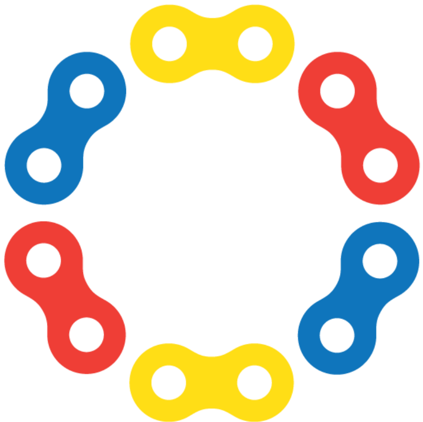
TPA Global



Value Chain Analysis -

The BEPS Generation of Functional Analysis

I. Introduction

The value chain for any firm links value-creating processes and activities. It refers to the entire performance process of a company, which begins with the research and development and ends with the delivery to the end consumer. While a function and risk analysis is geared to individual group companies, a value chain analysis applies on cross-company processes within the Group.

Companies always have and will continue to view the world and their competitive environment in a unique manner, have their own mission, vision, ambition and corporate objectives and define their own unique competitive advantages.

Due to this, there is no objective method to conduct a value chain analysis. Hence, the basic approach to be followed for any value chain analysis should start with identifying the industry-wide value chain and mapping the value linkages of the MNE within the industry. A value contribution analysis should contain evidence as to what prices, cost premiums, margins, etc. are, in light of the economic contributions the individual companies, considered reasonable.

In simplest terms, mapping the industry value chain requires identifying and separating the value creating activities of an MNE. Such separation could, for example be made, if:

- There is (or could be) an external market for the product or source of an MNE’s activity
- The activity represents a significant percentage of operating costs for the MNE
- The activity is performed by competitors of the MNE in different ways
- The activity has a high potential for creating distinctiveness

II. Why analyse a full value chain and failure of existing approaches

Transfer pricing methods have allowed MNEs to determine the intercompany compensation to each group entity by looking at the functions performed, risk assumed and assets employed since the inception of the OECD TP Guidelines in 1995. However, with the BEPS publications in 2015, the OECD is of the view that some of the approaches developed over the years do not provide a holistic view of allocation of margins/profit across the MNE Group i.e. the allocation of profit is often not aligned with the ‘people functions’ responsible for such profit creation.

With an intention of overcoming the extensive tax avoidance/evasion resulting from such mismatches, the following standard TP approaches/ methodology are now deemed as unusable/questionable:

- One-sided benchmarks that do not lead to a holistic analysis of all parties involved in the intercompany transaction;
- IP structures/entities without “people functions” claiming royalty from other group companies by acting as a legal owner of intangibles while no active value creation happens in such structures/entities; This can also be seen in the case of Contract R&D providers owning IP (and drawing royalties in respect of such IP) without absorbing “IP related costs”;

- Commissionaires structures with "significant people functions" contributing highly to the profit earned by the Group but drawing only a limited and fixed return;
- Geographically fragmented "people functions" involved in IP management and IP risk management leading to disputes regarding the actual place of value creation.

Thus, a value chain analysis is required to fully align the corporate governance framework, operating model and the tax/TP structure of an MNE. Any discrepancies in such alignment will trigger not only an additional tax liability (along with a penalty and interest) but also potential criminal charges.

III. Regulatory background associated with value Chain Analysis

OECD References

As a part of its 'Strategy on Development', adopted by the OECD Council at Ministerial level in May 2012, the OECD has embraced the concept of Global Value Chains (GVCs) and most recently, in the Base Erosion & Profit Shifting (BEPS) Report on Actions 8-10, published in October 2015 and the subsequent Discussion Draft on Revised Guidance on Profit Splits, published in July 2016, the OECD has further emphasized on the concept of GVCs and on carrying out a holistic value chain analysis.

BEPS Report on Actions 8-10:

The over-arching objective of the BEPS Actions 8-10 is to ensure that transfer pricing outcomes are in line with economic value creation. However, as each case is dependent upon its own facts and circumstances and the arrangements within the group, such an objective is to be achieved by accurately delineating the actual transaction and pricing it in accordance with the most appropriate method. This information is also to be included as part of the master file in support of a taxpayer's analysis of its transfer pricing, and will provide useful context in which the commercial or financial relations between members of the MNE group can be considered.

Discussion Draft on Revised Guidance on Profit Splits:

The purpose of the value chain analysis is to identify the features of the commercial or financial relations between the parties to determine an appropriate profit splitting factor. A value chain analysis should consider where and how value is created in the business operations, including weighing of the economically significant functions, assets and risks as well as people functions responsible for such functions, assets and risks, an impact of the economic circumstances that may create opportunities to capture profits in excess of what the market would otherwise allow, and whether such value-creation is sustainable, for instance, whether market advantages are protected due to barriers to entry to potential competitors or the impact of valuable intangibles.

Guidance from the Chinese Tax Authorities

Value chain analysis was introduced by the China SAT on 29 June 2016 in Notice 42, which stipulates the inclusion of flows of business, goods and materials, and capitals within the group, including design, development, manufacturing, marketing, sales, delivery, billing and payment, consumption, after-sale service, recycling, other processes related to goods, services or other relevant underlying targets of the related party transactions and all the parties involved in the TP local file. This should also be coupled with annual financial statements of each of the aforementioned parties for the immediately preceding fiscal year, measurement and attribution of value creation contributed by location specific factors and allocation policies and actual allocation results of the group's profits in the global value chain.

Guidance from the German Tax Authorities

The notification issued by the Federal Ministry of Finance in Germany in April 2005 states that the value added contribution of the taxpayer is often not visible in a function and risk analysis in a TP or other associated documentation. Therefore, the taxpayer must submit a description of the relevant value chain within its legal and actual opportunities in order to determine the value proportion of the individual companies in the total value of the Group.

IV. Is there a burning requirement for Value Chain Analysis?

YES!

This is because of the following key reasons:

- BEPS = Full tax transparency;
- BEPS = a merger of residence of "taxable income" with the residence of "people functions" responsible for generating it;
- BEPS feeds "greed at the level of tax authorities", i.e. the wide and/or different interpretations by different countries' tax authorities of the BEPS/TP guidance can trigger even more than double taxation on the same profits;
- BEPS has already triggered some tax authorities to:
    - Open the hunting season for aggressive tax structuring(s). For example, the Australian Tax Office; and
    - Request a full value chain disclosure in TP local country files and CbC reporting. For example, the Chinese Tax Authorities.

This means that the only way an MNE can defend its current tax/ TP structure is through:

- Full transparency on tax sensitive data;
- Complete disclosure of their value chain;
- Syncing its corporate governance, operating model and tax/TP structure in the same way as syncing its economic, legal and financial realities.

Our services

TPA Global has been conducting value chain analyses for over 10 years, assisting corporates in:

1. allocating appropriate segments of income to each group entity;
2. identifying and implementing actions on key value drivers to improve their operating margin;
3. identifying a breakdown of 'value creating' activities so that the management board understands which of their activities 'make the clock tick'.

The BEPS Project is now mandating the use of value chain analysis and its inclusion in TP documentation to achieve (1), (2) and (3) above.

With over 1000 professionals trained in value chain analyses, TPA Global is one of the world leaders in offering industry-specific value chain solutions!

Contact

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About Us

TPA Global provides international businesses with integrated and value-added solutions in improving financial performance, operational efficiency, strategic development and talent coaching through a cross-border and cross-discipline team of professionals which identifies the right solutions for customers and targets; efficient and streamlined advisory and implementation processes which cut through operational complexities across functions and borders; and superior customer service and support which proactively anticipate the evolving needs of the clients.