Action Items,” recommending measures to help combat what they viewed as unfair tax practices. The bulk of the OECD’s final recommendations were released in October 2015, but the OECD has continued to study certain issues and correspondingly refine certain recommendations.

A central focus of the OECD’s recommendations is increased transparency and reporting with respect to a company’s value chains, as well as the associated operating models, legal entity structures, and transfer pricing practices used to allocate profit to countries where the multinational conducts operations. Along the same line, the OECD also has made recommendations to address hybrid mismatch arrangements, preferential ruling regimes, perceived treaty abuse, and the inappropriate avoidance of a permanent establishment. Overall, the purported goal of the OECD’s recommendations is to cause

multinationals to recognize and report taxable profits in the jurisdictions where they create value—i.e., where their economic activity occurs.

Many countries have already adopted or are poised to adopt changes to their international tax systems based on the OECD recommendations, or in certain cases, have taken unilateral action outside the OECD’s recommendations to address perceived abuses.

With BEPS in full swing, multinationals are quickly realizing that BEPS may affect far more than just their tax planning. They are seeing that BEPS may have an impact on the end-to-end global value chain—the flow of production from raw material to finished product to final sale, and all of the logistics and operations in between. BEPS also may affect the operating model supporting the business’ core value-drivers (i.e., functions, assets, and risks).

In other words, BEPS may significantly impact the way multinationals do business by requiring a much closer alignment between a company’s value chain, operating model, and tax structure. As a result, BEPS is causing many multinationals to not just reevaluate tax planning, but also *where and how they run their business operations*.

For more insights about BEPS, visit www.kpmg.com/us/beps.



Why BEPS?

According to the OECD, “BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.

Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level.

Moreover, when taxpayers see multinationals legally avoiding income tax, it undermines voluntary compliance by all taxpayers.”

BEPS and value chain considerations

Redefining value creation and taxable presence

The BEPS framework defines “value creation” in a substantially different way than under historic international tax norms. Prior to the issuance of the new OECD guidelines, cross-border tax planning relied heavily on the location of the group entities that owned intellectual property (IP) and assumed key business risks through intercompany contracts. Multinationals often assigned lesser “routine” profits to its operating affiliates and larger “residual” profits to the entity underwriting the group risk. Such planning was often done independent of an assessment of an enterprise-wide value chain. The OECD’s guidelines target this type of planning.

The new guidelines require a much more robust review of a company’s value chain and the allocation of profits to the locations where value is created through:

- People, encompassing the entire workforce,
- Physical assets, such as factories, retail stores and data centers

In contrast, other assets—including mobile assets such as IP or other intangibles (i.e., trade secrets and contractual rights)—will not necessarily be given much weight in assessing where value is created, particularly if separated from people or physical assets. Accordingly, the fact that IP or trade secrets are “owned” by a subsidiary located in a particular jurisdiction will no longer mean, in and of itself, that meaningful profits would be recognized in that jurisdiction.

In this way, BEPS has effectively redefined the concept of “value creation” and the application of the arm’s-length standard to allocate profits among affiliated companies. Coupled with proposed changes to broaden tax nexus and increased substance standards to receive preferential tax treatment (e.g., “IP/patent box” regimes), these changes can have a major impact on the amount of taxes that multinationals have to pay and may render certain operating structures unsustainable going forward.

For example, under the new nexus (or “permanent establishment”) standards, a taxable presence can be found where local personnel have significant customer interaction and influence on sales orders. If a company in lower-taxed Ireland sells to customers in higher-taxed France, the new standard may cause the Irish company to be taxable in France and to start charging its customers French indirect taxes.

Considering a major move as the solution

At first glance, some multinationals may think BEPS boils down to one fundamental question: “In choosing the optimal operating model, how should we balance the deployment of scarce resources such as human and financial capital with the corporate tax rate?” In other words, should people and assets be deployed to lower-taxed jurisdictions to preserve historic tax rates, or should the company maintain the status quo and absorb the resulting increase in tax costs?

The answer, of course, is “it depends.” Some companies may consider moving, or building out, key workforce

and business operations in more attractive tax jurisdictions. Tax considerations alone will not drive this decision, but are often a key factor. Although the OECD's recommendations clamp down on countries handing out one-off "sweetheart" tax deals to attract foreign investment, countries are free to use their corporate tax rate as an incentive for new investment. For example, the United Kingdom is scheduled to reduce its corporate tax rate to 17 percent in April 2020, down from its current 20 percent rate. The United States is also likely to "get in the game" with proposals to reduce the current federal tax rate of 35 percent to 15 or 20 percent.

A major move might yield major tax savings, but these savings must be weighed against myriad other factors that affect where and how a company decides to operate its business.

Understanding value chain impact

BEPS will likely have the greatest impact on two types of companies:

Multinationals with highly integrated, end-to-end global supply chains: These are global companies that run the business through a web of suppliers located in many different countries. Typically this involves raw material sourcing, manufacturing and distribution spanning multiple countries in route to end customers also spread across multiple regions.

Multinationals with significant high-value intangibles: This includes global pharmaceutical, technology, and software conglomerates. These companies own valuable IP, such as patents and trademarks. These assets are more mobile than physical assets and may be located in favorable tax jurisdictions. Prior to BEPS, companies with mobile intangibles could set up subsidiaries that "owned" these intangibles in low tax countries and pay tax on profits there, while products and services were delivered to customers often located in higher-taxed countries.

Cases in point

To demonstrate the potential value chain impact of BEPS on these types of companies, consider three scenarios.

1 Multinational consumer goods company



Pre-BEPS:

A U.S.-based multinational consumer goods company sells its products to regional customers in the European Union (EU) through a regionally based principal company in the Netherlands. The company reports the majority of its EU profits in the Netherlands and enjoys a low effective tax rate on these profits because of a combination of available deductions or favorable tax rulings permitted under Netherlands law.



Under BEPS:

Because the majority of its EU workforce and assets are located outside the Netherlands, the company may have to report substantially more profits in some of the higher-taxed EU countries where it is making sales, thus neutralizing the tax benefits (though not necessarily the business efficiencies) of using a regionally based principal company. In addition, the company may be liable for collecting VAT/indirect tax on all of its sales in each EU country.



Bottom line

The company clearly has some big decisions to make about its business operations. Should it relocate key employees who are based in the United States and its larger European markets to the Netherlands? Or should it keep its people where they are, but pay more taxes in the EU? How much of the business would have to move to the Netherlands to support the existing tax structure? What is the impact of these choices on reputation, employees, and customers?

2

Multinational technology company



Pre-BEPS:

A U.S.-based multinational technology company reports a significant share of its foreign profits in a low-taxed jurisdiction. It does this by centralizing its patents in an intangible property holding company located in a favorable tax jurisdiction. Group companies pay the patent owner for the right to exploit those patents in the company's foreign markets.



Under BEPS:

Without associated "value creation" connected to people and assets, ownership of those patents will largely be disregarded in determining where the company reports its taxable profits. The company's profits will be shifted away from the location of the IP holding company to where its people and physical assets are located—that is, its significant markets and possibly even in the United States. As such, the company will be subject to higher tax rates.



Bottom line

The company will be challenged to assess its overall value chain and consider alternative operating models to balance its tax costs with other operational considerations relating to where to locate its value-creating activities. This might mean adding key decision-makers who oversee the company's global IP development activities in the location of the IP holding company. Alternatively, it could mean moving the location of its IP holding company to a jurisdiction that offers a more favorable balance of business climate and tax costs. And as we will discuss later, there is far more that goes into this equation.

3

Multinational consumer electronics company



Pre-BEPS:

A Singapore affiliate of a U.S.-based multinational technology company enlists a third-party contract manufacturer in China to produce the company's featured products. The Singapore company sells the products to affiliates in Europe at a substantial margin and is responsible for covering the costs of group companies supporting the supply chain. Singapore compensates its Chinese affiliate to oversee the contract manufacturer's activities. The China affiliate also qualifies raw material suppliers throughout Southeast Asia and negotiates pricing. The suppliers send the raw materials to the China manufacturer, which assembles the finished product and then passes it on to a third-party logistics provider in the Netherlands. Singapore compensates European affiliates for coordinating and managing the third-party logistics as well as operating a system of warehouses in the company's major European markets. These affiliates also play a significant role in the customer sales process.



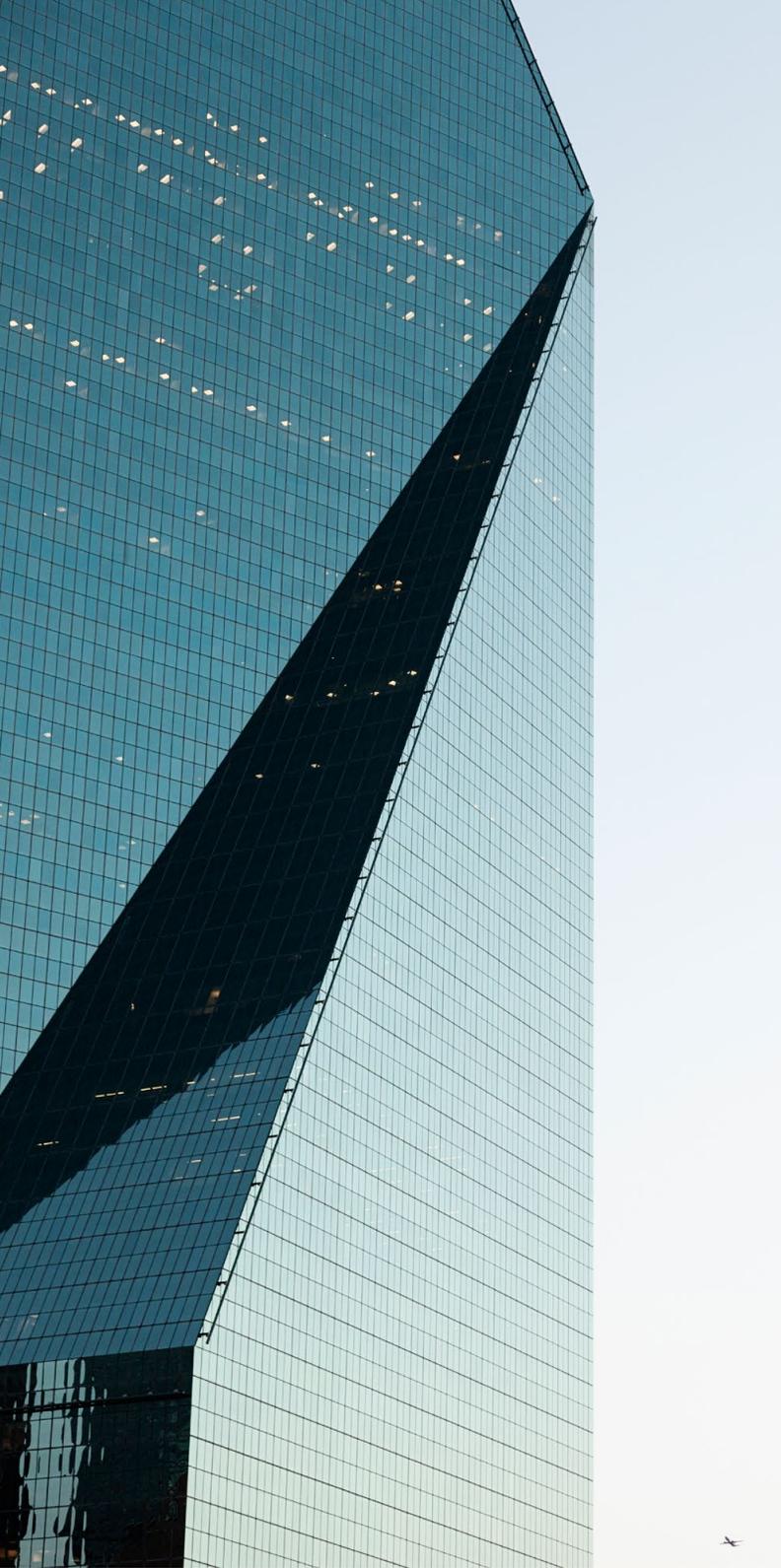
Under BEPS:

The company, which has substantive operations and workforce presence across the globe, is likely to owe more tax, and in more jurisdictions, than it did pre-BEPS where substantial profits were recognized in Singapore. BEPS reforms are geared to find more "value creation" in the locations where the company supports its global supply chain.



Bottom line

This company has perhaps the biggest challenge. It will likely have trouble satisfying the tax authorities in the various jurisdictions where it operates that it has appropriately reported its profits in the right jurisdictions. Countries are likely to disagree on where, and how much, value is created throughout the global value chain. This can lead to double taxation. Are there modifications to its supply chain that the company could consider to mitigate these risks—and perhaps even find an advantage over competitors? Possibly.



Other forces at play

Savvy executives know that BEPS isn't the only force causing multinationals to reevaluate how they structure and operate their business.

As we embark on the age of always-on consumerism, increasing demands for customization, an ever-increasing shift towards e-commerce, and expectations trending to same-day delivery, new demands are being placed on organizations to be nimble, cost efficient, and adaptable.

At the same time, the service economy and exponential advances in technology allow smaller, more digitally oriented competitors to enter the market with lower barriers to entry, while larger organizations continue to morph industry lines as more and more compete to become platform companies.

Organizations are taking important steps to cope with these evolving trends. For example, KPMG's Global Transformation Study found that 96 percent of organizations are in some phase of transformation. In order to meet these increasing transformation demands, in many cases new technologies and advanced analytics have had a particularly important role in the changing business landscape, including:

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Tracking U.S. tax reform

As they respond to BEPS, U.S.-based multinationals should also be keeping an eye on possible U.S. tax reform.

Although details are unclear, President Donald Trump and the Republican-led House of Representatives both support a consumption-based tax system, which is radically different than what has historically been in effect.

The President has also pledged to protect U.S. jobs by hitting U.S. businesses with some type of tax penalty if they manufacture products outside of the United States.

KPMG continuously tracks tax reform and other key political developments. To keep informed about the latest developments, check our Web site: www.kpmg.com/us/tax-reform



Big data

Data sets have grown exponentially over the past decade, in part because data is increasingly being gathered by pervasive and smart mobile devices, aerial sensors, software logs, cameras (CCTV or mobiles), microphones, radio-frequency identification (RFID) readers, wireless sensor networks, and other Internet of Things (IoT) devices. Availability of such very large and complex data sets enables advanced data analytics that can spot “new” correlations to support business decisions.



Advanced analytics

Advanced data analytics is a very broad category of inquiries that can be used to identify deficiencies and help drive changes and improvements to business processes and practices. While traditional analytics that comprise basic business intelligence (BI) examine historical data, tools for advanced analytics focus on future behavior patterns and events, allowing businesses to conduct “what-if” analyses to predict effects of potential modifications to business strategies.



Human-machine interfaces (HMIs)

HMIs are user interfaces in a manufacturing or process control system. HMIs can be anything ranging from a Programmable Logic Controller (PLC) with a touch display to control various processes, to augmented reality systems supported by robots. HMIs enable significant efficiencies, better troubleshooting and data collection, improved health and safety for personnel, and also help in significant cost reductions in the long run.



Digital-physical interactions

The advent of high-quality 3-D sensors, haptic sensors, 3-D printers, etc., have dramatically decreased time-to-market, logistics costs, lead times, and overall costs to deliver and serve. Such technologies are not only enabling existing business models, but also enabling highly disruptive business models.



Industry 4.0

Industry 4.0 generally refers to the idea of pulling these technological advances together to automate manufacturing technologies. In running these “smart factories” within a modular structure, cyber-physical systems monitor physical processes, create a virtual copy of the physical world, and make decentralized decisions. Over the Internet of Things, cyber-physical systems communicate and cooperate with each other and with humans in real time, and via the Internet of Services, both internal and cross-organizational services are offered and used by participants of the value chain.

Enabled by these and other new technological advances, companies are able to transform their operations from being linear supply chains to highly integrated supply networks supported by digital infrastructure and labor, wherein all aspects of the organization’s value chain operate in alignment with each other. In this environment, low-cost labor may become a lesser factor as investments in “factories of the future,” located near developers, become more desirable. This may require multinationals to change where they locate their operations, assets, and resources, with whom they partner, or even how they define their markets.

Value chain analysis and conversion

The implementation of OECD BEPS recommendations around the world is driving multinationals to consider redesigning their value chain to align with the new global standards. At the same time, there are similar pressures being driven by the changes in consumer expectations and technological advances being adopted to help meet those demands. Either way, there's no getting around it—realigning a company's value chain to adapt to these new realities is an incredibly complex undertaking with significant risks and rewards.

There is no one-size-fits-all approach, and there are many trade-offs to be made. But KPMG's Value Management practice has pinpointed four important factors for success:

1

Start with data insights

Before making strategic value chain changes, multinationals must understand exactly how BEPS, possible U.S. tax and trade reforms—and a wide variety of other factors—will affect the value chain. Companies need to be able to leverage sophisticated data analytics capabilities to gather disparate data—structured as well as unstructured—from across business units, suppliers, and multiple countries, and map it to the end-to-end supply of goods and services as well as the overall business organization. The data can help companies support where they believe value is created and why they report profits as they do.

Armed with a full grasp of the data, multinationals can enlist highly trained strategists and operational specialists to conduct scenario analyses, evaluating the impact of different business decisions across the value chain. This type of analysis is a strategic exercise that takes into account the “art of the possible” in business model design as well as the new global tax environment. This can give company leaders insight into the best way to do business based on the many factors impacting the value chain design—BEPS and otherwise.

2

Get the right stakeholders on board

Are the right people involved in making important decisions that may affect a company's operations, value chains, tax structure, and even location?

These decisions require a diversity of perspectives and know-how—not only people who understand the tax and trade issues, but also people who understand the high-level strategic issues in the industry. They also demand personnel with specific functional knowledge, such as IT, finance, operations, logistics, supplier management, procurement, and customer experience, among others.

All of these groups need to have a seat at the table and input in the final decisions.



3

Emphasize collaboration and communication

Are the right stakeholders within the organization talking to one another? Is there collaboration between key people who may never have talked to one another in the past, such as the head of supply chain and the head of tax? Are they coordinated with the C-Suite as they drive the company's strategy?

It is critical to encourage knowledge-sharing and develop synergy among stakeholders across internal organizational boundaries. A great first step is to share a common framework that explains the company's core values and how it applies to this initiative. This way, stakeholders have the same frame of reference and well-aligned goals before they tackle complicated evaluations of their operating model.

4

Integrate tax with the business

If tax is going to play a role in value chain alignment, it must be closely integrated with the business in two ways. First, in terms of ensuring the tax efficiency of an existing or new operating model, the new tax norms require a thorough understanding of the value chain and a transfer pricing methodology that allocates profits to where value is generated.

The second consideration comes in terms of structuring internal tax support for the new operating model. There are numerous ways to accomplish this, and each organization needs to determine which works best for the individual realities of their business. Some companies reorganize the tax department so it is vertically integrated into various business functions. For example, rather than having a tax controversy lead or a compliance lead, there is a tax lead who is responsible for cloud computing and another for technology solutions. In other companies, lines of business are each assigned a tax lead who is embedded in the tax department.

It is also becoming increasingly more common for tax leadership (VP of Tax) to work directly with operations leadership (VP of Global Supply Chain) to map out potential scenarios and considerations with the overall operating model.

Value Management at KPMG

KPMG's Value Management services help companies enhance their value and secure competitive advantage by achieving supply chain and operating model efficiencies. Our Value Management services are led by an integrated team of professionals from our Advisory and Tax practices with years of combined operations experience. Our Value Management Center of Excellence combines these cross-functional teams, technology, and process accelerators to help companies execute on growth opportunities, reduce cost and risk, enhance return on investment, and drive efficiencies across operations.

About the Authors



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