Value chain analysis

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I am responsible for transfer pricing for a multinational group. Following the changes to transfer pricing arising from BEPS, I am hearing a lot about the need for 'value chain analysis'. What is a value chain analysis, do I need to undertake one and how do I go about doing it?

First things first, what is a value chain?

A 'value chain' as a concept was first formulated by Michael Porter, in *Competitive advantage* in 1985. In simple terms it is a systematic way of examining all of the activities performed by a business to determine the sources of competitive advantage and how these translate into profit.

It is really an answer to the question 'how does a business create value', with value being the difference between what a business is able to sell its goods/services for, and the cost of creating them.

A value chain as a concept is distinct from a supply chain, which typically focuses on the flows of goods and services.

What is a value chain analysis?

In headline terms, a value chain analysis tells the 'value creation story' of a group: how and where economic value is created, and by which parties within a multinational enterprise (MNE). This is important both for disclosure in the updated transfer pricing documentation standard recommended by the OECD, but also as a way to test and corroborate the alignment of transfer pricing outcomes with economic value creation.

The world of international tax, including transfer pricing, has been going through a period of accelerated change and upheaval as a result of the OECD/G20's base erosion and profit shifting (BEPS) programme. This extensive programme resulted in a package of 13 reports across the themes of coherence, economic substance and transparency.

The BEPS programme has initiated a raft of changes that are making their way on to tax rule books across the world. For transfer pricing there are important areas of change within the 'economic substance' and 'transparency' themes. The need for a value chain analysis is rooted in both and is at the heart of BEPS from a transfer pricing perspective.

I already have transfer pricing benchmarking. Why should I analyse the value chain?

One of the areas of challenge in transfer pricing that BEPS has sought to address is the narrow focus on an activity or transaction in isolation. This may be compounded with a selective view of the 'tested party' to the transaction without this being grounded in the value chain, i.e. the context of how the MNE creates value. This results in increased potential for mispricing.

BEPS emphasises the need for aligning transfer pricing outcomes with economic value creation, and provides enhanced guidance on what is required to be disclosed in documentation in this regard. An analysis of the value chain therefore creates the vital context for more granular transfer pricing analysis.

The OECD report *Aligning transfer pricing outcomes with value creation, Actions 8–10*, sets out an update to the *OECD Transfer pricing guidelines for multinational enterprises and tax administrations* ('OECD guidelines') that collectively attempt to align the taxation of profit to economic value creation. To do this it uses a new articulation of delineating the actual transaction (versus the contractually represented one) and setting out analytical frameworks to apply to intangibles and risk to determine the transfer pricing consequences.

This report, amongst other things, updates chapter I of the OECD guidelines. Chapter I sets out the fundamental guidance for applying the arm's length principle and reinforces that comparability analysis is at the heart of it.

The changes to chapter I emphasise the requirement to look deeper than the contractual arrangements. The importance of 'contract versus conduct' has long been a topic of debate in transfer pricing, but it is now clear that the contract is the starting point only. The result of this will place more weight on the substance of arrangements, and how this relates to economic value creation.

To apply the arm's length principle one needs to determine the economically relevant characteristics of the commercial relationships between entities including establishing the functions, assets and risks of the parties and how they relate to the wider generation of value by the MNE group.

So in answer to the question, benchmarking alone is unlikely to be robust transfer pricing support, where this analysis does not ground the transaction, and the contributions being made to the value creation by the parties to the transaction, in the value chain.

What are the transfer pricing disclosure requirements for value chain analysis?

The OECD report *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13* updates chapter V of the OECD guidelines. There is now detailed specification as to the three tier approach and what is required to be included in a master file and local file, as well as setting out country by country reporting requirements.

- A master file (the group 'blueprint'), sets out an overview of the group's business including important drivers of business profit and description of principal contributions to value creation by individual entities within the group, its intangible assets, important service arrangements, intercompany financial activities and overviews of financial and tax positions (Annex I) .
- A local file is the transactional record for the year and supporting analysis for each entity. It should set out entity specific details and more detailed financial and operational information on specific intercompany transactions and include both comparability analysis and explain why the transfer pricing methodologies used are the most appropriate. It needs to be calibrated at the entity level although files for different entities may be aggregated (Annex II).

- A country by country report (Annex III).

The master file requires two key areas of information relating to a value chain analysis:

- drivers of business profit; and
- principal contributions to value creation by individual entities, i.e. with reference to key functions performed, important risks assumed and important assets used.

The purpose of this is to provide an overview of the group and to enable a relation to the value creation as a whole by the granular local file economic analysis and support for material categories of controlled transactions.

The local file requires detailed, entity level functional analysis. Chapter I, as updated by Action 13, makes it clear that the functional analysis should make reference to value creation.

What are the steps to undertake a value chain analysis?

Whilst each business will have its own, unique value creation story, a consistent methodology can be applied to map this out.

The steps below are necessarily shown at a high level. There are a range of techniques that can be applied within the steps and whilst we touch on some of these below, and our experience of what works well, this is not definitive.

Step 1: Establish drivers of business profits ('value drivers') and relative importance

A business will spend a great deal of time and effort focusing on its value drivers and an articulation of these can often be found in its annual accounts, industry overviews and analysts' reports.

Value drivers will often be relatively common in principle across industry sectors but the nature and importance of these can vary enormously from business to business.

One helpful approach is to consider framing the value drivers with reference to the tangible and intangible assets that are used and created. This can help focus the articulation and assist with a systematic assessment and identification of value creation which can then be further examined in the next steps.

It is important to look beyond the tangible and intangible assets that are recognised for accounting purposes or the intangible assets that carry legal protection. It is worth investing time at this stage exploring intangible assets that arise from areas such as the creativity of the workforce, the culture of the organisation or the relationships the business has with third party suppliers and customers.

Not all contributions to value creation are equal and this step should also evaluate the relative value. For example leading on brand with heavy marketing may be critical for one business, whereas for another it may be a 'by product' of technical superiority of a product. The relative weighting may either be a qualitative ordering of importance, or a numerical fixing of the relative weight (which may be important if steps 3 and 4 below are followed).

Step 2: Determine and map principal contributions by legal entities/ territories

The step above, where undertaken with sufficient diligence, will describe the value drivers. The next step is to then determine and map the contributions to that value by legal entities (or taxable presence in territories), and risks borne. The OECD guidelines now contain important analytical frameworks that should be applied as part of doing this e.g. how to attribute economic ownership of intangible assets, and the assumption and control of risk. The importance of relative contributions can also be weighted.

This will provide a clear view of how important functions, assets and risks relate to wider value creation, which can support disclosures to be made in the master and local file.

There are two further steps which can be undertaken to test (and support) the alignment of transfer pricing outcomes with economic value creation, which as described above is one of the key aims of the BEPS programme.

Step 3: Allocate system profit to territories

Steps 1 and 2 above can, where contributions to value are weighted numerically, provide the basis of a high level profit allocation and so the analysis can be extended where an overall 'system profit' is calculated and then allocated in line with the weightings determined in the above steps.

Whilst it has some analogies, a value chain analysis is not a transactional profit split and undertaking one does not necessitate a transactional profit split be selected as the most appropriate method. Further guidance is expected from the OECD on profit splits, with the current consultation draft setting out the importance of a value chain analysis as a tool to support in the delineation of transactions and broad-based analysis of circumstances. It makes it clear the OECD's view that a value chain analysis is a tool to assist in establishing the basis for comparability analysis (be that based on transactional profit split method or otherwise), not a substitute for the analysis.

Step 4: Compare alignment with transfer pricing outcomes

Step 3 will have set out an allocation of profits with reference to the relative contribution by entities to value creation. This view can be compared against the results of existing, or proposed, transfer pricing of the range of controlled transactions across the group. Where the value chain analysis corroborates the profit results of the transactions then there is further support to attest to the validity of the individual aspects of the pricing.

Where there are mismatches this may help identify areas for further focus and supplementary analysis. It also enables a setting out of the position in a way suitable for engaging with stakeholders across the business as it translates a (sometimes arcane) tax topic into something more immediately relatable, i.e. how a business creates value and how this should be recognised across territories.

What should you do next?

- Review existing transfer pricing analysis and documentation to determine if they contain a value chain analysis.
- Gather information on your value chain from existing material.
- Undertake a stepped approach to laying out your value chain including determination of key contributions by entities across the group.
- Document the analysis in a form suitable for inclusion in transfer pricing master files and local files.
- Consider testing allocations of system profit against existing transfer pricing outcomes to further corroborate or flush out areas for focus. ■

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