

# Is Supply Chain Management a mere Commercial Issue?

In today's highly competitive global marketplace, every enterprise strives to minimize costs and gain a strategic edge over competition. To achieve this, enterprises tend to focus more on operational factors of a supply chain such as transportation, inventory and logistics processes while overlooking the broader strategic aspects that can create long term values. For example, Apple assigning manufacturing of its iPhones to entities in other jurisdictions which can offer reduced costs and technical capabilities along with economies of scale. However, an important question arises; is operational optimization alone sufficient to secure sustainable competitive advantage?

This is where a deeper, more holistic view of supply chain management becomes crucial. The synergy between operational strategies and tax is immensely vital and this is where Tax Efficient Supply Chain Management (TESCM) becomes significant. It focuses on optimization of taxes via allocating business activities/ functions among different entities based in different countries. Having said that, at the same time it's important to keep TESCM out of tax evasion.

This article explores how TESCM can be carved within the legal framework, following Organization for Economic Co-operation and Development (OECD)/ Base Erosion and Profit Shifting (BEPS) guidelines to ensure that profit allocations and tax payments are transparent and supported by economic substance.

## Traditional Supply Chain Model

- Traditional supply chain model focuses on function specific risks and rewards. A clear understanding of this distinction can be seen by examining the illustration below.
- For instance, a manufacturing entity, A Co., produces goods and sell them to distributors, who distribute/ sells these products to customers across various markets. The risks associated with the same are also highlighted below.



### Manufacturer

- Inventory Risk
  - Quality & Warranty Risk
  - Intangibles
- Capital Investment
  - Pricing Risk
  - Volume Risk
  - Credit Risk

### Distributor

- Inventory Risk
  - Intangibles
  - Pricing Risk
  - Volume Risk
  - Credit Risk

### Customer

## Implications

- Under the traditional supply chain model, each legal entity within the chain assumes risk associated with its respective functions, and the profits generated by them are taxed according to the rules of its respective jurisdiction. Since tax rates and regulations differ widely between jurisdictions, this often results in a substantial cumulative tax burden for the main/ manufacturing company, and to mitigate this cumulative tax burden, TESCM framework becomes particularly relevant.

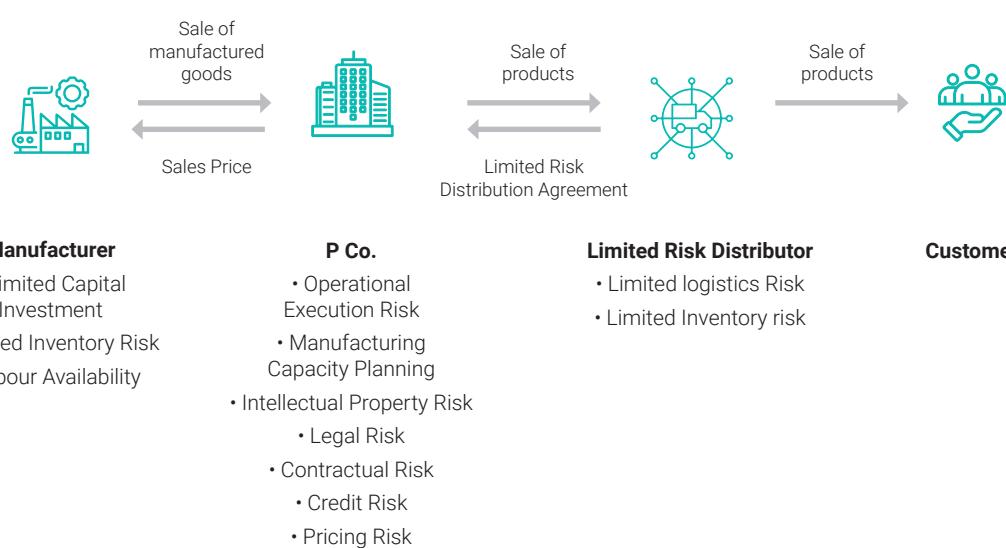
## TESCM - in brief

- TESCM considers tax as an integral part of the overall supply chain processes to optimize global effective rate of tax of an enterprise. The fundamental concept of TESCM is to establish a Principal Company (P Co.) in a low taxed jurisdiction and transfer appropriate amount of functions, assets and risk to such low taxed jurisdiction to justify the allocation of taxable profit and thus get benefit of lower tax rate of that respective jurisdiction.
- P Co. should be allocated more management control and business risks to be entitled to entrepreneurial profits while other operating companies perform limited functions with limited risks, receiving a relatively low profit share. Hence, the structure and allocation of value-adding functions and commercial risks between P Co. and other operating companies are critical in designing a tax-optimal model.

- By carefully designing supply chain frameworks, companies can save tax outflows. This enables enterprises to reduce their global tax liabilities. TESCM, thus plays a crucial role in improving an organization's competitive edge and maximizing value creation across its global operations.

## Tax-Efficient Supply Chain Model

- P Co. is established in a low-tax jurisdiction, and all the physical movement of goods are routed through P Co. only, who serves as a centralized hub, and manages key supply chain functions.
- Due to the centralization of key functions in one entity, P Co. is responsible for all functions, including manufacturing capacity planning, inventory ownership, and deployment with minimal/ limited risk to both the manufacturing and distributor entities.



## Implication

- Under TESCM model, other operating entities i.e., manufacturer and distributor, assume minimal risk and earn correspondingly low level of income that commensurate with their limited functions, assets and risks allocated to them. This allows P Co., to concentrate most of the group's profit at the level of P Co., who therefore retains substantially all the commercial risks.
- Most commercial risks of distributors such as market, inventory, and credit are transferred to P Co. in various ways as given below, so distributor earns only a small, stable arm's-length margin:
  - ✓ P Co. indemnifies bad debts (removes credit risk).
  - ✓ P Co. buys back unsold goods (removes inventory/ market risk).
  - ✓ Flash title or consignment stock keeps ownership with P Co. until sale (removes damage and slow-moving stock risk).

- Risks are transferred to P Co. through toll/contract manufacturing, consignment, buy-back guarantees, allowing the manufacturer to operate as a routine, low-risk entity with a stable arm's-length return.

One can argue that the aforesaid mechanism demonstrates profit shifting from the taxable countries to tax heavens/ low tax jurisdiction, however, the same can still be justified if P Co.'s functions, assets, and risks are aligned with the profits it earns and P Co builds on capacity to undertake additional functions and responsibilities by having sufficient actual capability to handle the changes in the supply structure. In other words, the structure would be acceptable if the supply chain is compliant with the guidelines as released by OECD/ BEPS Action Plan. In general, OECD/ BEPS does not bar tax optimization, it deters artificial profit shifting and tax erosion without substance.

Apropos, tax optimization within a business enterprise can be carried out in accordance with OECD/BEPS guidelines and frameworks and with commercial

substance. Considering the same, following factors can be considered:

**1. Alignment of profit with functions and risks** – As already discussed above, TESCM structure allows P Co., to assume most of the associated risks and profits via, effectively centralizing activities in a jurisdiction with favourable tax rates. Meanwhile, other entities within the supply chain operate under limited risk and profit thereby, minimizing their tax liability. Thus, it is important to highlight that all entities need to align their profits with their set of activities/functions. It should not result in a large share of profits to be parked in an entity based in low-tax country which has very few/ no employees and does not perform real operations and has no substance commercially. For this, following points needs to be considered:

- ✓ Does each entity have real employees, operations and assets?
- ✓ Do people in that location actually make decisions and have the capability to take on the additional responsibility?
- ✓ Alignment of value creation at each entity and their corresponding profits;
- ✓ Extremely high royalties or interest payments to tax heavens without adequate functions.

## **2. Aligning supply chain with the principles of**

**Permanent Establishment (PE)** - Merely establishing a P Co. does not exempt an organization from tax obligations in other jurisdictions. A tax efficient supply chain can still be risky if a PE of P Co. is constituted in another country. If PE of P Co. is created in another jurisdiction, the intent to achieve lower taxation through the principal entity will not succeed, as the establishment of a PE would trigger tax liabilities in that foreign jurisdiction. Therefore, it is crucial to structure the supply chain without triggering PE exposure, to ensure that the business model does not inadvertently create a taxable presence in another jurisdiction.

**3. Transfer Pricing** - Intra-group transactions to be conducted at arms-length along with supported documentation and comparable market data. Tax authority closely scrutinize the transfer pricing arrangements to prevent profit shifting. Filing of Master File and Country-by-country reporting (CbCR) is one such requirement to ensure transparency.

**4. Compliance with international standards i.e., OECD and BEPS** - These guidelines simply require entities to adapt their supply chain management to focus on real economic substance rather than shifting profits to low-tax jurisdictions. This means supply chains must be designed and managed around where value is created, aligning with BEPS goal of ensuring multinational corporations pay a fair share of tax in the countries where their economic activities occur.

## **Conclusion**

As BEPS measures continue to reshape the tax planning structures, TESCM seems a useful avenue for multinationals seeking both compliance and competitive advantage. It is not an exercise of exploiting loopholes in tax systems of a jurisdiction but about designing a global operating model that genuinely mirrors how a business functions in reality as per the commercial requirements. By prioritizing economic substance and aligning operations with global tax requirements, enterprises can reduce global tax burdens, mitigate transfer pricing risks, and move toward a more efficient and sustainable tax operating model.

Considering the complexity of existing jurisdictional environments, enterprise should engage experienced professionals to review their global tax and transfer pricing policies, which can help them to identify hidden risks, uncover operational and tax inefficiencies, and ensure alignment with today's rapidly evolving supply chain frameworks.

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