Rethinking value chain analysis

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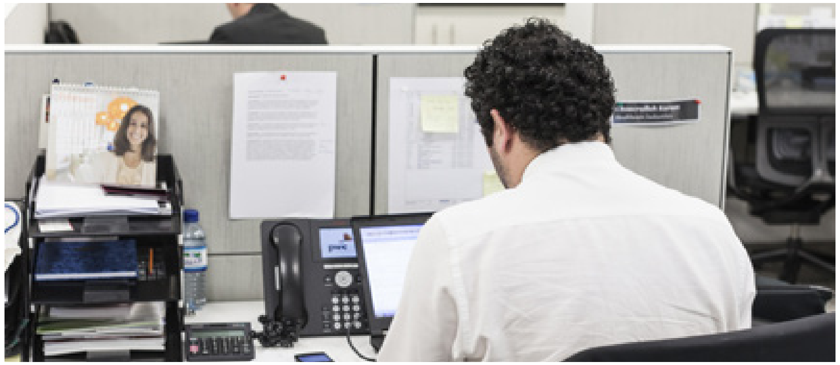
As controversial as transfer pricing can be in many regards, there is an established set of principles and methods generally agreed upon under the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Cooperation and Development (OECD Guidelines) and most local statutes and regulations. Most of the controversy is in interpreting the facts and applying the available methods based on evidence from third party transactions. Typically, only the simplest sides of transactions are looked at, while the entrepreneurial entities and the full value chain receive limited review. We refer to this as classical transfer pricing.

Much of the BEPS discussion focuses on how to effectively and accurately interpret the functions, risks and assets (tangible and intangible) of a multinational enterprise (MNE).



Classical transfer pricing approaches and techniques are under review as the members of the OECD (and G20) are debating and publishing action papers focused on the concept of base erosion and profit shifting (BEPS), urging the importance of applying what classical transfer pricing principles intended to achieve; ensuring the arm's length nature of intercompany transactions. Much of the BEPS discussion focuses on how to effectively and accurately interpret the functions, risks and assets (tangible and intangible) of a multinational enterprise (MNE). An understanding of the MNE's full value chain is at the heart of the newly developed BEPS framework such that the value chain of the consolidated taxpayer is considered in assignments of profitability (and associated transfer prices) to individual entities.

Many taxpayers these days are considering and often using this comprehensive approach to transfer pricing called value chain analysis (VCA). The approach involves an investigation into the functions, risks, and assets of the controlled group as a whole, and an evaluation of how they integrate with the group's key value drivers. The conclusions from these analyses are often used to attribute group profits to key functions, risks, assets, and value drivers of the business.

VCA is not an easy task, especially for an MNE with complex function and risk matrices spread across different entities. Transfer pricing practitioners have been debating the "right" way to conduct a VCA in such situations. This article explores the two leading approaches to the VCA; the Formulaic VCA and the Empirical VCA. We argue that in certain cases, Empirical VCA could be the more defensible approach as it attempts to align with the arm's length principle, which continues to be the one enduring principle in the ever changing world of transfer pricing.

BEPS initiative and VCA

The OECD has finalised a number of BEPS action papers, many of which posit that classical transfer pricing must be interpreted and applied in the context of the entire value chain of the MNE, urging the need for proper application of classical transfer pricing.[1] The OECD is addressing demands from governments to be able to see the entire value chain of a business without being limited to the part that is residing in their country. Much of the discussion revolves around identifying the appropriate entrepreneurial principal

1 The OECD finalised Action Papers 8-10: Aligning Transfer Pricing Outcomes with Value Creation as well as Action Paper 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting. The OECD also released a discussion draft concerning the use of profit splits in a value chain context.

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entity or entities in the MNE group transfer pricing arrangements and verifying the profits assigned not only to the routine service providers in the controlled group, but to the entrepreneur(s) as well. As a result, an analysis of the MNE's key operational and management activities generating entrepreneurial profit may lead to the transfer pricing structure being recharacterised if the facts and economic substance of the arrangements differ from the transfer pricing arrangements in place.

There is a worry that such recharacterisations could be applied too often and too widely. To limit the potential for unsupportable recharacterisations, a transfer pricing structure should be based on sound findings of fact from a carefully executed and thorough functional analysis, and fully grounded in principles of finance and economics. As such, it is critical in the post-BEPS environment to enforce the classical transfer pricing framework with a VCA mindset. The arm's length principle should be respected at all times and performance of functions and entrepreneurial risks and ownership structures should be evaluated based on arm's length evidence.

BEPS Action Papers 8–10 require a review of the entire MNE and a supporting economic substance and risk analysis for allocations of entrepreneurial profit to principal entities. Master file, local file, and country-by-country reporting requirements under BEPS Action Paper 13 will require much more thorough documentation than has historically been required. This is the new environment of transfer pricing, with VCA at the forefront.

Classical transfer pricing and the arm's length standard are still the prevailing principles of transfer pricing; however, the requirements for supporting a company's transfer pricing system are rapidly evolving and are demanding a more complete review of the entire value chain. This trend should not be perceived as a deviation from classical transfer pricing since the value chain perspective is, in fact, engrained in what classical transfer pricing intended to achieve. Only by creating a carefully designed, thoroughly documented, and well-executed and maintained transfer pricing system looking at the entire value chain of a controlled taxpayer group can a taxpayer gain some relative comfort and protection from over-reach by tax authorities in the future.

Different approaches to VCA

The OECD refers to VCA but the construction of a proper value chain is still undefined. Two schools of thought have been leading the VCA debate. One approach, the formulaic approach to VCA (Formulaic VCA), has been in use by some practitioners for several years. The formulaic approach is based more on creating minutely detailed weighting and scoring templates regarding key business activities and company business processes. These weights and scores are often developed through extensive company management workshops, and involve developing management's views into the detailed weighting and scoring templates that rank and score business processes and functions. The outcome of this approach is effectively a global profit split approach based on the identified value drivers. This approach is quite practical for taxpayers operating in industries where third party information about peers is limited or unavailable. In cases where third party data are widely available, however, the Formulaic VCA could be more susceptible to tax authority challenge as the tax authorities may try to replicate the findings of the Formulaic VCA using the third party evidence.

The second approach is based on the maximum use of arm's length information and applies classical transfer pricing tools to principal group peers to evaluate the entire value chain of the MNE. This is a relatively new approach, relying on classical transfer pricing skills to develop key insights into the value chain using objective third party evidence. The analysis is supplemented by insights and information supplied by management, and with maximum use of classical transfer pricing tools. We call this the empirical approach to VCA (Empirical VCA).

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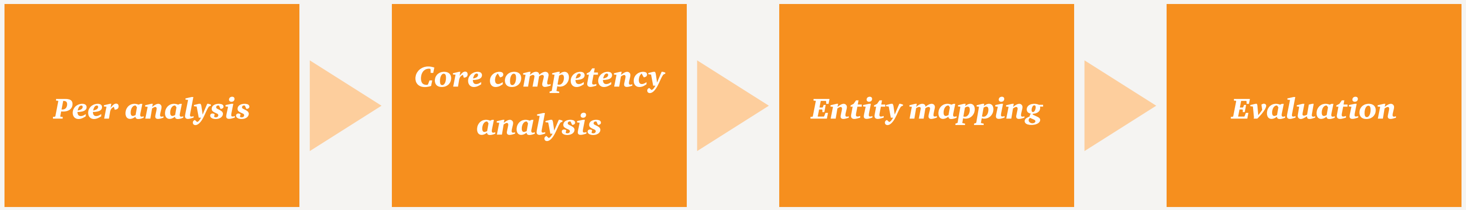
Empirical VCA

The structure-conduct-performance (SCP) paradigm and the core competency framework that is based on peer analysis are at the heart of Empirical VCA design, which provides powerful insights for the entire value chain of a business. The approach relies on third party evidence to formulate a structure that complies with the core intent of classical transfer pricing. Empirical VCA has four primary steps: peer analysis, core competencies analysis, entity mapping, and evaluation of results (see Figure 1).

Figure 1: Four phases of empirical VCA



Peer analysis phase

A peer analysis is conducted for the overall consolidated group and it is broader and applies to the entire value chain of the organisation. The peer analysis is intended to identify the sources of sustainable competitive advantages for the taxpayer relative to its peers. The peer analysis in this phase is different from the comparable company analysis employed in one-sided tests. Industry peers are selected for the consolidated group and represent comparability on a consolidated level. This analysis requires a thorough review of publicly available data for the MNE's primary competitors and peers in its industry. In certain cases, the peer analysis may focus on a specific function of the taxpayer, evaluating the functional competency of taxpayer vis-à-vis functionally comparable peers.

Core competencies analysis phase

The array of competencies of the MNE are identified and analysed under Empirical VCA. Here, the functions performed, risks assumed, and assets owned by the consolidated group are documented, and the profits or losses attributable to each competency are determined. This phase is conducted based on a thorough functional interview and a careful review of publicly available information and analyst reports about a taxpayer company group. The end product for this analysis will be a heat-map type illustration showing core competency areas of the taxpayer vis-à-vis its peers. Determining the core competencies of the taxpayer and comparing these with its peers is a crucial part of an Empirical VCA.

The core competencies phase of the analysis will allow practitioners to use arm's length data and publicly available information, along with information provided by the MNE's management, to identify layers of profitability that can be attributed to the primary functions and core competencies of the MNE. In this phase, practitioners should also identify the interaction of core competencies with risks and investments, managerial control of risks, and financial capacity to bear risks, which are the hallmarks of economic substance. Classical transfer pricing tools should be employed to determine arm's length profitability ranges for each routine function and core competency area. If necessary, functional and geographic segmentation of peer financials, where available, accounting adjustments, and other comparability adjustments should be employed to account for comparability differences between the taxpayer and the peers.

Entity mapping phase

Third, profits or losses attributable to core competencies and routine functions are mapped to each legal entity based on its specific facts and competencies, employing classical transfer pricing techniques to the extent possible. This phase identifies which functions, core competencies, and elements

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of economic substance can be attributed to each entity in the controlled taxpayer group. A focus on intercompany agreements and economic substance, with a maximum use of third party evidence, will indicate an allocation of profit within the MNE group that will be supportable by: i) the arm's length standard; ii) established principles of risk and investment; and iii) the BEPS Action Papers 8-10. Under this method, entities employing routine functions will be entitled to routine returns, whereas entities performing core competencies with economic substance will receive applicable entrepreneurial returns. When a split of entrepreneurial profit is required between entities performing core competencies, often approaches other than the classical approaches need to be employed. Further, in cases where intangibles are involved, appropriate allocations of profits to entities performing development, enhancement, maintenance, protection, and exploitation (DEMPE) functions, as described in the BEPS Action 8 report, should be considered.

The entity mapping phase is a profit-split exercise under Formulaic VCA, by design. Empirical VCA, on the other hand, provides the taxpayer with the ability to identify where in the value chain excess profits are earned and core competencies are employed, and it does not default to a profit-split-type apportionment. It provides enough insights about core competencies that it can effectively differentiate routine functions from core competencies and allocates profits accordingly via the profit-split approach or any other approach that may be suitable.

Evaluation phase

In the final phase, a variance analysis is performed between the taxpayer's existing transfer pricing policies and the conclusions of the Empirical VCA to identify any areas of risk and opportunities to bolster or improve existing transfer pricing policies. This phase involves a gap analysis between the conclusions of the entities analysis and the current allocation of profits within the controlled taxpayer group based on currently administered transfer pricing policies. If the MNE's current transfer pricing policies and the results of the Empirical VCA entity mapping are in alignment, then the Empirical VCA approach will provide strong support for existing transfer pricing policies. If the review indicates a need for better alignment in certain areas, then the existing policies can be reviewed and potentially modified to bring them into alignment with the VCA conclusions, strengthening support for the taxpayer's transfer pricing arrangements going forward.

Conclusion

Overall, Empirical VCA makes maximum use of third party data through the application of classical transfer pricing techniques. Rather than looking only at the prices of individual transactions or at the profitability of the simplest side of intercompany transactions, the empirical approach to VCA looks at the consolidated totality of the MNE and its peers. This approach assigns arm's length returns to each entity in the consolidated MNE group based on the overall body of arm's length evidence for each participant in the value chain and provides direct support not only to the routine service providers in the MNE group but to the principal entities as well. We believe that, in certain cases, Empirical VCA is 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.

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