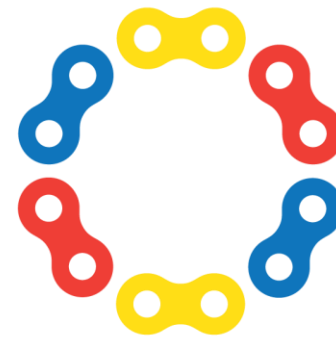


# Value Chain Analysis - How To Take In Control Of The New Generation Of TP Documentation Requirements (BEPS Action 13)

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# Contents

- What is value chain analysis (VCA)?
- Why is a VCA required now?
- OECD Reference
- Chinese Reference
- Value Chain by Porter
- Background for carrying out the value chain analysis
- VCA techniques
- Impact of not conducting a VCA analysis/ Conclusion
- Questions

# What is value chain analysis (VCA)?

- It refers to the entire performance process of a company.
- It commences from the stage of research and development till its completion with the delivery to the end consumer.
- It requires identifying and separating the value creating activities of an MNE.
- It should contain evidence as to what prices, cost premiums, margins, etc. are, in light of the economic contributions of the individual companies, considered as reasonable.

# Why is a VCA required now?

- As per the BEPS publications in 2015, the OECD is of the view that some of the approaches developed in the past 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.
- In light of the same, 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;
  - 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.

# OECD REFERENCES

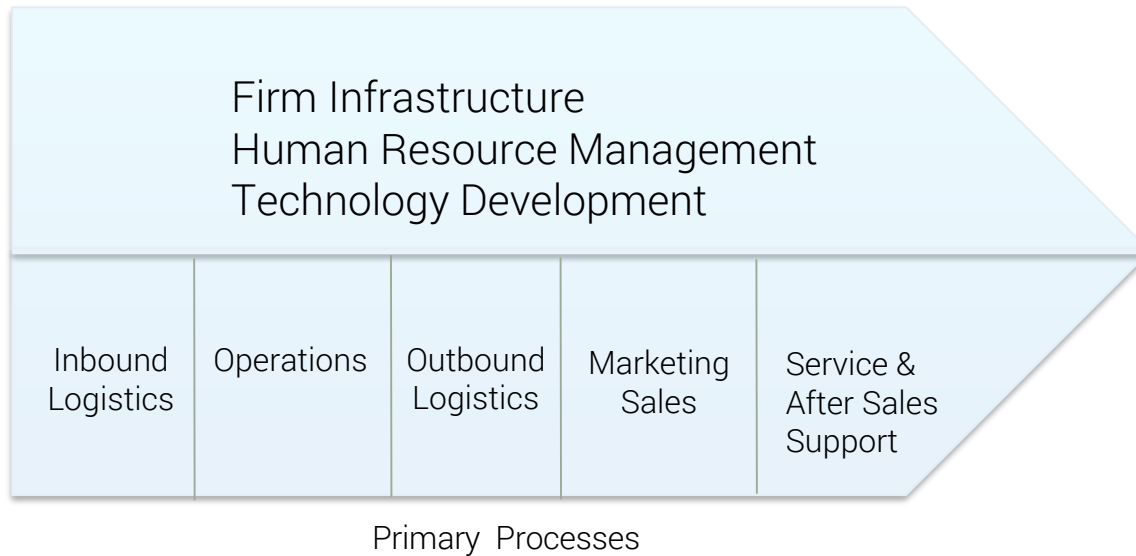
- As a part of its 'Strategy on Development', adopted by the OECD Council at Ministerial level in May 2012, the OECD has embraced the concept of Global Value Chains (GVCs).
- In the recent BEPS Report on Actions 8-10, published in October 2015 and the subsequent Discussion Draft on Revised Guidance on 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.

# Chinese Reference

- China SAT has introduced value chain analysis on 29 June 2016 in Notice 42.
- It 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.

# Value Chain by Porter

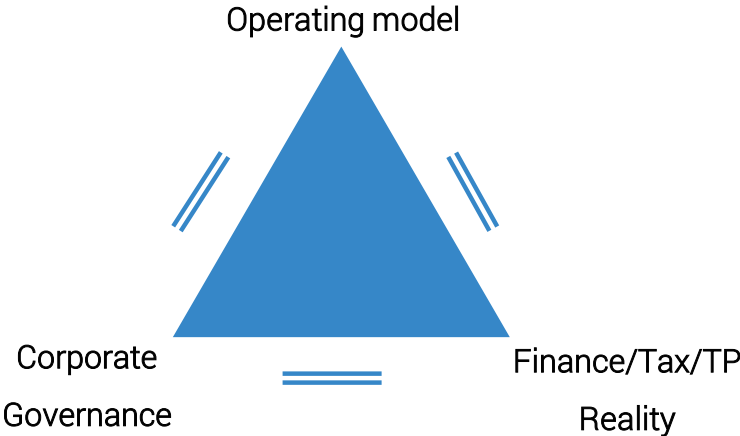
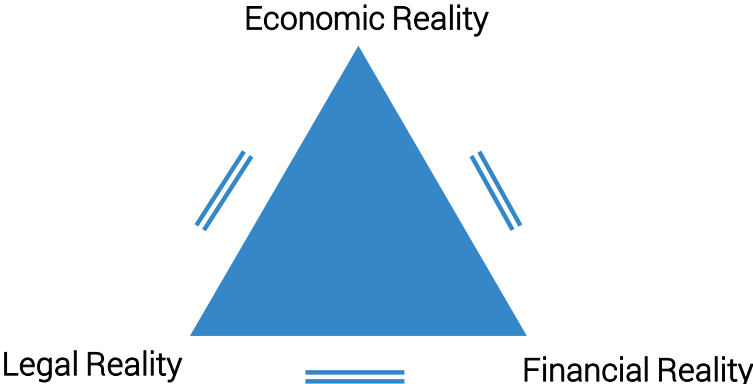
The traditional view of the value chain was developed by Michael Porter:



Traditional view is predominantly focused on internal processes, similar to current concept of supply chain management

# Background for carrying out the value chain analysis

Initial alignment of business model & TP model

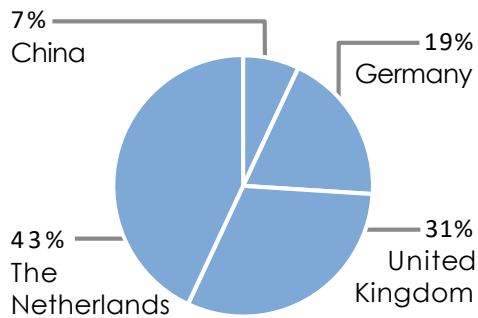




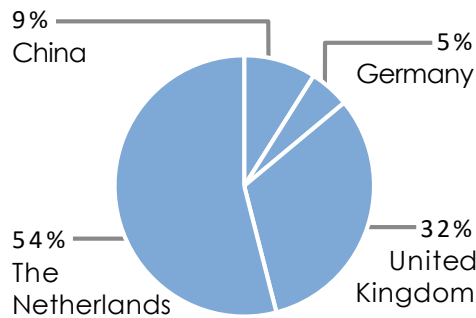
# VCA techniques

## Technique 1: Alignment Between Operating Margin, Sales and FTEs

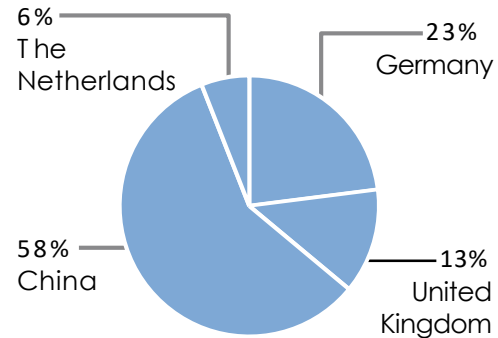
Operating Margin (OM) Ratio  
Country OM to Total Group OM



Sales Ratio  
Country Sales to Total Group Sales



Full Time Employee (FTE) Ratio  
Country FTEs to Total Group FTEs



Misalignment is visible when expressed as the ratio of country and total group for operating margin, sales and FTEs. The higher the delta, the greater the need to provide explanations to the Tax authorities.

# VCA technique 1- Example

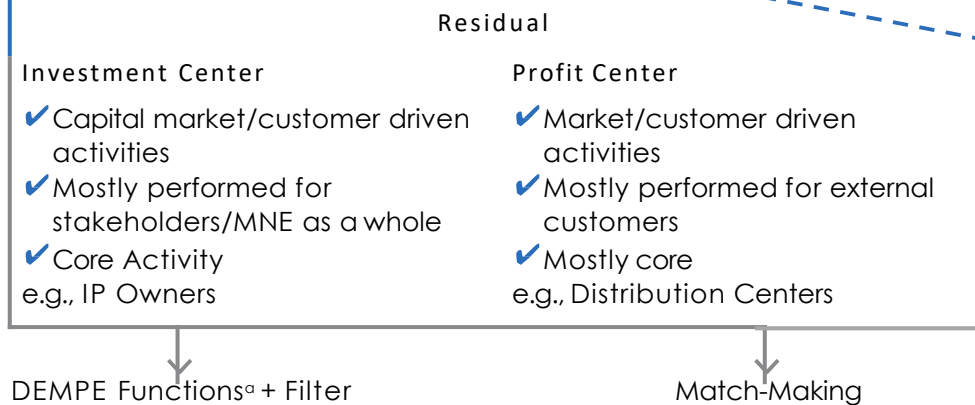
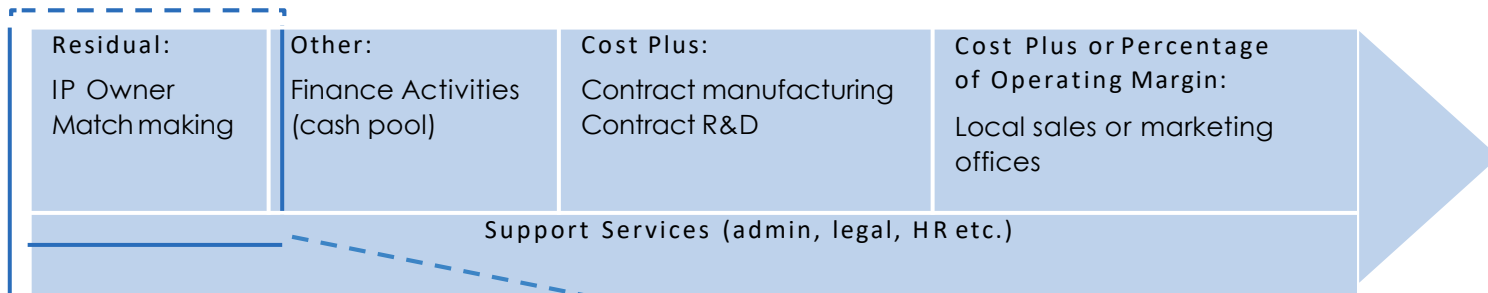
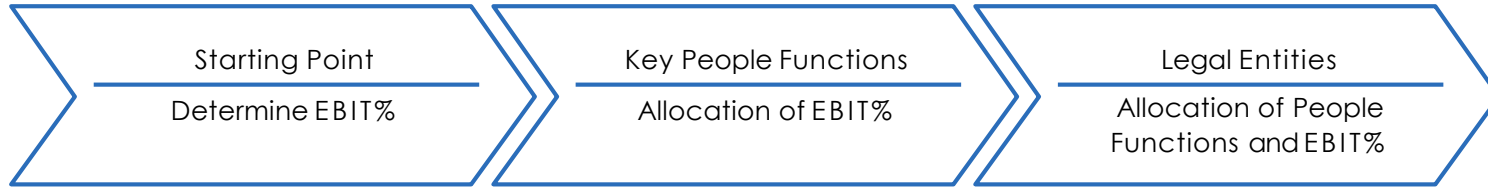
An example of conducting a value chain analysis based on technique 1 is presented below:

It can be seen from the pie charts that only 6% of FTEs reside in the Netherlands who contribute 54% of Sales and 43% of Operating Margin, while 58% of FTEs reside in China who contribute 9% of Sales and 7% of Operating Margin to the MNE.

This, at the very outset, will at least lead to a question from the tax authorities on such discrepancy. Thus, the MNE should include an explanation (derived from conducting a value chain analysis) of such circumstances in its tax/TP documentation(s) and returns.

# VCA techniques(continued)

Technique 2: Basic Approach to divide the residual profit



Source: TPA Global.

<sup>a</sup>Development Enhancement Maintenance Protection Exploitation Functions.

# VCA technique 2- Example

An example of conducting a value chain analysis for an MNE involved in the pharmaceutical industry is presented below:

Assumption 1: EBIT= 15%

Assumption 2: Return for routine functions= 5% (to be given to finance activities, contract manufacturers, contract R&D providers and support service providers in the figure on the previous slide)

Therefore, residual=  $15\% - 5\% = 10\%$ , which needs to be split between the investment and the profit center (as shown at the bottom of the previous slide)

Thus, a value chain analysis needs to be conducted to determine the appropriate return to be split the residual between the profit and the investment center. This analysis should also take into account the position of the MNE in the industry in which it operates as well as its own operational activities.

Based on the industry standard for pharmaceutical MNEs, a return for the investment center and the profit center has been identified to be 2.5% and 7.5% respectively.

# VCA techniques(continued)

## VCA Technique 3—Fully Integrated Approach

Primary Business Processes	Key functions performed (and entities responsible for performing)						
	Unit	Unit	Unit	Unit	Finance	HQ	OPCOs
Design to build (infrastructure)							
Order to cash							
Demand to supply (operational infrastructure)							
Purchase to pay							
Finance to manage							
Total # of FTEs in each unit							
Total cost for each unit							

### Steps for Applying Technique 3

1. Determine Group's consolidated EBIT
2. Allocate EBIT over "primary business processes"
3. Define interaction between "key functions" and "key processes"
4. Quantify relative weight of activity for each interaction

Source: TPA Global.

# Impact of not conducting a VCA analysis/ Conclusion

- 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.
- An example of such non-alignment can be seen in the case of an MNE filing a CbCR, a masterfile and a CIT Return because in both the CbCR and an Action 13 complaint masterfile, the taxpayer will be required to provide the number of FTEs contributing to each function within the MNE Group; however, the same level of information is not contained in the CIT Return, which could lead tax authorities to initiate an audit (potentially leading to criminal liability along with an administrative penalty).

# Q&A



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