

Value Chain Analysis – The Bridge between Operating, Governance and Tax/TP Models of an MNE

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Speakers



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Agenda

- ❖ Basics of value chain analysis
- ❖ Techniques of conducting value chain analysis
- ❖ Case studies
 - ❖ Pharmaceutical Industry
 - ❖ Insurance Industry
 - ❖ Toys and Games industry
- ❖ Aligning Masterfiles, Local Files, CbCR and Tax Returns
- ❖ Tax Corporate Governance and value chain analysis
- ❖ Local/domestic regulations on value chain analysis
- ❖ Appendices

Basics of Value chain analysis

Value Chain Analysis: Definition

- The **entire performance process of a company**, which begins with the research and development and ends with the delivery to the end consumer.
- There is no objective method to conduct a value chain analysis.
- Each VCA should **start with identifying the value chain within the industry**.
- Mapping “value creation” requires identifying and separating the value creating activities of an MNE. Examples:
 - There is (or could be) an external market
 - Activity represents a significant percentage of operating costs
 - The activity is creating distinctiveness
 - The activity is performed by competitors in different ways
- Value chain linkages should contain evidence in the relevant context. E.g.: prices, margins, etc. are considered as reasonable.

VCA: 3 different perspectives

Strategy context

What are the key factors driving the strategy of a company, which can be accomplished by observing the key trends in the industry, the focus and trends of the market forces, key factors of growth of competitors etc.

Corporate Operating and Governance Model Context

Next, based on an analysis of the external market references as well as financial performance of the company, it should be determined how the company operates as well as how key decision makers influence these value drivers.

BEPS Context

Based upon the above, the functions performed in the company can be given a weight/score and depending on this weight/score, the remuneration for each of the "people function" should be determined.

Why is VCA required in today's scenario?

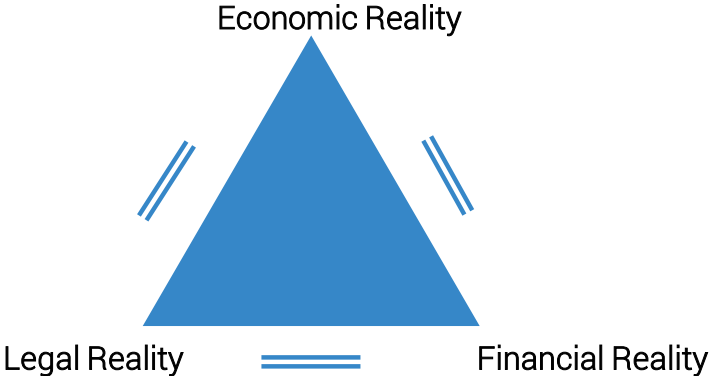
As per the **BEPS publications in 2015**, the OECD is of the view that some of the transfer pricing approaches developed over the years no longer provide a holistic view of allocation of margins/ profit across an MNE Group, i.e. the **allocation of profit is often not aligned with the 'people functions' responsible for such profit creation.**

The following are now questionable in light of VCA analysis under BEPS:

- ❖ One-sided benchmarks (\neq holistic analysis)
- ❖ IP-structures that do not absorb any costs
- ❖ Commissionaire structures drawing disproportionate limited and fixed return
- ❖ Geographically fragmented IP structures

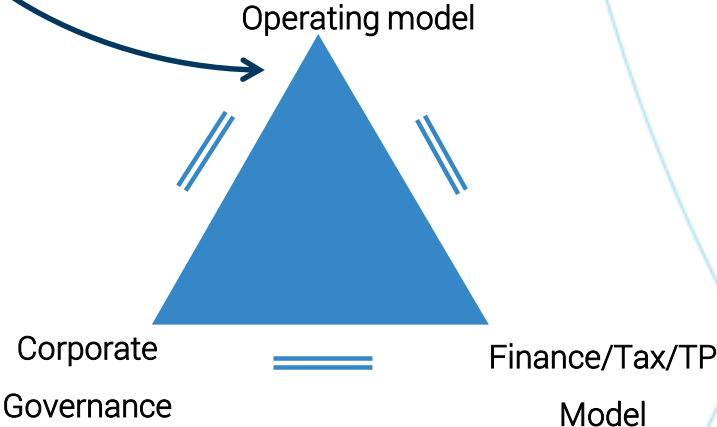
VCA: The BEPS Generation of Functional Analysis

Pre BEPS Functional Analysis



Move from
Pre to Post
BEPS

Post BEPS Value Chain Analysis



Source: TPA Global

Value chain analysis – Techniques & Case Studies

VCA: 3 different techniques

Technique 1

Alignment Between Sales, gross Margin, Operating Margin and FTEs

Technique 1 is applicable to MNEs with simplistic value chains where calculation of various ratios such as sales, gross margin and FTEs within a local entity versus the whole group can help visualize the retention of value within the MNE

Technique 2

Porter's approach to value chain

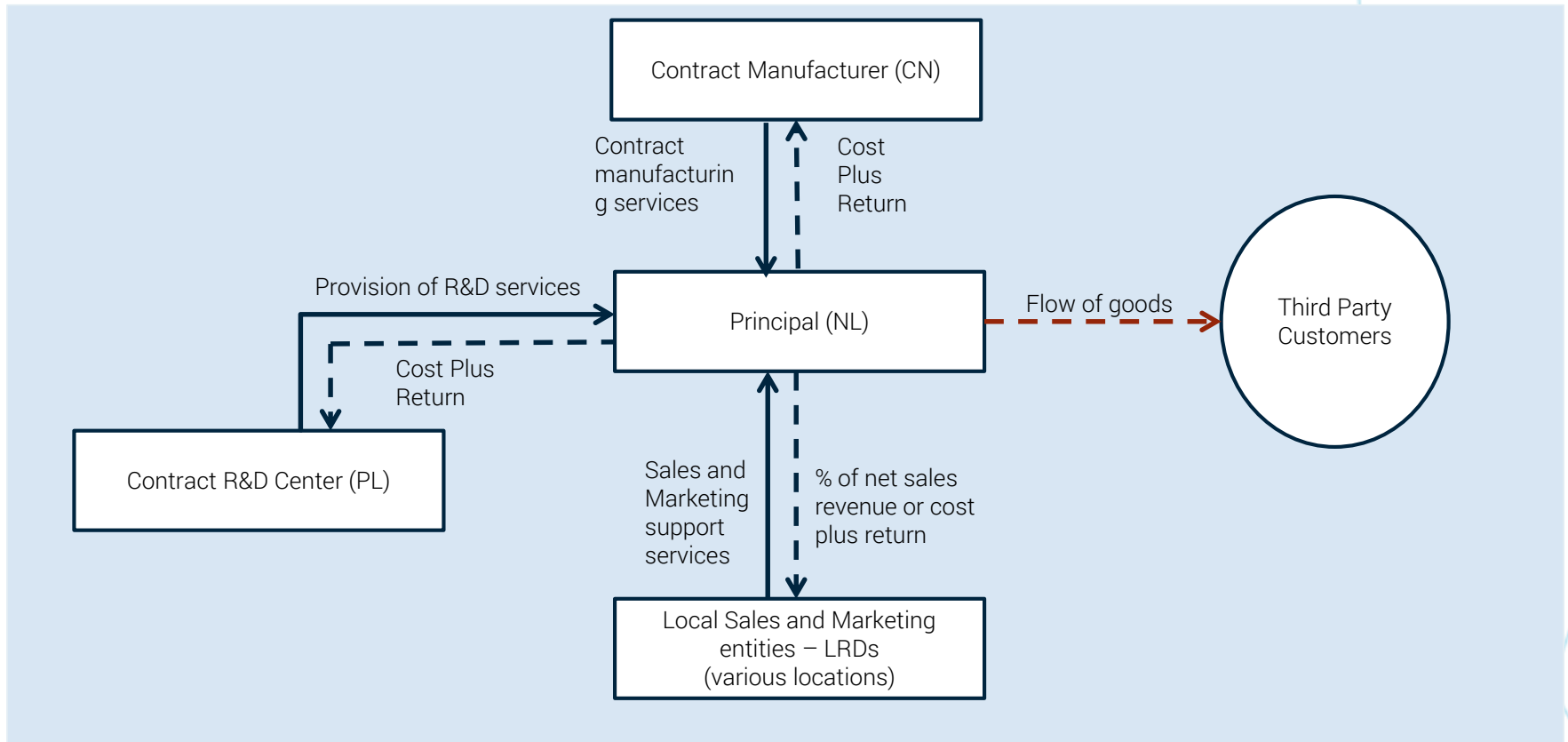
Technique 2 is applicable to MNEs with operations that bear a low degree of integration with each other, thereby making it difficult to identify the contribution of each individual entity. Hence, this technique allows for allocation of remuneration per functional category.

Technique 3

Process Contribution Analysis

Technique 3 is applicable to MNEs with highly complex and integrated operations that require involvement of multiple group entities in each function. This technique allows for identifying value creating process within the MNE and the relative contribution made to such processes by group entities.

Case Study for Technique 1: Value Chain of a Pharmaceutical Company



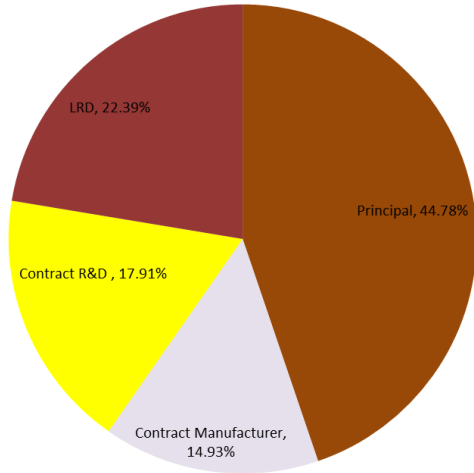
→ Intercompany Services

- - → Return for Intercompany Services

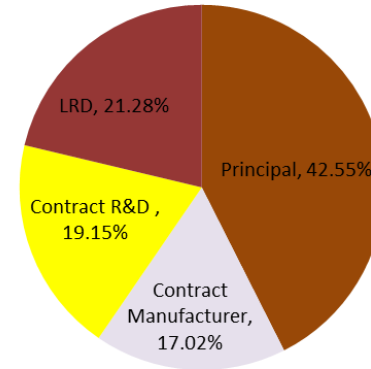
- - → Third party transactions

Case Study for Technique 1: Value Chain of a Pharmaceutical Company

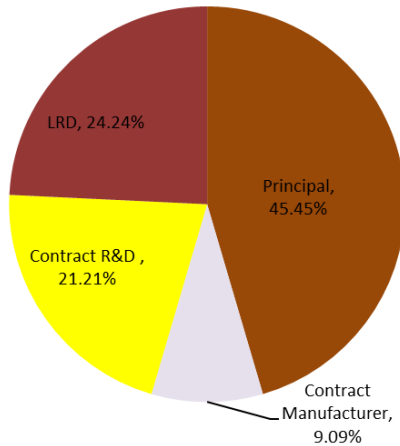
Revenue to Total Group Revenue



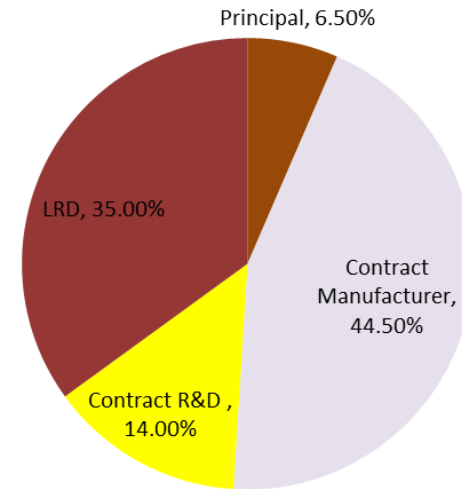
GM to Total Group Gross Margin



OM to Total Group Operating Margin



FTEs to Total Group FTEs



Case Study for Technique 2: Value Chain of an Insurance Company



Responsibility profile*	Investment centre	Investment centre	Investment centre	Revenue centre	Revenue centre	Profit centre	Cost centre	Revenue centre
Type of Return	Residual	Residual	Residual	% of sales or cost plus	% of sales or cost plus	Residual	Cost Plus	% of sales or cost plus

*Responsibility center profile is identified on the basis of functional analysis interviews, number of FTEs, type of functions performed and risks assumed.

After providing cost plus or mark-up on sales returns to relevant group entities, residual needs to be divided between:

- Investment centre (“IC”) that performs 100% DEMPE functions on intangibles
- Profit centre (“PC”) that performs 100% match-making on all open positions (except intangibles)

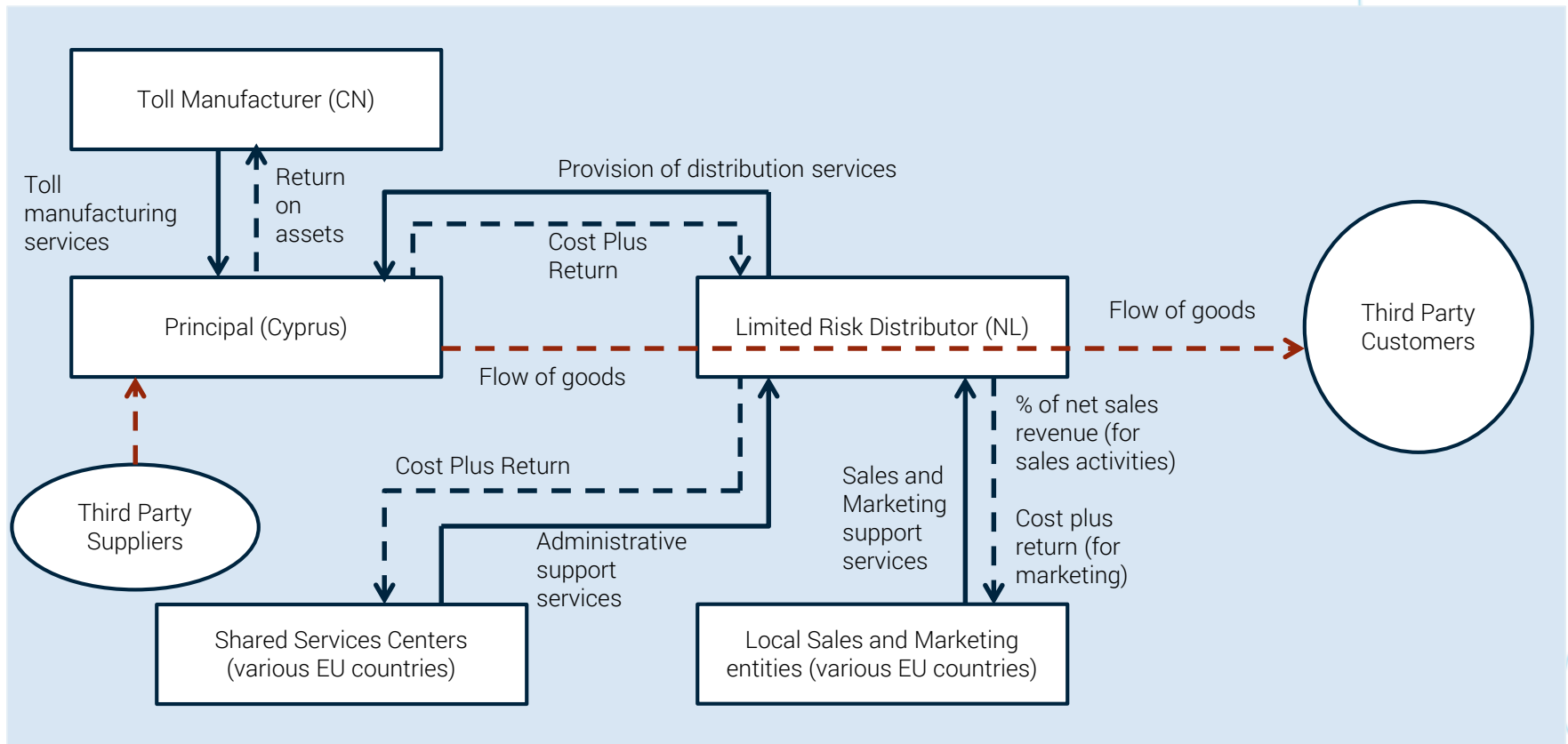
The following slides provide a mechanism for such allocation.

Case Study for Technique 2: Value Chain of an Insurance Company

Model			1. Relevant industry-wide EBIT	
			2. Less = EBIT portion to compensate "routine functions" in MNE	
			Results = EBIT available for performing investment + profit center roles in MNE = residual profit	
			3. Industry-specific royalty rate %	4. Less = OPEX portion to run DEMPE functions and absorb DEMPE risks in MNE

Royalty as % of sales	Total EBIT as % of sales	1	2	3	4	5	6	7	8	9	10
	IC+PC portion	0,75	1,5	2,25	3	3,75	4,5	5,25	6	6,75	7,5
	IC portion	Residual IC/PC	IC/PC	IC/PC	IC/PC	IC/PC	IC/PC	IC/PC	IC/PC	IC/PC	IC/PC
1	0,5	0,5/0,25	0,5/1	0,5/1,75	0,5/2,5	0,5/3,25	0,5/4	0,5/4,75	0,5/5,5	0,5/6,25	0,5/7
2	1	n.a.	1/0,5	1/1,25	1/2	1/2,75	1/3,5	1/4,25	1/5	1/5,75	1/6,5
3	1,5	n.a.	1,5/0	1,5/0,75	1,5/1,5	1,5/2,25	1,5/3	1,5/3,75	1,5/4,5	1,5/5,25	1,5/6
4	2	n.a.	n.a.	2/0,25	2/1	2/1,75	2/2,5	2/3,25	2/4	2/4,75	2/5,5
5	2,5	n.a.	n.a.	n.a.	2,5/0,5	2,5/1,25	2,5/2	2,5/2,75	2,5/3,5	2,5/4,25	2,5/5
6	3	n.a.	n.a.	n.a.	0	3/0,75	3/1,5	3/2,25	3/3	3/3,75	3/4,5
7	3,5	n.a.	n.a.	n.a.	n.a.	3,5/0,25	3,5/1	3,5/1,75	3,5/2,5	3,5/3,25	3,5/4
8	4	n.a.	n.a.	n.a.	n.a.	n.a.	4/0,5	4/1,25	4/2	4/2,75	4/3,5
9	4,5	n.a.	n.a.	n.a.	n.a.	n.a.	4,5/0	4,5/0,75	4,5/1,5	4,5/2,25	4,5/3
10	5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5/0,25	5/1	5/1,75	5/2,5

Case Study for Technique 3: Value Chain of a Toys and Games Manufacturer



Intercompany Services
 Return for Intercompany Services
 Third party transactions

Case Study for Technique 3: Value Chain of a Toys and Games Manufacturer

Functions / Functional Units within the Group	IP Development & Management	Supply Chain	Sales & Marketing	Legal	Finance
Total Number of FTEs in each function	900	400	2000	16	70
Total Number of significant people functions	15	4	8	1	1

#	Key Processes	#	Sub-process					
1	Management of Portfolio of IP	1a	Design / License to Build	X	x		x	
		1b	Licensed Brand Partner Relationship Management	X				
2	Management of Supply Chain	2a	Supply Chain Management		X			
		2b	Manufacturing Resource Planning		X	x	x	
3	Commercial Execution	3a	Financial Management / Order to Cash			X		X
		3b	Customer Engagement & Relationship Management			X	x	

Legend	
X	High Involvement
x	Low/ Limited involvement

Total Number of significant people functions at the level of Principal	0.8	1	2.5	0.5	0.2
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Conclusion	Less than 50% of significant people functions are located at the level of the Principal Entity
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Value chain analysis – Removing misalignments

Applicability of VCA: Alignment of Master file, CbCR and Tax Return

Master file

Contains a “blue print” of the MNE group:
(i) the MNE group’s organizational structure;
(ii) a description of the MNE business(es)
(iii) the MNE; intangibles
(iv) the MNEs intercompany financial transactions;
(v) the MNEs financial and tax position.

CbCR

Contains key elements of the financial statements by jurisdiction, providing local tax authorities visibility to revenue, income, tax paid and accrued, employment, capital, retained earnings, tangible assets and activities.

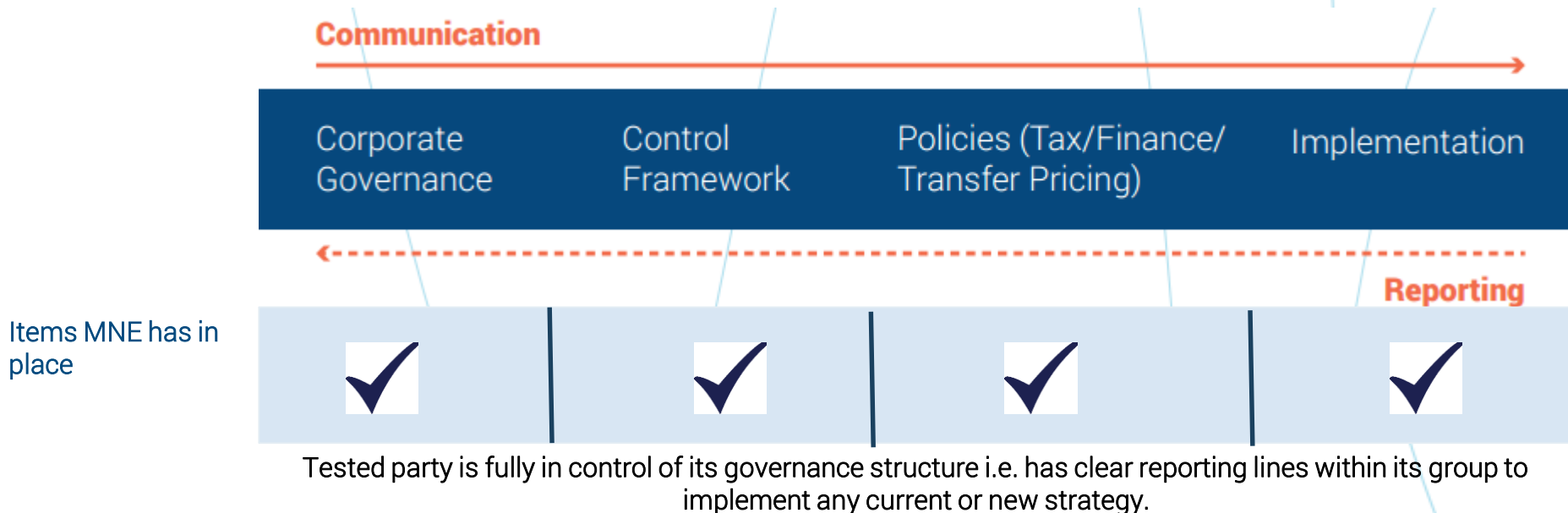
Tax Return

Contains information regarding only the local entity disclosed for local corporate tax filing obligations, including its intercompany transactions with other entities in the group.

← THE MISMATCHES CAN NOW BE ALIGNED USING VCA →

Tax Corporate Governance & Value chain analysis

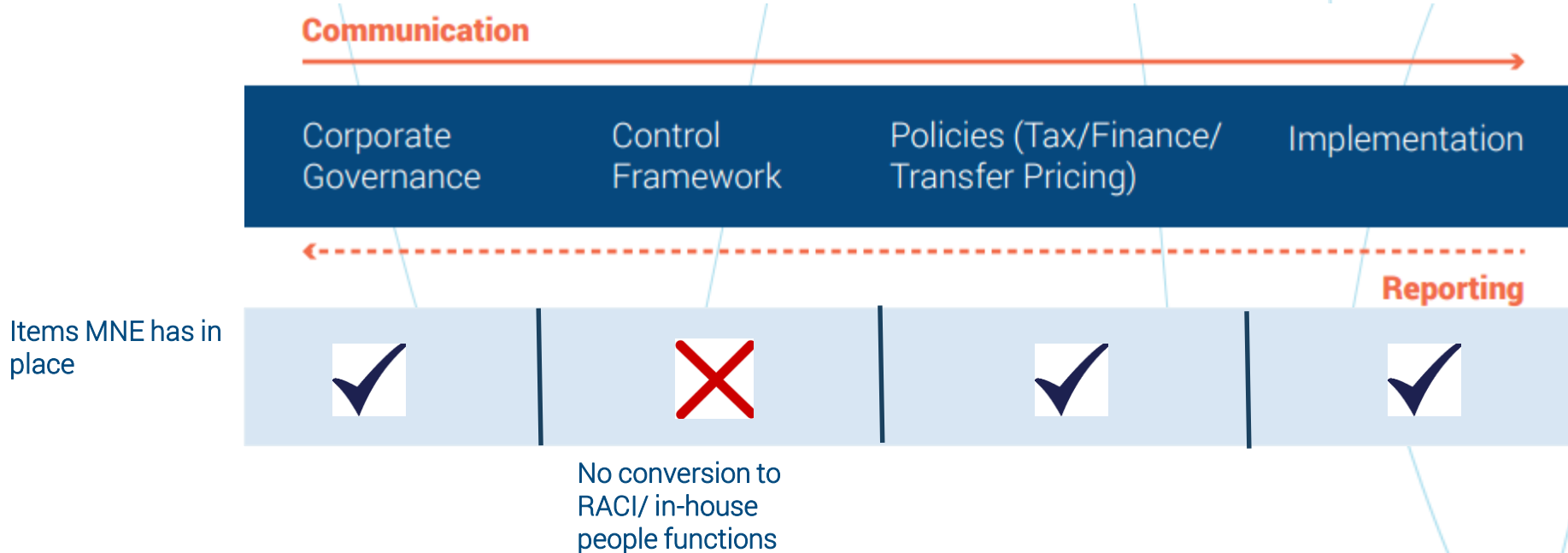
Generic Governance Model including Tax



Key Messages:

- ❖ Corporate governance models
- ❖ Liability issues of boards
- ❖ Corporate governance beyond tax matters

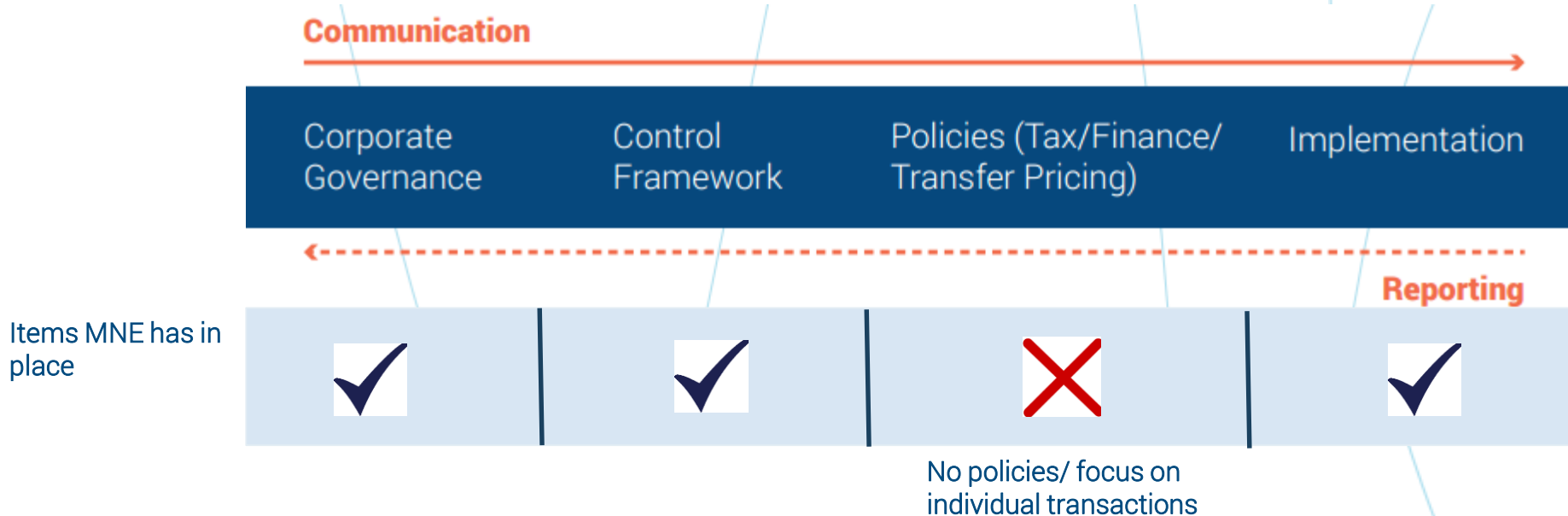
Governance Models for tax in Practice (1)



Points of discussion:

- ❖ What happens if no clear division of roles and responsibilities are defined on operational and tax matters?
- ❖ Who signs off on the CbCr and tax returns?
- ❖ Who is responsible for a “Value Chain Analysis” in China?

Governance Models for tax in Practice (2)

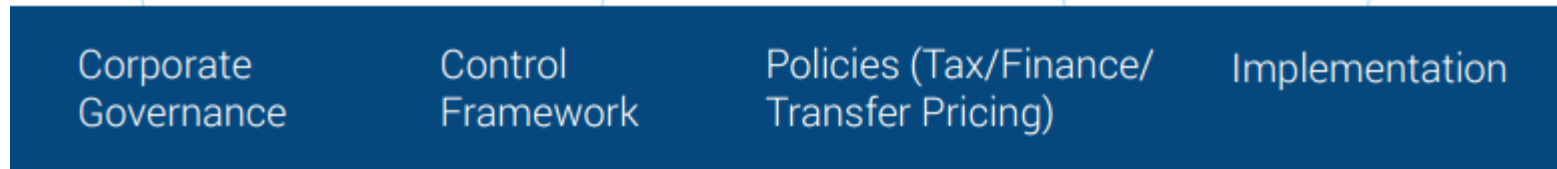


Points of discussion:

- ❖ What happens if your TP documentation captures each individual intercompany transaction (operational perspective only), while no written TP policies exist?
- ❖ What additional purposes does a TP policy serve?
- ❖ Is a value chain analysis published in your 'corporate social responsibility' document setting a clear policy standard?

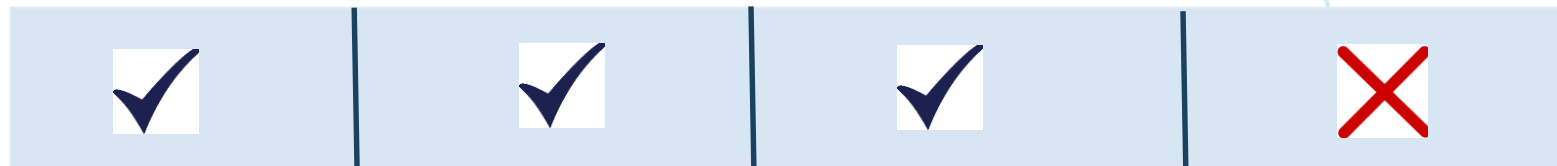
Governance Models for tax in Practice (3)

Communication



Reporting

Items MNE has in place



No financials on individual transactions to test against policies

Points of discussion:

- ❖ What is the impact if your TP documentation only supports your TP policy papers, while:
 - No financials are available on intercompany transactions; or
 - Your financials are not measured against your TP policies; or
 - Your financials tell a different story than your TP policy.

Value chain analysis – Local Regulatory Guidance

VCA in China

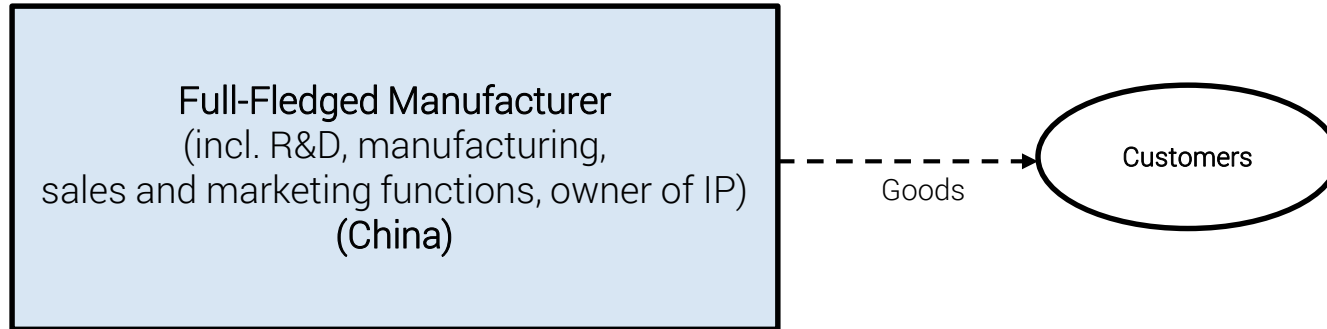
Source: Public Notice Regarding Refining the Reporting of Related Party Transactions and Administration of Transfer Pricing Documentation (SAT Public Notice [2016] No. 42, dated 29 June, 2016)

- New requirements on TP disclosure/documentation including:
 1. 22 related party transaction forms (including Country-by-country reporting forms.
 2. TP documentation (incl. Master File, Local File and Transactional Specific Documentation).
- Value chain analysis is newly added and requested to be included in the local file only.
- Notice 42 on value chain analysis stipulates the inclusion of the following into the local file:
 1. 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.
 2. Annual financial statements of each of the aforementioned parties for the immediately preceding fiscal year.
 3. Measurement and attribution of value creation contributed by location specific factors.
 4. Allocation policies and actual allocation results of the group's profits in the global value chain.

Relevance: This guidance provided by the Chinese tax authorities compels the MNEs to conduct a value chain analysis while preparing their tax/TP documentation in order to not be challenged by the tax authorities at the very outset.

Value Chain Analysis in China

- Before restructuring

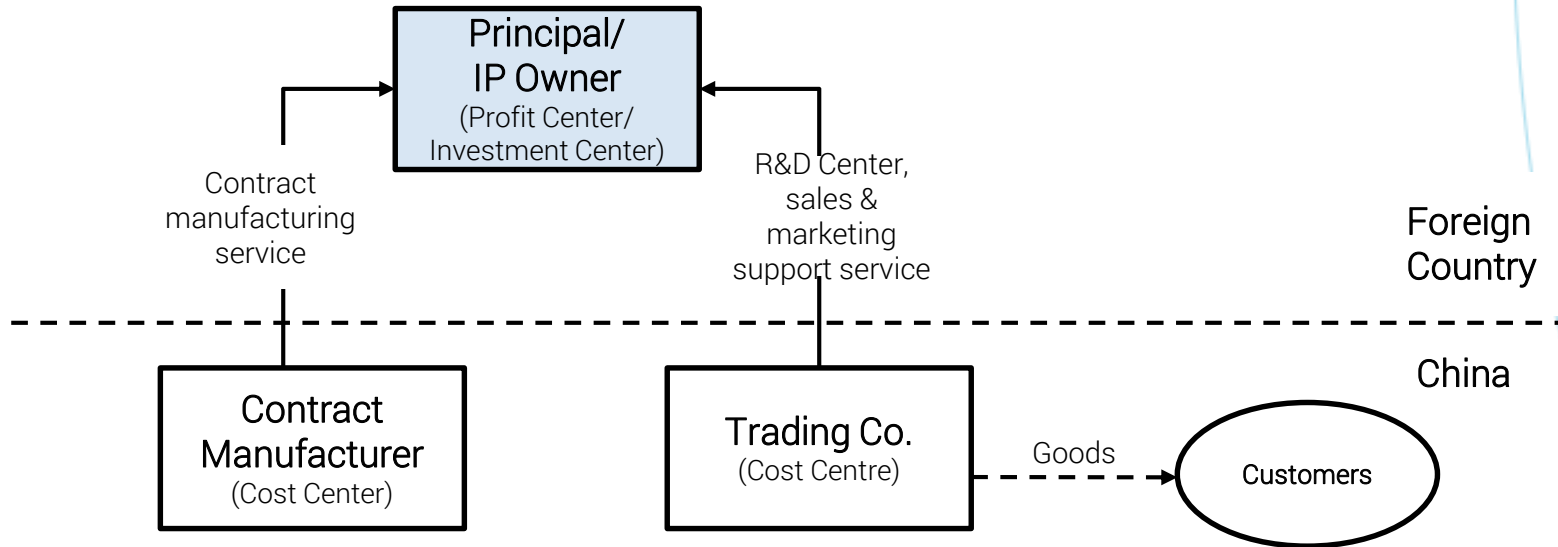


- Position in the global value chain

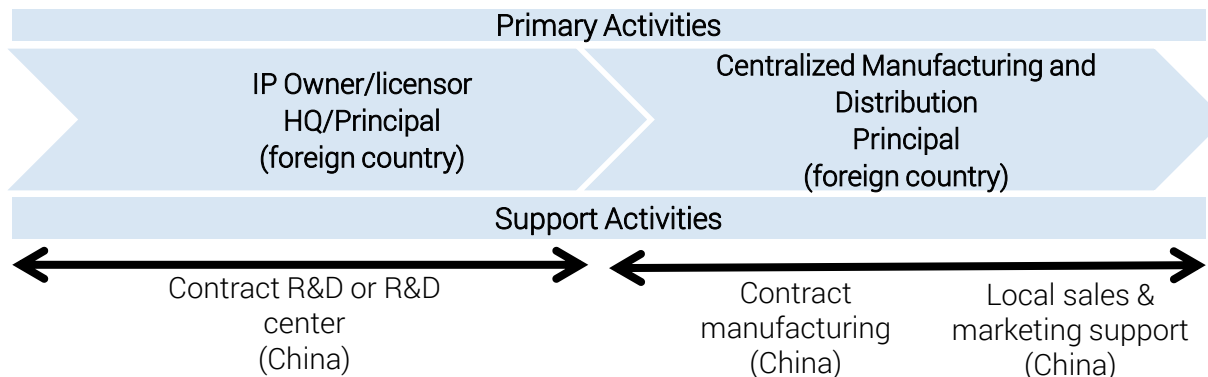


Value Chain Analysis in China (...continued)

- After restructuring



- Position in the global value chain



VCA in Germany

Source: Ministry of Finance Notification, April 2005

- While a function and risk analysis is geared to individual group companies, a Value Chain analysis applies regularly on **cross-company processes within the Group**. A value contribution analysis contains evidence as to what prices, cost premiums, margins, etc. are, in light of the economic contributions the individual companies, considered reasonable.
- The **economic contributions includes the results of all activities** associated with the manufacturing of products and the provision of services where an immediate connection can be made to the products/services received by the end customer (for example, purchasing, production, storage, delivery of Products, service delivery, marketing, sales and customer service).
- The **supporting activities** carried out within the group to manufacture products or provide services to customers **are also included in such economic contribution** (for example, Research and development, procurement management, human resources, communications, Business management and organization, accounting, Financing).
 - ❖ The following approach should be used to carry out a complete value chain analysis:
 - ❖ Firstly, the individual business processes for value creation within the Group must be identified;
 - ❖ Subsequently, the relative weighting of individual business processes to the whole value chain must be determined,
 - ❖ Lastly, an analysis should be made of the contribution of the respective Group company to the individual business processes.

Relevance: The value added contribution of the taxpayer is often not visible in a function and risk analysis in a TP or other associated documentation. If this is not the case, the taxpayer must submit a description of the relevant value chain within its legal and actual opportunities.

Value Chain Analysis in Germany

1) German requirements (Guidelines 2005)

- Identification of material value drivers
- Valuation of material value drivers
- Allocation of material value drivers

2) VCA perspectives

- By industry - i.e. what triggers value creation?
- By company – i.e. what F/R/A + "people functions" trigger value creation?

3) Individual value contribution

Market price

<Input + mark-up>

Value contribution per group entity

4) Process based approach

- Identification of business processes
- Weighting of individual primary processes
- Analysis of individual value contributions by functional department and/or legal entity
- Relative weights to overall value contributions of the relevant parties involved

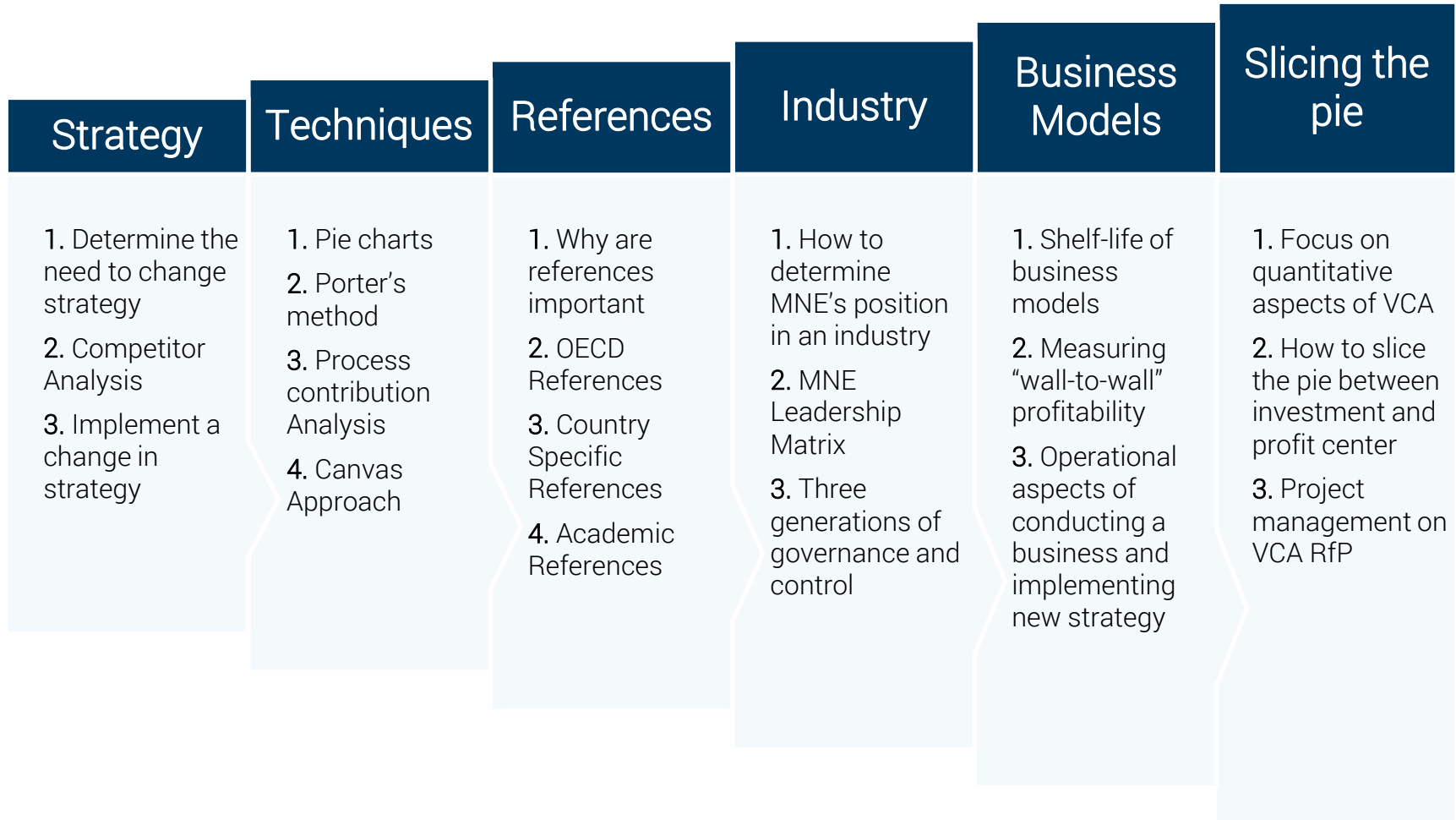
5) Advantages of a VCA

- Economic and process driver approach
- High stability and flexibility
- No external data necessary

6) Application and practical experience

Appendices

TPA's Service Offerings on VCA



In-house Coaching and Training

1. Introduction to VCA

- What is strategy?
- What is value chain analysis (VCA)?
- Why is VCA required today?
- What are VCA techniques?

2. References

- Why are references important?
- Academic references
- OECD references
- Country specific references

3. VCA and industry trends

- How to read industry trends and profitability?
- VCA/leadership matrix
- Differentiating the 3 generations of corporations in control
- Operational aspects of running a VCA

4. Quantification

- How to quantify a sliced value chain?
- Techniques to determine value creation and contribution

A course on 'Value Chain Analysis' organised by TPA/ e-bright, to be launched in Spring 2017



Source: Report of the OECD titled “IMPLICATIONS OF GLOBAL VALUE CHAINS FOR TRADE, INVESTMENT, DEVELOPMENT AND JOBS OECD, WTO, UNCTAD “, Prepared for G 20 summit, 6 August 2013

- International production, trade and investments are increasingly organised within so-called global value chains (GVCs) where the different stages of the production process are located across different countries. Globalisation motivates companies to restructure their operations internationally through outsourcing and offshoring of activities.
- Firms try to optimise their production processes by locating the various stages across different sites. The past decades have witnessed a strong trend towards the international dispersion of value chain activities such as design, production, marketing, distribution, etc.
- This emergence of GVCs challenges conventional wisdom on how we look at economic globalisation and in particular, the policies that we develop around it.
- Therefore, 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 has created a global, country-led knowledge sharing platform for policy dialogue on GVCs, Production Transformation and Development.
- This Platform was set up in May 2013 with an intention to:
 - identify new measures and indicators to analyse participation to GVCs and the development impact;
 - obtain new evidence on policy conditions for successful participation and upgrading in GVCs;
 - improve understanding of the determinants of participation in GVCs;
 - develop concrete policy recommendations on how to increase impact of strategies and policy tools to promote participation and upgrading in GVCs.

Relevance: Value chains have become a dominant feature of the world economy, involving countries at all levels of development, from the poorest to the most advanced. The production of goods and services is increasingly carried out wherever the necessary skills and materials are available at competitive cost and quality. Thus, a need was felt to develop an understanding of the same.

Source: BEPS Report on Actions 8-10, published in October 2015

- This guidance ensures that pricing methods will allocate profits to the most important economic activities. It will no longer be possible to allocate the synergistic benefits of operating as a group to members other than the ones contributing to such synergistic benefits. For example, discounts that are generated because of the volume of goods ordered by a combination of group companies will need to be allocated to these group companies.
- However, each case is dependent upon its own facts and circumstances and the arrangements within the group. For example, in a decentralised group, the parent company may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in a centralised or integrated group, the board of directors and senior management of the parent company may make important decisions concerning the affairs of its subsidiaries, and the parent company may support the implementation of these decisions by performing general and administrative activities for its subsidiaries as well as operational activities such as treasury management, marketing, and supply chain management.
- Therefore, in particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

Source: BEPS Report on Actions 8-10, published in October 2015

- The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates (e.g. mining, pharmaceutical, luxury goods) and of the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed.
- In cases involving the use or transfer of intangibles, it is especially important to ground the functional analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain. Where necessary, the analysis should consider whether independent parties would have entered into the arrangement and if so, the conditions that would have been agreed.
- The over-arching objective of the BEPS Actions 8-10 is to ensure that transfer pricing outcomes are in line with economic value creation. Such an objective is achieved by accurately delineating the actual transaction and pricing it in accordance with the most appropriate method. The latest discussion draft of July 2016 provides more specific guidance in this respect.
- This information is likely to be included as part of the master file in support of a taxpayer's analysis of its transfer pricing, and provides useful context in which the commercial or financial relations between members of the MNE group can be considered.

Relevance: The guidance provided by the BEPS Action Plans 8 – 10 ensure a clear delineation of economically relevant functions and risks the actors within an enterprise responsible for their performance. This separation is then to be used as a basis for splitting profit of the enterprise.

Source: Discussion Draft on Revised Guidance on Profit Splits, published in July 2016

- All business operations can be expressed through a value chain and many MNE groups operate through a global value chain. This alone does not imply that the transactional profit split should be applied.
- The determination of an appropriate profit splitting factor should reflect the key value drivers in relation to the transaction.
- The value chain analysis may be helpful in the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used.
- A value chain analysis should consider where and how value is created in the business operations, including in particular:
 - ❖ consideration of the economically significant functions, assets and risks, which party or parties perform the functions, contribute the assets and assume the risks, as well as whether and how the functions, assets, and risks of the parties may be interdependent or otherwise interlinked;
 - ❖ how the economic circumstances may create opportunities to capture profits in excess of what the market would otherwise allow, such as those associated with unique intangibles, first mover advantages, or other unique contributions;
 - ❖ In considering where and how value is created, the analysis should also consider 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.

Relevance: The analysis accepts that although most business operations undertaken by an MNE group are integrated to some degree, a high degree of integration means that there is more likely to be a case of parallel integration by the associated enterprises in the value chain, rather than sequential integration. In such case where each party shares economically significant risks, a transactional profit split may be found to be the most appropriate method for splitting the profit.



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