

# How to do BEPS compliant qualitative and quantitative VCA?

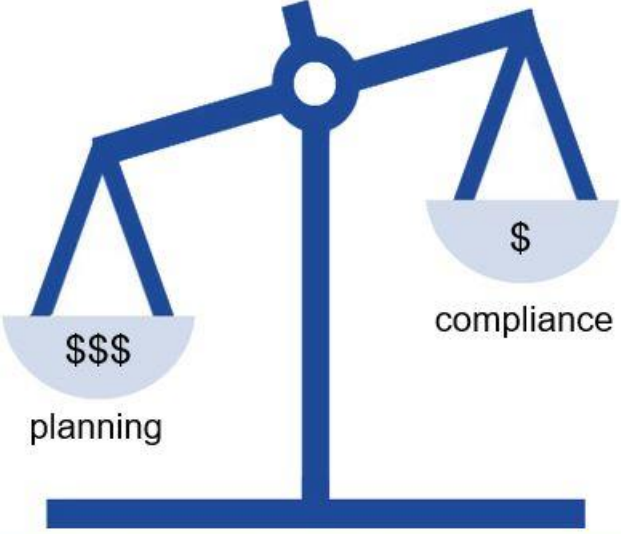
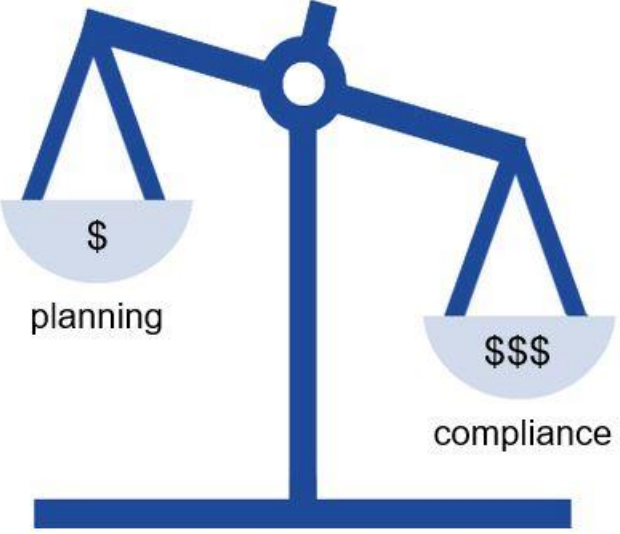
Marc Zaal, Partner, TPA Global

September 19, 2019

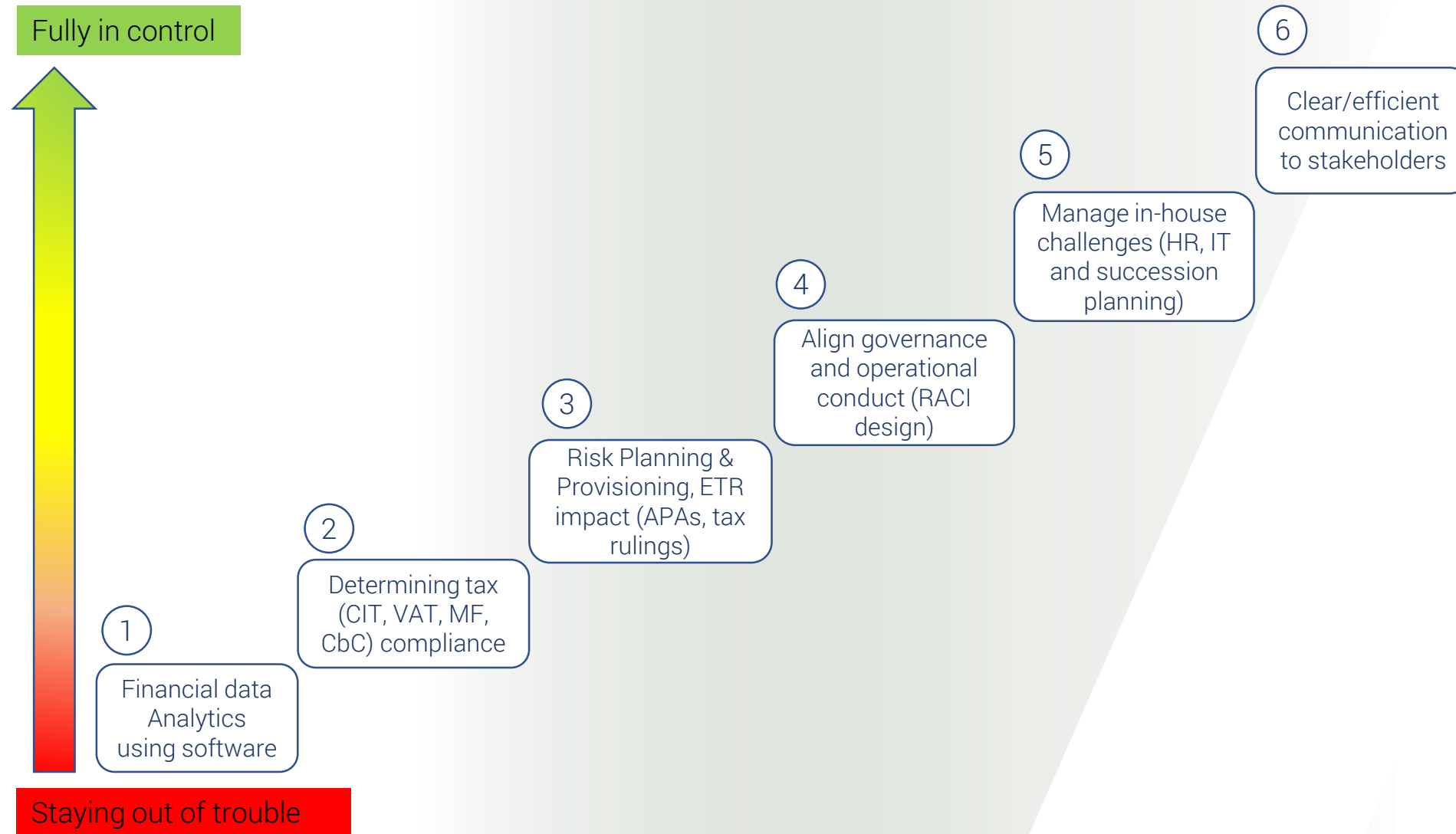
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# Introduction

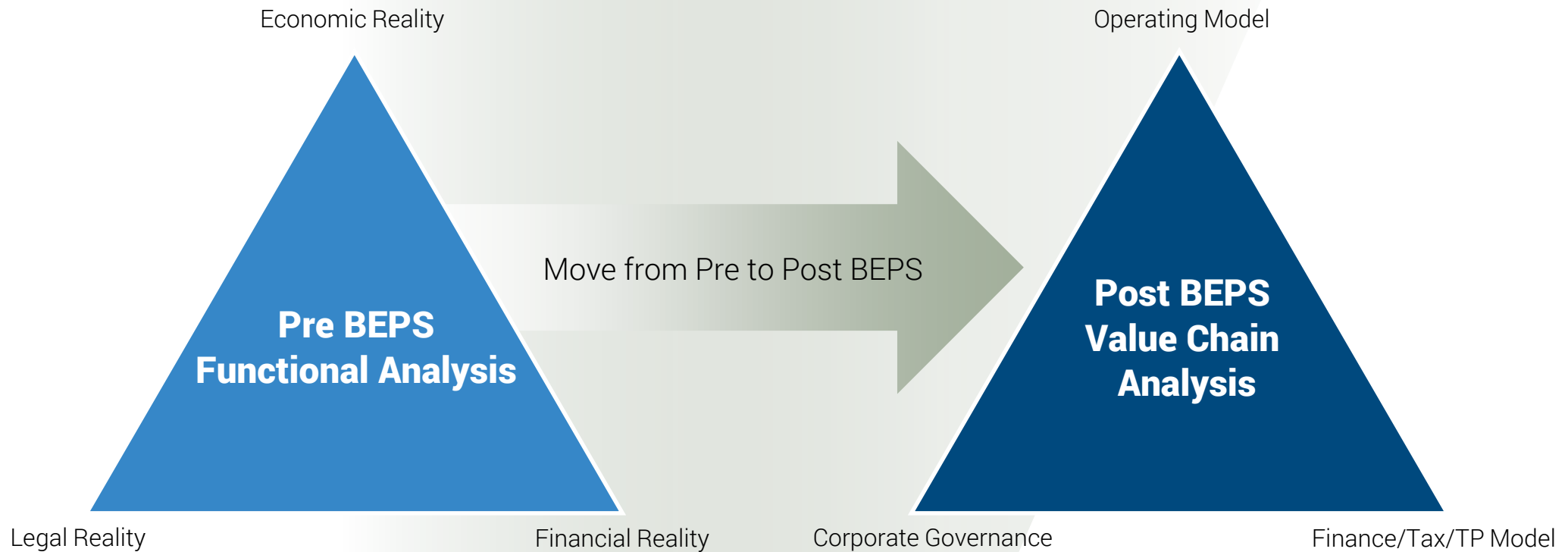
# BEPS has changed the Tax World

| Before  | <u>Now</u>   |
|---|--|
| Planning -> Compliance  | Compliance -> Risk and opportunity management  |
| Limited automation  | Search for process efficiency and automation   |
| <p data-bbox="555 561 907 596"><b>CFO's perspective</b></p>  <p data-bbox="428 1025 565 1061">planning</p> | <p data-bbox="1633 561 1984 596"><b>CFO's perspective</b></p>  <p data-bbox="1518 918 1656 953">planning</p> <p data-bbox="1921 1032 2058 1068">compliance</p> |
| Tax and TP function = profit center   | Tax and TP function = "cost center"!?  |

# Tax risk management – a holistic approach



# Tax risk management – a pragmatic approach



# Value Chain Analysis

# How to use a value chain storyboard?

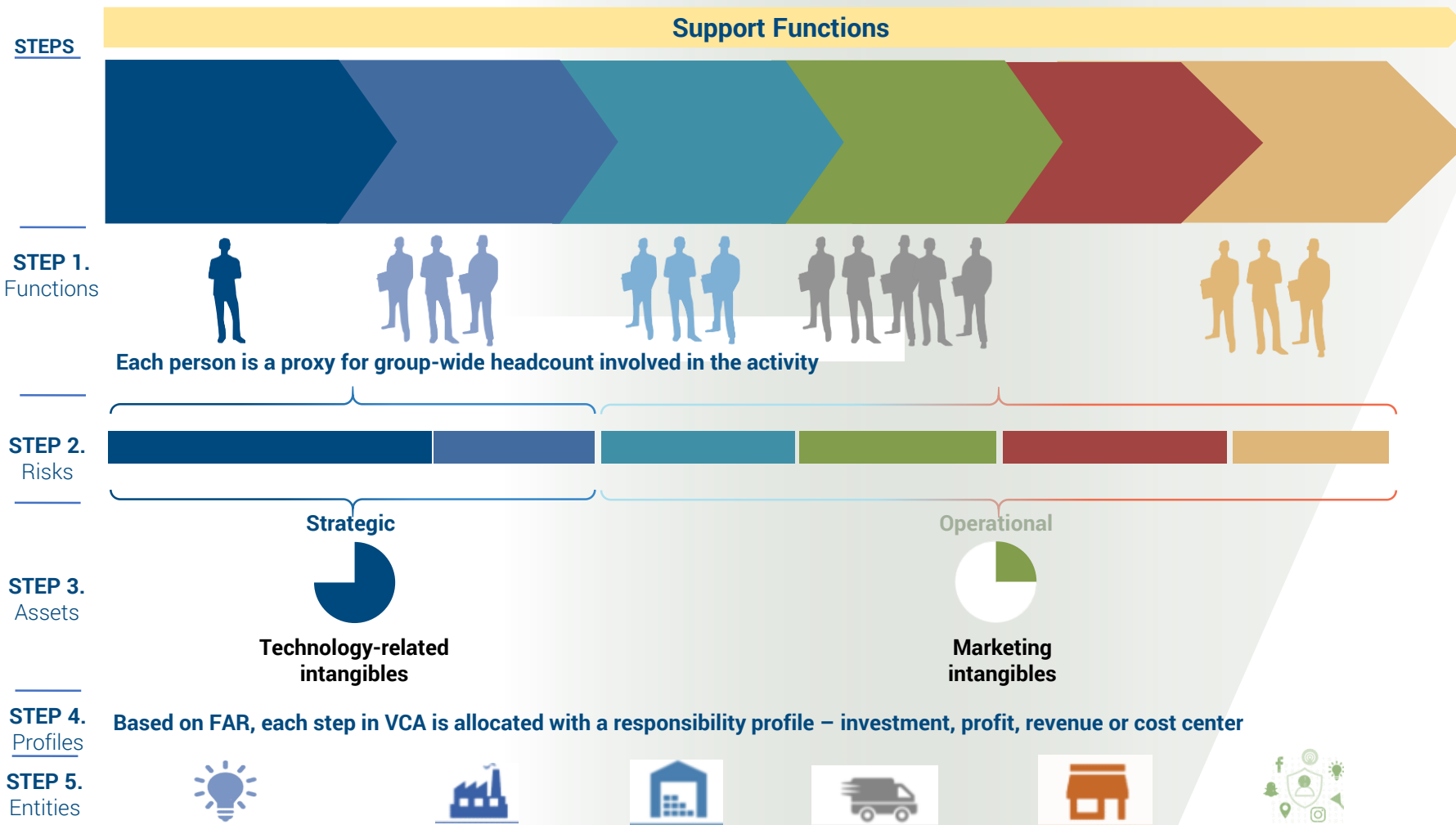
One version of the truth:

- TP documentation
- Negotiation
- Dispute
- Communication to Board
- Communication to other stakeholders



# Qualitative VCA

# Qualitative VCA

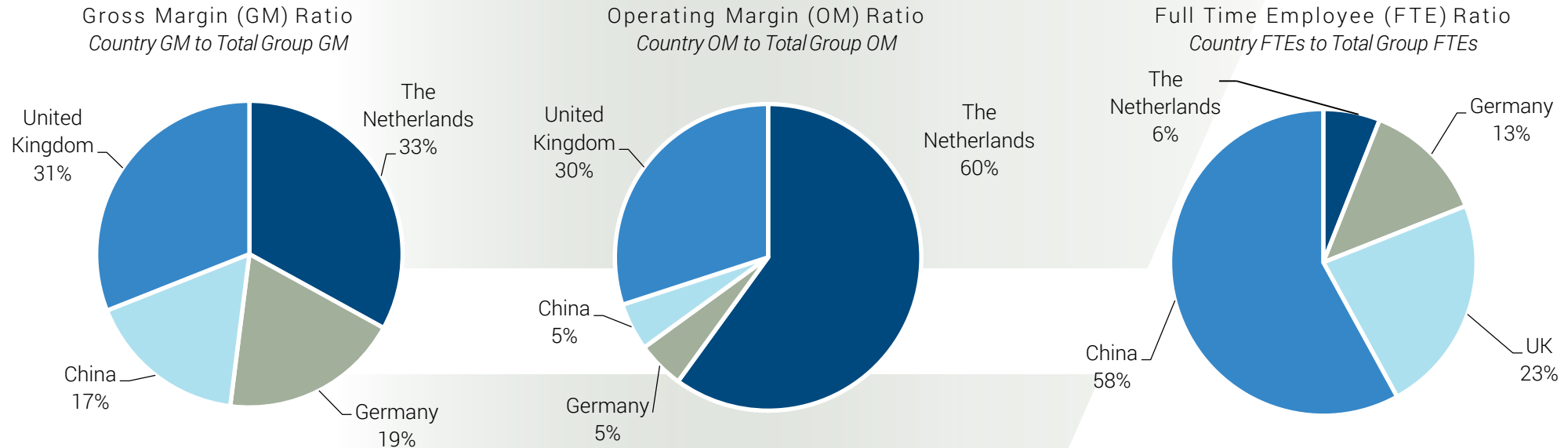


# VCA Technique 1:

How to analyze and align the operating model

## Alignment Between Gross Margin, Operating Margin, and FTEs

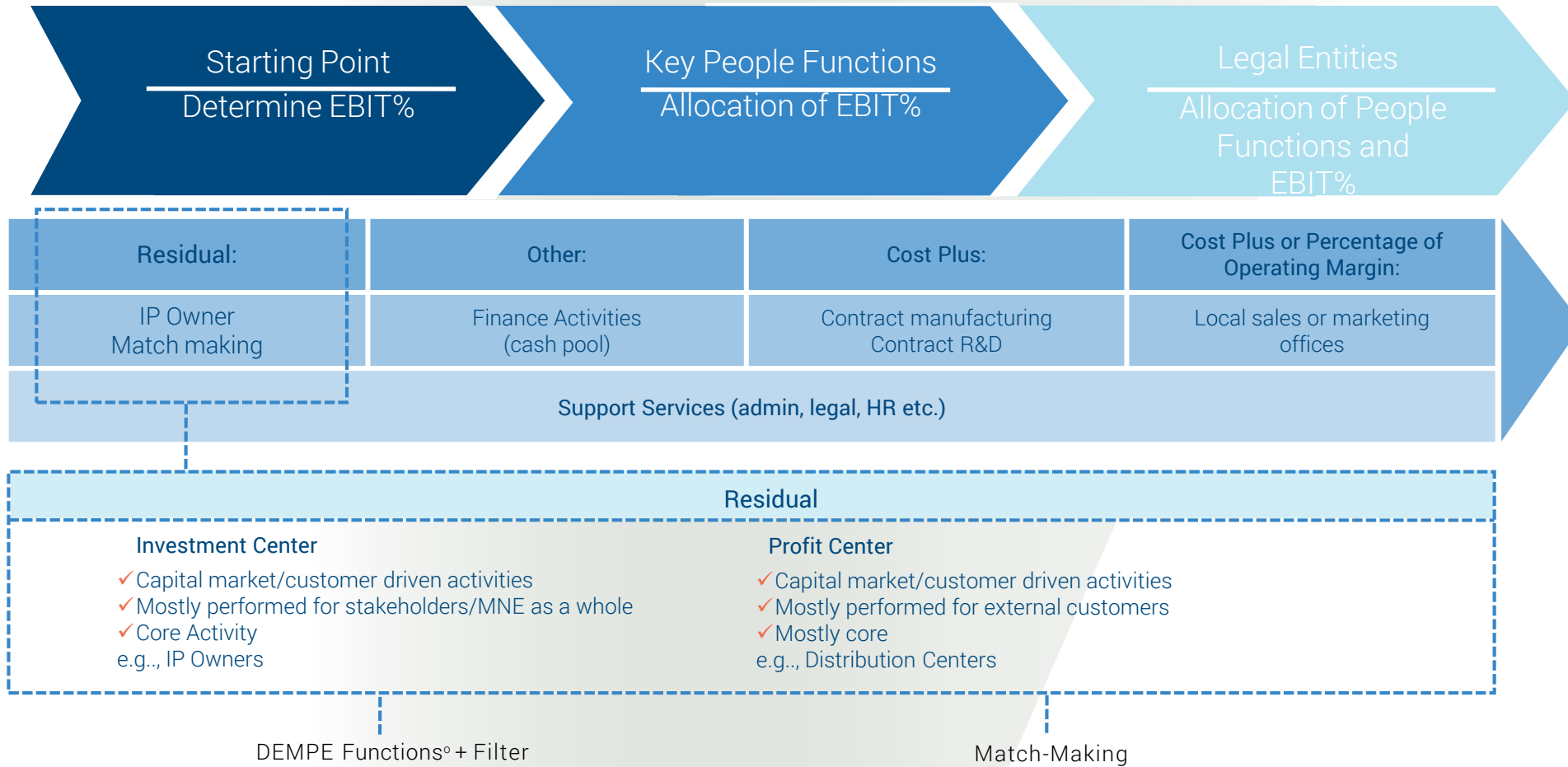
### Illustrative



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

# VCA Technique 2:

Basic Approach to divide the residual profit



Source: TPA Global. - <sup>a</sup>Development Enhancement Maintenance Protection Exploitation Functions.

# Quantitative VCA

# Transactional TP vs Quantitative VCA: Impact on ETR

| Financial reporting     | CH         | UK         | US         | Fr         | Germany    | Other      | Cons         |     |
|-------------------------|------------|------------|------------|------------|------------|------------|--------------|-----|
| Revenue                 | 400        | 600        | 700        | 500        | 600        | 1'200      | 4'000        |     |
| COGS                    | 120        | 180        | 210        | 150        | 180        | 360        | 1'200        |     |
| Gross Margin            | 280        | 420        | 490        | 350        | 420        | 840        | 2'800        |     |
| Brand royalty (2%)      | 72         | -12        | -14        | -10        | -12        | -24        | -            |     |
| Interco Services (150)  | 150        | -25        | -29        | -21        | -25        | -50        | -            |     |
| Interco Interest (1.5%) | 27         | -8         | -4         | -5         | -2         | -8         | -            |     |
| Opex                    | -160       | -250       | -300       | -200       | -300       | -575       | -1'785       |     |
| <b>EBIT</b>             | <b>369</b> | <b>125</b> | <b>143</b> | <b>114</b> | <b>81</b>  | <b>183</b> | <b>1'014</b> |     |
| Interest                | 50         | -          | -          | -          | -          | -          | 50           |     |
| <b>EBT</b>              | <b>319</b> | <b>125</b> | <b>143</b> | <b>114</b> | <b>81</b>  | <b>183</b> | <b>965</b>   |     |
| Tax Rate                | 8%         | 19%        | 35%        | 33.33%     | 30%        | 25%        |              |     |
| Tax                     | 26         | 24         | 50         | 38         | 24         | 46         | 207          | 22% |
| <b>Net Income</b>       | <b>293</b> | <b>101</b> | <b>93</b>  | <b>76</b>  | <b>57</b>  | <b>137</b> | <b>758</b>   |     |
| Quantitative VCA        | CH         | UK         | US         | Fr         | Germany    | Other      | Cons         |     |
| EBIT                    | 175        | 160        | 180        | 150        | 100        | 250        | 1015         |     |
| Interest                | 50         | -          | -          | -          | -          | -          | 50           |     |
| <b>EBT</b>              | <b>125</b> | <b>160</b> | <b>180</b> | <b>150</b> | <b>100</b> | <b>250</b> | <b>965</b>   |     |
| Tax                     | 10         | 30         | 63         | 50         | 30         | 63         | 246          | 25% |
| <b>Net Income</b>       | <b>115</b> | <b>130</b> | <b>117</b> | <b>100</b> | <b>70</b>  | <b>188</b> | <b>719</b>   |     |
| Tax Risk ?              | <b>-15</b> | 7          | 13         | 12         | 6          | 17         | 38           |     |

Source: TPA Global

# New generation of benchmarks

TPA Global has developed an approach conducting qualitative and quantitative VCA, comprising the following steps:

- Step 1** • Performance of a qualitative VCA, including the identification of the key value drivers, functions, unique and valuable intangibles, assets, risks, efficiencies/synergies, DEMPE functions and an MNE peer group comparison.
- Step 2** • Conducting a quantitative MNE peer group data analysis to identify the economically relevant variables for the industry through correlation and regression analyses.
- Step 3** • Comparing the quantitative VCA performed for the MNE against the outcome of the industry-wide correlation and regression analyses.
- Step 4** • Identifying relevant allocation keys to tie the results of the quantitative VCA back to local entities to compare with the results stemming from the applied transactional transfer pricing model by the MNE group.
- Step 5** • TPA Global will use a scoring model to assess whether the quantification method and allocation keys used to quantify and allocate value across entities in the MNE group are BEPS compliant.
- Step 6** • Establishing a benchmark based on the quantification and the relevant allocation key(s), within the results of the quantitative VCA are allocated back to the local entity.

## Your benefits:

- BEPS-compliant alignment between quantitative VCA and the transfer pricing model;
- One story of the truth: aligned Master File, Local File, CbCR and tax return;
- Anchoring of your value chain against your peer group;
- A powerful tool that can reasonably satisfy tax authorities' growing interest to evaluate taxpayers' total value chain before evaluating appropriate allocation of profits to specific transactions.



# VCA / BEPS version of Transfer Pricing – Quantitative approach

- Quantitative VCA is presented as a corroborative method for transactional transfer pricing.
- Quantitative VCA should not be confused with a profit split method.
- TPA uses the following anchors to make VCA more objective – less subjective:
  1. **Regulatory anchor** – countries regulations requirements;
  2. **Industry anchor** – variables / value drivers that have an economically significant impact on your EBIT;
  3. **BEPS-compliant anchor** – BEPS criteria for a proper quantification of carve-outs and allocation to countries / legal entities.
- Objectification of Quantitative VCA creates clean audit trail ready for audit and court cases.

# Regulatory Anchor

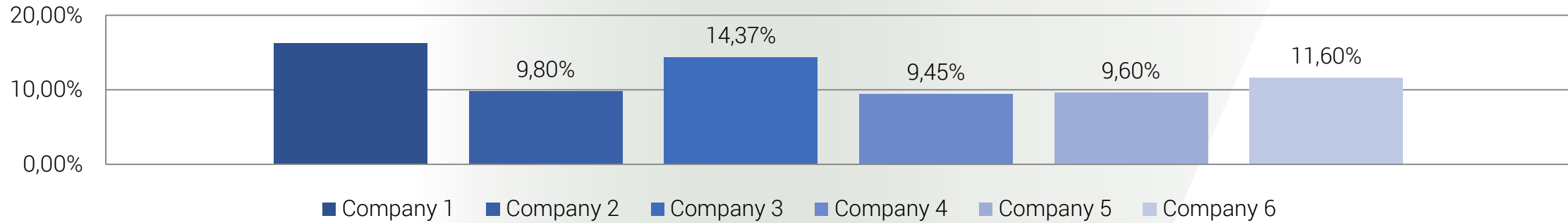
“2.141 In practice, **allocation keys** based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. **Other allocation keys** based for instance on incremental sales, headcounts (number of individuals involved in the **key functions that generate value** to the transaction), time spent by a certain group of employees if there is **a strong correlation** between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be **appropriate depending on the facts** and circumstances of the transactions.

2.142 Asset-based or capital-based **allocation keys** can be used where there is **a strong correlation** between tangible or intangible assets or capital employed and creation of value in the context of the controlled transaction....”

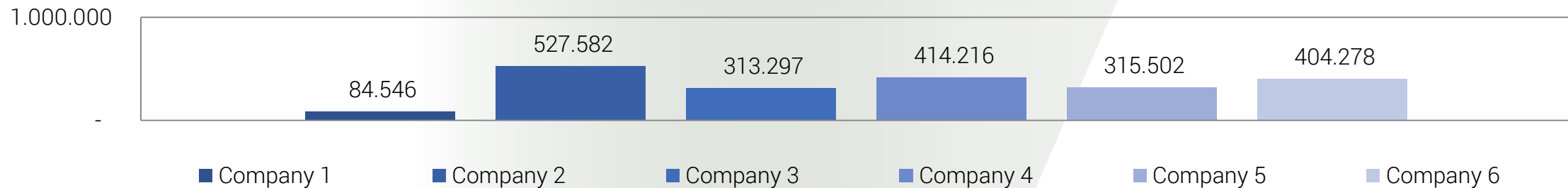
2.144 **An allocation key** based on expenses may be appropriate where it is possible to identify **a strong correlation** between relative expenses incurred and relative value added. For example, marketing expenses may be **an appropriate key** for distributors-marketers if advertising generates material marketing intangibles, e.g. in consumer goods where the value of marketing intangibles is affected by advertising. Research and development expenses may be suitable for manufacturers if they relate to the development of significant trade intangibles such as patents. However, if, for instance, each party contributes different valuable intangibles, then it is not appropriate to use **a cost-based allocation key unless** cost is a reliable measure of the relative value of those intangibles. “

# Industry Anchor

### RoE 2014-2016



### Profit per FTE 2014-2016 (EUR)

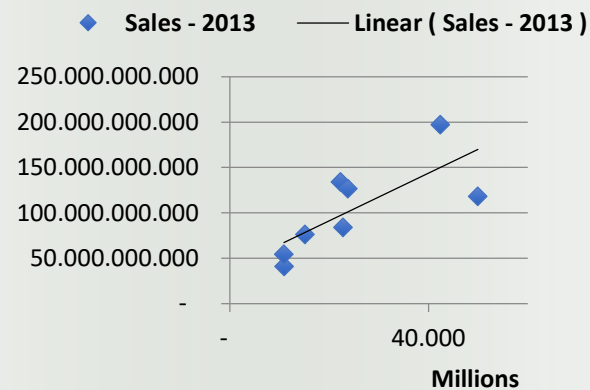
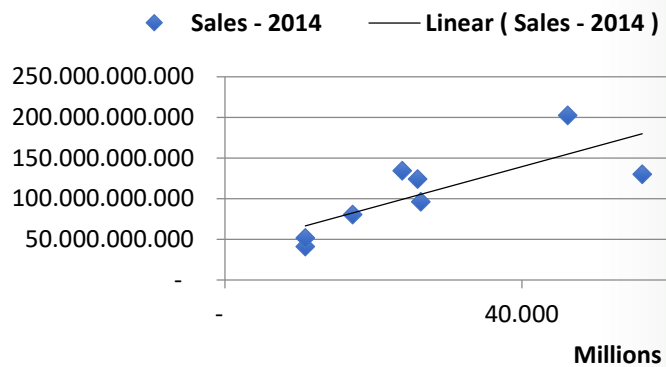
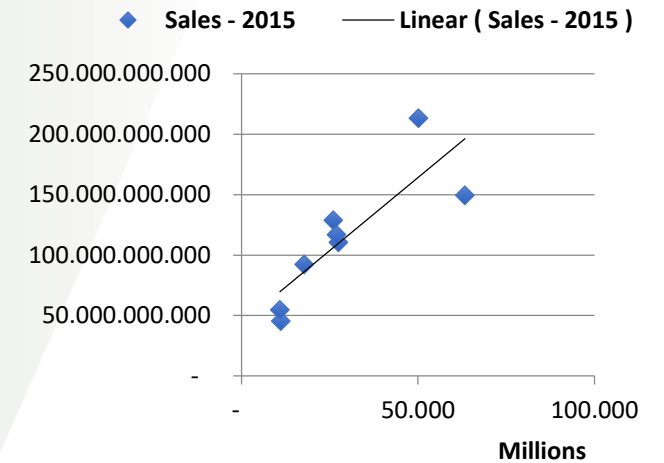
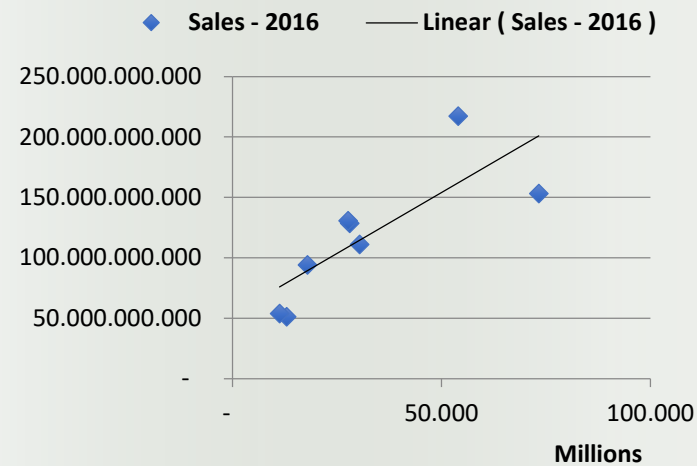
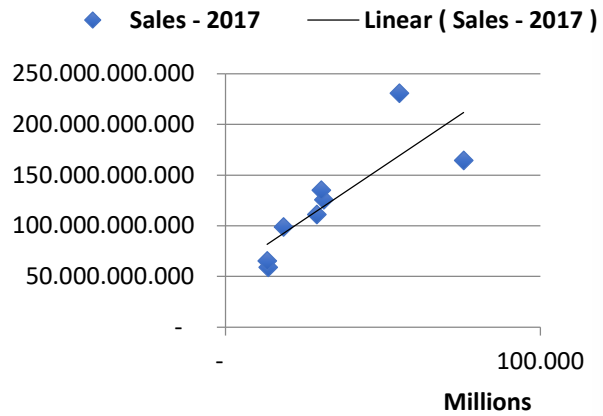


# Industry anchor – Relationship of variables

| Source  | Variable 1                     | Variable 2                                   | Correlation as per source   |
|---|--------------------------------|--|---|
| OECD Transfer Pricing Guidelines 2017   | Sales/Fixed assets             | Gross margin                                 | If Sales/Fixed assets ratio increases<br>=> Gross margin increases                                |
|   | EBIT                           | Employees                                    | If number of employees increases<br>=> EBIT increases   |
| Stephen L. Curtis – Journal of Forensic & Investigative Accounting (2016);<br>S. Lee and Sang-Bum Park- A Study on the Association between operating leverage and risk: The case of the Airline Industry (2014) | Fixed costs/Total costs        | Profit Margin<br>(Profit before tax/Revenue) | If Fixed costs/Total costs ratio increases<br>=> Profit Margin increases                          |
|   | Fixed costs/ Total costs       | $\Delta$ PBT/ $\Delta$ Revenue (risk)        | If Fixed costs/ Total costs ratio increases<br>=> $\Delta$ PBT/ $\Delta$ Revenue (risk) increases |
|   | $\Delta$ PBT/ $\Delta$ Revenue | Profit margin<br>(Profit before tax/Revenue) | If $\Delta$ PBT/ $\Delta$ Revenue ratio increases<br>=> Profit margin increases                   |
| Ministry of Economy, Trade and Industry of Japan 2004   | R&D expenditure                | Return on equity (ROE)                       | If R&D expenditure increases<br>=> ROE increases  |
|   | Intangible assets              | Sales  | If intangible assets increase<br>=> Sales increase  |
|   | Tangible assets                | Sales  | If tangible assets increase<br>=> Sales increase  |

# Industry anchor – Relationship of variables

## Variable 1 (tangible assets) / Variable 2 (sales)



# BEPS Compliant Anchor



# Company specific BEPS compliant anchor: OECD reference material to define 1-4 scoring

Quantification – each point below should be scored with 1 – the quantification meets the criterion or 0 – the quantification does not meet the criterion

1. The quantification should be based on **objective** data. (Para 2.138 of OECD Transfer Pricing Guidelines, 2017)
2. The quantification should be based on **comparable** data. (Para 2.138 of OECD Transfer Pricing Guidelines, 2017)
3. The quantification should rely on all the **economically significant** functions, assets and risks contributed by the parties to the value driver. (Para 2.178 of Revised Guidance on the Application of the Transactional Profit Split Method - BEPS Action 10, 2018)
4. There should be a **strong and relatively consistent correlation** between the variable and the creation of value represented by the relevant profits. (Pars 2.172 of Revised Guidance on the Application of the Transactional Profit Split Method - BEPS Action 10, 2018)

Allocation keys – each point below should be scored with 1 – the allocation meets the criterion or 0 – the allocation does not meet the criterion

1. Allocation keys should be based on **objective** data. (Para 2.138 of Revised Guidance on the Application of the Transactional Profit Split Method - BEPS Action 10, 2018))
2. Allocation keys should be supplemented where possible **by external market data** that indicate how independent enterprises would have divided profits in similar circumstances. (Contribution analysis definition under Chapter 1 of OECD Transfer Pricing Guidelines, 2017)
3. Keys for the allocation of profits may be based on the **relative contributions** of the parties, as measured by their functions, assets used and risks assumed. (Para 2.168 of Revised Guidance on the Application of the Transactional Profit Split Method - BEPS Action 10, 2018)
4. Allocation keys should demonstrate a **strong correlation** between the allocation key and the value created. (Para 2.141-Para 2.145 of OECD Transfer Pricing Guidelines, 2017)

- **Scenario 1: total average score is close to 4 (3.5 - 4)**
  - Quantitative VCA is fully objective and BEPS compliant
  - Quantitative VCA can be applied for change in allocation of profit in the past and the transactional model in the future.
- **Scenario 2: total average score is close to 3 (2.5 - 3)**
  - Quantitative VCA is reasonably BEPS compliant
  - Quantitative VCA can be applied as a corroborative approach for change in allocation of profit in the transactional model in the future
- **Scenario 3: total average score is equal or lower than 2**
  - Quantitative VCA is not BEPS compliant
  - Quantitative VCA should not be applied for any change in the allocation of profit in the past or the transactional model in the future.



TPA Global Network

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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.

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