Advyce GmbH

How to tax-optimize your procurement

ImpulsLetter Q1

Abstract

Optimization of procurement costs has been a great savings generator since the early 90s. On their way to maturity in procurement excellence, organizations have optimized what to buy, where to buy and how to buy. However, we have noticed that even with mature clients the procurement savings through tax optimization remain mostly untapped. This is all the more interesting as for instance effective tax rates (ETR) differentials between highly industrialized and low-tax countries amount to more than 20%. The objective of this paper is to explain the reasons for this and to show a way to optimize the situation thoroughly.

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Procurement tax component not optimized today

With the professionalization of the procurement function main efforts are to optimize cost components and many organizations have done so successfully - with the remarkable exception of the tax component. Our experience shows four good reasons for that:

1. Tax costs are not only product related but depend also on the country, the selling and procuring organization are registered
2. Tax costs depend on the chosen legal and tax scheme from one single entrepreneur on the one side to multi-entrepreneur schemes on the other extreme
3. Operational business units do not have tax targets as optimization levers are bigger on corporate level
4. Tax is a major compliance issue for globally acting organizations and thus under direct control of the executive board, mainly the CFO

Complex savings potential calculation

Tax optimization in procurement is easy to imagine: if your supplier currently manufactures a finished good in China, your procurement organization operates in Germany and you sell it to France, the benefits will be generated in Germany with an ETR of around 30%. Moving your procurement department's operations closer to China, for instance to Hong-Kong, will allow your organization to generate the benefits there and profit form an ETR of 16,5%.

The immediate conclusion would be to transfer all procurement orders to a tax optimized country. The apparent savings potential then sums up to 20% as the effective taxation rate in highly industrialized European countries is close to 30% and main interesting international locations offer importantly lower taxation rates.

In reality savings potentials are lower as transforming a procurement organization for tax reasons is very challenging and risky:

- the cross-functional aspect (procurement, logistics and finance/tax) implies **high organizational complexity**
- **compliance risks are high**, for instance with corporate tax, internal transfer pricing and function shifting: Highly industrialized countries' tax authorities have put a major effort in controlling transfer pricing systems with the effect of lowering the benefits drastically. On top of that, these countries have also installed a "function shifting" taxation system which allows the authorities to tax the delocalization of a corporate function to a low-tax country.
- tax advantages can only be realized on **selected product categories** and not the whole procurement volume
- the **future operating costs** of building up a procurement function in a new location can be important and **balance initial savings:** Tomorrows salary levels, infrastructural costs and cost of living in location selected might be higher than today

Knowing the different challenges and based on our operational expertise, we recommend strongly to first run a business case analysis, align executive and supervisory boards and then only start execution.

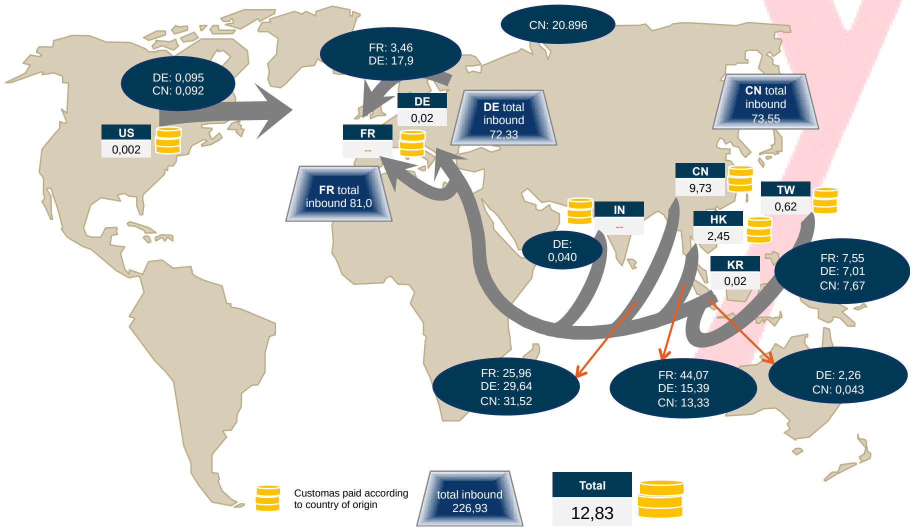
Country	Switzerland	Ireland	Luxembourg	Singapore	HongKong	...
Effective Tax Rate ETR	8.5%	12.5% for trading income	21%	17%	16,5%	...
Loss carry forward	7 years	indefinite	indefinite	indefinite	indefinite	...

Structured approach leads to sustainable savings

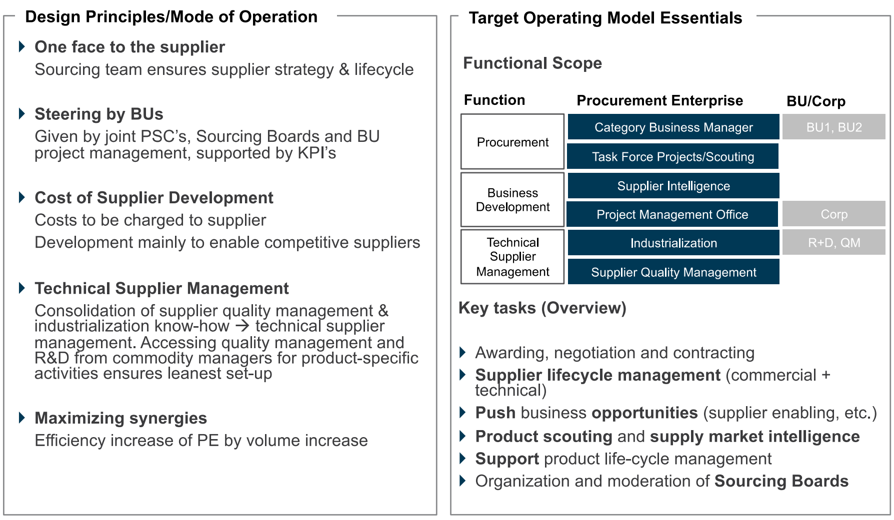
Pre-requisite 1: As the complexity of this cross-functional optimization approach is high, we strongly recommend to run such a project on executive board level. Pre-requisite 2: You will have to adapt your company's legal/tax organization and should definitely build a cross-functional team with finance/tax, procurement, logistics, external legal advisors and external consultants: only the alignment of all involved corporate functions plus the challenge trough the external expertise from the very beginning will lead to a sustainable success.

The main tasks to be executed in the business case are the following:

1. Analyze thoroughly your procured goods physical flows with the objective to build procurement category risk-classes for transferable procurement volumes. Focus especially on the value creation chain of your final products in order to illustrate your own organizational value add



2. Analyze your current operating procurement model for the addressable categories: current supplier footprints, current purchaser locations, current associated procurement functions (supplier quality management, etc.), procurement IT-systems availability



3. Assess your organizations current tax scheme between one single entrepreneur and multi-entrepreneur, integrate the current transfer price model used. Also integrate historical evolutions of this schema in order to address change risks with local authorities

Category	Method	Comments
Traditional transaction-based pricing methods	Comparable uncontrolled price method	Direct comparison of prices used in controlled transactions with those used in transactions between independent enterprises
	Resale price method	The gross level profit margin of controlled transactions is compared with those of transactions between independent enterprises
	CostPlus method	The gross level markup on cost of controlled transactions is compared with those of transactions between independent enterprises
Profit based methods	Transactional net margin method	The net profit levels of controlled transactions are compared with those of transactions between independent enterprises
	Profit split method	Profit generated by the controlled transaction is apportioned between the associated enterprises based on the arm's length principle

4. Run a location selection process in order to identify the best fitting country. Focus first on operational levers (proximity to supply base, availability of work-force, cost of operations, etc.) and then address potential tax advantages

Criteria	Weighting	Country	Weighting	Switzerland	Ireland	Luxembourg	Singapore	Hong Kong SAR	China
Tax system (incl. substance requirements and other tax criteria)	0%	Business (Income) Taxation, e.g. Corporate Income Tax ("CIT")	50%	5	4	2	3	3	2
		Witholding Taxes (WHT) on interest & dividends to non-resident companies (subject to reduction based on applicable DTT)	10%	3	3	4	5	5	4
		Utilization of negative income from a tax perspective, e.g. loss carry forwards	10%	4	4	5	5	5	3
		Tax parameters of OSRAM organization	10%	2	1	1	2	5	3
		Stability of the legal system	10%	5	5	5	4	4	3
		Double tax treaties (DTTs)	5%	5	5	5	5	3	5
		Agreements re exchange of information (EOI) / legal and administrative cooperation	5%	5	5	5	4	4	4
Loss carry forward	0%	Existing loss carry forward (yes/no)	100%	2	1	1	1	5	3
Reliability of tax system	0%	e.g: Tax on cost reduction in comparison to Germany etc.	100%	5	5	5	4	4	1
Costs	40%	Average salary procurement executive with degree (€ p.a.);	30%	1	3	2	4	4	5
		Salary increase risk	10%	5	5	4	3	3	1
		Average office space rent p.a.	30%	2	5	4	4	3	4
		Existing OSRAM office (yes/no)	10%	5	1	1	5	5	5
		Travel cost (1-5)	20%	3	3	3	4	5	5
Soft factors	50%	Time difference to CET (hrs.)	15%	5	5	5	3	3	3
		Availability of workforce	15%	4	5	3	4	4	3
		Distance to supplier base and OSRAM organisation	35%	3	3	3	4	5	5
		Distance to international airport with connection to OSRAM HQ and relevant suppliers	15%	5	1	1	5	5	5
		Language / Communication (1-5)	10%	4	5	4	5	5	3
		Cultural differences (1-5)	10%	5	5	5	4	4	2
Risks	10%	Political / legal / IP	33%	5	5	5	4	4	3
		Geographical	33%	5	5	5	5	5	5
		Currency	33%	5	5	5	4	4	4
		Weighted Score		3,52	3,79	3,31	4,08	4,22	4,07

5. Build scenarios based on cost advantages and associated operational and tax risks in order to find best fitting solution for your organization

Decision parameters

- Operational restructuring ongoing
- Tax situation: entrepreneur solution needs strong equity (revenues > 500 M€, risks associated)

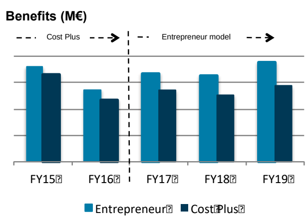
Recommendation

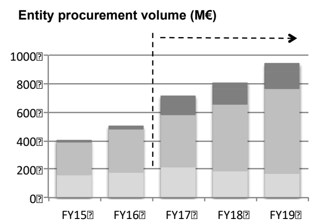
2-step approach

1. Finalize detailed TOM and ramp-up entity in parallel with 3 BUs in cost plus solution
2. Evaluate TP position 12 months ahead and consider change to entrepreneur solution

Benefits

- Start with Cost Plus secures major part of savings with lower risks
- High additional financial impact: XX M€ for FY15 (75% of XXM€ for ramp-up reasons), XXX M€ for the next five years
- Procurement efficiency increase from XX M€ to XX M€/ FTE (above benchmark)





Conclusion

As a conclusion, our project experience shows tax-optimized procurement leads to a saving up to 10% on addressable scope. It is definitely a board task and requires a high excellence in project execution.

At ADVYCE we want to set an example -

because our world has become more complex

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Technological expertise is of particular importance in a digital world. At **ADVYCE** it is an integral part of the consulting services ranging from business analytics tools to the evaluation of the legacy systems in order to permanently confirm the effectiveness of recommendations for the customer.

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