COVID-19 Global Response:
Manufacturing Industry Analysis

May 2020

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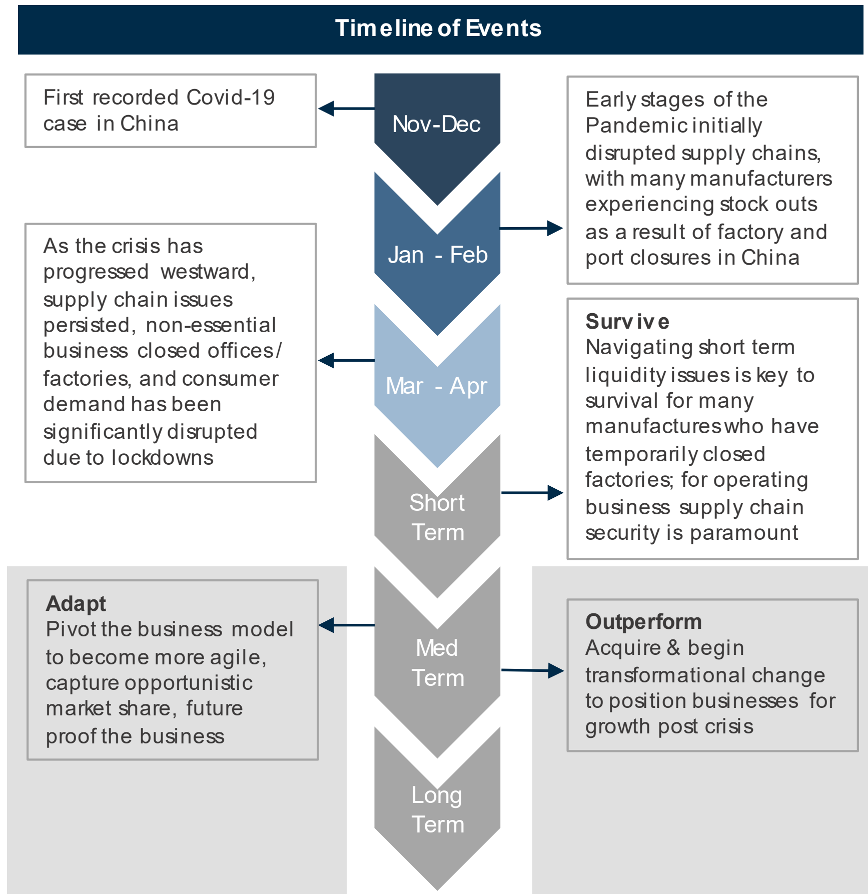
Scope of this Document

Despite the significant supply chain disruptions of the COVID-19 crisis, manufacturers have a unique opportunity to leverage global business support measures to adapt and position for long term growth and resiliency – we provide strategic guidance on these opportunities in this report. High level overview of the report contents below.



Key Issues in the Manufacturing Industry

Pressure to reduce dependency on China
Increased tariffs from US - China trade war were already prompting some companies to shift manufacturing from China to other jurisdictions (e.g. Go Pro's shift to Mexico, Hasbro's shift to US/Mexico/Vietnam/India, Aten's return home to Taiwan).[1] China's reduced production capacity following the global pandemic has pushed many other manufacturers to rethink their reliance on China.

Sharp Decline in Consumer Demand
Due to lockdowns as well as reduced pay/unemployment, consumers have reduced spending particularly around discretionary items. Businesses likely to reduce capital spending during recovery/transition periods as they look to rebuild cash reserves.

Pressure on Labor/Transit
Manufacturers are faced with many new hurdles insofar as producing and shipping products due to loss of air cargo capacity, marine port congestion, border closures and other movement restrictions.

Low Valuation Opportunities
Low valuations can present certain planning opportunities, the long term benefits of which may significantly outweigh the immediate cost. For example, rather than building out capacity organically, manufacturers may decide an M&A approach may better serve to achieve the desired diversification.

Reduced Cash Flow
Although a shift away from China (or other heavily affected region) may seem desirable on its face, manufacturers facing liquidity issues may struggle to have the near term ability to invest in new plants/operations elsewhere. These problems may be compounded by exit issues on the Chinese side (e.g. exit tax, tax on relocation of employees, liquidation issues, asset/IP transfer restrictions, etc.)

Uncertainty around Government Incentives to Domesticate Production
The optimal timing for supply chain shifts remains largely unknown as some countries (e.g. Japan)[2] unveil incentives to domesticate production while others have not yet released similar guidance or have focused incentives solely on specific industries (e.g. US government push to onshore production of semi-conductors and pharmaceuticals).

1.. Source: New York Times. 05 April 2019.
2. Source: Forbes. 10 April 2020

Critical Questions

- What IP do the entities in your structure have, is this IP transferrable from one jurisdiction to another from regulatory, commercial, and tax perspectives?
- How reliant is your supply chain on one jurisdiction or one supplier?
- Where are your R&D functions, are you currently availing of incentives in those jurisdictions? Can the R&D function be migrated?
- How impacted is the cost of your goods by the U.S.-China trade war tariffs or other customs charges?
- Is your production heavily reliant on experienced and skilled labor in your current manufacturing hub?
- What are the full and interquartile ranges for your cost-plus subsidiaries?
- Do your intercompany agreements have force majeure clauses?
- Where do you currently have losses? Where do you expect to incur losses due to COVID-19?
- What is the company's current debt profile? Would your board entertain more debt?

What is your action plan?

Short Term: Survive

- Map current supply chain, identifying value of IP owned by the Group, R&D functions in various jurisdictions, and intercompany flows.
- Identify potential migration options and hurdles.
- Develop initial strategy to shift or diversify supply chain based on policy shifts, commercial needs and consumer patterns (either organically or through strategic acquisitions).
- Generate current liquidity by applying for forgivable loans, temporarily reducing or suspending the markup on service fees paid to cost-plus subsidiaries and driving income tax reductions/losses through accounting and TP adjustments.

Medium Term: Adapt

- Model the global tax impact under various structuring scenarios:
  - Evaluate potential new operating model by jurisdiction.
  - Focus on lower cost hub jurisdictions in IP planning.
  - Consider tax implications for the restructuring as well as the tax implications post-restructuring (e.g. any withholding tax or U.S. BEAT implications of intercompany flows).
  - Consider any government incentives to domesticate to parent company jurisdiction (e.g. U.S. bonus depreciation and export incentive regime (FDII)).
  - Evaluate the role of digital communication and other technology (artificial intelligence, cloud, etc.) in your supply chain, aligning with operations and balancing with digital tax concerns.

Long Term: Outperform

- Make go versus no go decision on restructuring weighing tax and commercial benefits with other factors including landed costs, depth of experience, maturity of manufacturing and supply chain in current model, innovation etc.
- If “no-go”, seek alternatives to complete overhaul including:
  - Revisit transfer pricing model and consider re-defining the functions of the local business with the objective to reduce overall tax costs.
  - Fully explore and utilize tax benefits or incentives or local financial subsidies in the existing jurisdiction.
  - Relocate or re-invest parts of the business to/ in investment-welcomed and tax-appealing areas. For example:
    - Might transshipping from China through Vietnam manage tariff exposure?
    - Might a warehouse location in Mexico or Puerto Rico be preferable to serve US based customers and benefit from free trade agreements (e.g. USMCA)?
    - Can one critical piece of manufacturing process be moved to another jurisdiction (e.g. Dominican Republic) so that the origin of a product is sourced elsewhere?
- If “go”, conduct due diligence from the perspectives of tax, legal, employees, financial and statutory compliance and confirm if there are any outstanding matters which need to be settled before restructuring including:
  - Settle intercompany balances and historical liabilities in a tax efficient manner.
  - Manage the termination / transfer of labor and business contracts without creating disputes and social stability issues and in a tax efficient manner.
  - Understand and confirm the exit tax on business closure and transfer of goods, assets and/or IP.
    - Consider lowering the transaction value to reasonably reduce tax leakage.
    - Explore availability of intra-group restructuring relief to defer tax payment and ease cash flow.
  - Plan for transfer pricing issues on charging of IP fees post-restructuring.

Why A&M Taxand

A&M Taxand's international tax specialists have extensive expertise uncovering planning opportunities and acting as a trusted advisor to generate value for manufacturing companies. Our breadth of experience with both inbound and outbound supply chains positions us well to advise on the continuously changing tax and commercial landscape.

Our seasoned team of specialists are available to share more information on all business support measures and their impact by jurisdiction around the globe. Contact any of the professionals below for information on first response considerations by country.

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