

Transfer Pricing Insights:

Framework for TP Value Chain Analysis

A Changing Landscape

The Organization for Economic Cooperation and Development's ("OECD's") Base Erosion and Profit Sharing ("BEPS") has resulted in the worldwide implementation of more stringent requirements for justifying transfer pricing policies and preparing appropriate transfer pricing documentation. New disclosure requirements coupled with tax authorities' increased scrutiny of economic substance places a newfound emphasis on a company's ability to develop and document an accurate and informative value chain analysis. While this skill will be paramount when planning and defending transfer pricing policies in the future, guidance from the OECD and tax authorities regarding the preparation of value chains is remarkably limited. Moreover, identifying and defining value chains has not historically been of such importance. With this in mind, this article offers taxpayers and transfer pricing professionals alike a five step process for conducting a value chain analysis, spanning from gathering and organizing necessary information to ultimately defining the value chain(s) that underpin a multinationals operations.

5 Steps for Value Chain Analysis

1. Collect raw data and information
2. Identify entities and Process Functions
3. Connect the entities and functions
4. Value the links in the value chain
5. Create a diagram for documentation

1. Collect Raw Data and Information

Consistent with traditional practices for preparing a transfer pricing study, we recommend a qualitative and quantitative approach to retrieve and organize the raw information necessary for a value chain analysis. Surveys and interviews with personnel should focus on discovering the functions performed, risks incurred and assets employed by the group's entities. Financial reports, invoices and contracts should be gathered as well to shed light on transactional volumes, profit margins and third-party arrangements.

Surveys and Interviews



- Overview and history of group
- Entity - level functions performed
- Entity - level risks incurred
- Entity - level assets employed

Statistical and Financial Calculations



- Transactional volumes
- Existing transfer pricing calculations
- Group and entity - level financial results and projections

2. Identify Entities and Process Functions Performed

Supply Chain Operations Reference ("SCOR") is a process reference model developed and endorsed by the Supply Chain Council and many Fortune 500 companies to describe the business activities associated with satisfying customer demand. Since its development in 1996, SCOR has become the standard cross-industry diagnostic tool for supply chain management.

The model is used to ensure all essential functions and the corresponding entities are taken into consideration in a value chain analysis. By describing value chains using a common set of prototypical Process Functions, disparate functions can be linked to describe the depth and breadth of the entities in any value chain. Using the information gathered in Step (1), one can create a SCOR model. Broad definitions of the six prototypical Process Functions are provided below in *Table 1*. To develop the model, one should list the entities involved with each Process Function starting from "Plan" and ending with "Return." The model is used to organize the essential information collected in Step 1. After completing the SCOR model, the information will be mapped onto a value chain in Step 3.

Table 1: SCOR Process Modeling Template

Process Function	Definition of Process Function	List Entities
Plan	Processes that balance aggregate demand and supply to develop a course of action that best meets sourcing, product, and delivery requirements (e.g. Logistics, Planning, Corporate Management)	
Source	Processes that procure goods and services to meet planned or actual demand (e.g. Procurement, Warehousing)	
Make	Processes that transform a product to a finished state to meet planned or actual demand (e.g. Manufacturing, Refining)	
Deliver	Processes that provide finished goods and services to meet planned or actual demand (e.g. Transportation, Distribution)	
Return	Processes associated with returns or receiving returned products and support activities with delivery (e.g. Customer Support, IT, Accounting)	

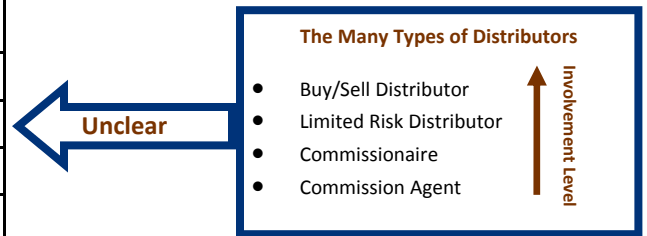
3. Connect the Entities and Functions

Michael Hammer, MIT Professor, pioneered Business Process Redesign (BPR) as a business management strategy to help better support an organization’s mission and reduce costs. One key aspect of any BPR analysis is the creation of a value map worksheet. A value map worksheet illustrates the relationship between the entities of a multinational’s business and the functions they perform.

A generic template for a value map worksheet is illustrated below in *Table 2*. By expanding the rows and columns of this template it is possible to accommodate even the largest, most complex value chains. Careful thought and planning should be used when defining the many functions performed by the multinational’s entities to accurately depict economic substance; *Figure 1*, for example, illustrates how a standard function, “Distribution”, can carry varying amounts of involvement for an entity.

Entity	U.S. Co	Canada Co.	U.K. Co.
Functions			
Retail			
Distribution			
Transportation			
Production			
Input Supply			

Figure 1: Accurately Defining Functions in Relation to Economic Substance



Master File Informational Requirements Achieved via Value Chain Analysis

- Important drivers of business profit
- Description of the supply chain for the group’s five largest products and/or service offering by turnover
- A list and brief description of important service arrangements between members of the MNE group
- A description of the main geographic markets for the group’s products and services
- A brief written functional analysis describing contributions of value creation by entities
- A description of business transactions occurring during the fiscal year

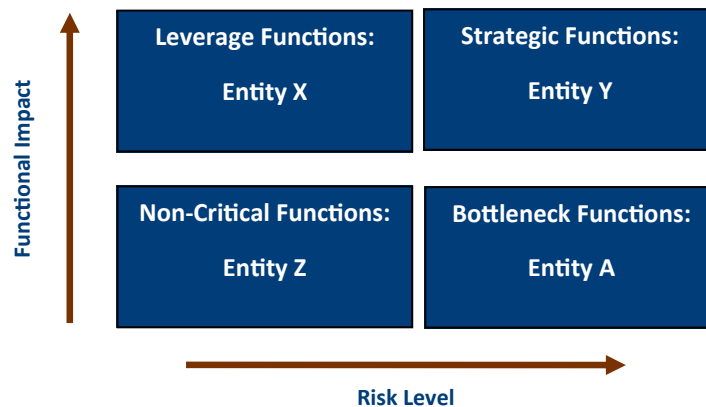
4. Valuing the Links in the Chain

The updated requirements for appropriate transfer pricing documentation outlined in the revised Chapter V of the OECD Guidelines state that a simplistic description of a value chain is not sufficient to claim compliance; rather, the requirements suggest taxpayers identify the key/important elements of the value chain. Specifically, the description of the value chain documented in the Master File should offer details on a multinational enterprise’s “key functions performed, important risks assumed, and important assets used.”

The Portfolio Purchasing Model (“PPM”), developed by Peter Kraljic, can provide a valuable framework to assess relative magnitudes of functional impact and risks assumed by entities. Since its initial development, a variety of permutations have occurred to adapt this model to all dimensions of the supply chain, including demand profiling, products and throughput rate. Taking these variations of the model into account, a version suited for value chain evaluation for the purposes of transfer pricing can be created by replacing the specific items with the actual functions performed by an entity and profits by the impact of the function on performance as illustrated in *Figure 2*. The four quadrants can then be defined as:

- Leverage Functions: Functions that have high impact on performance, e.g. branding
- Non Critical Functions: Functions that are rudimentary and low risk, e.g. freight-forwarding
- Strategic Functions: Functions that are high risk and high impact, e.g. R&D activities
- Bottleneck Functions: Functions that have low impact but high risk, e.g. location-restricted activities

Figure 2: Modified PPM Matrix



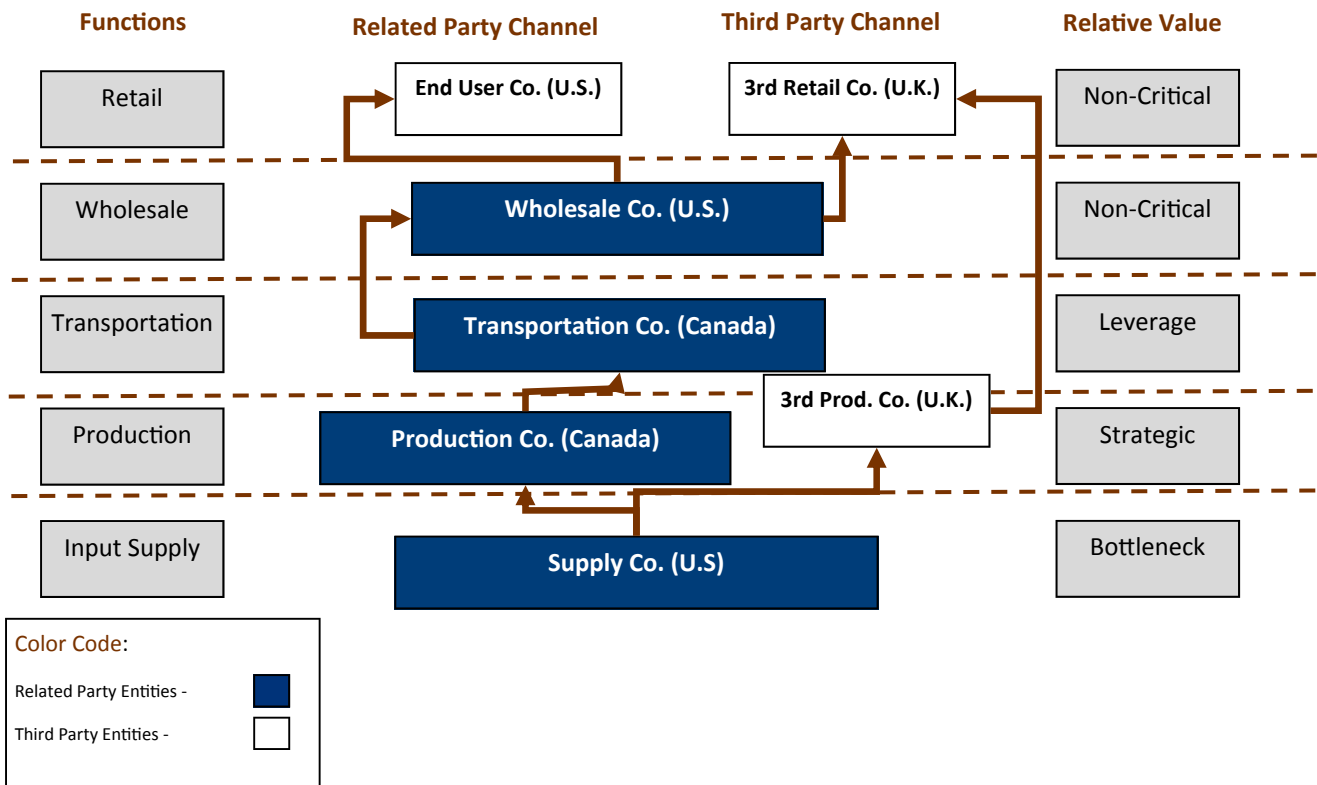
5. Create a Summary Diagram

The updated requirements for appropriate transfer pricing documentation outlined in the revised Chapter V of the OECD Guidelines recommend one or more diagrams be included in the documentation that show the value chain(s) of a multinational's five largest products and any other products and/or services amounting to more than 5 percent of group turnover. While the specifics of the diagram are not outlined therein, the revised Chapter V does indicate that the following information is necessary to illustrate a value chain:

1. Geographic Markets
2. Functions performed by entities
3. Differences in risks assumed

As the OECD and tax authorities have not offered a prescriptive approach for illustrating a value chain, it is upon taxpayers and transfer pricing professionals to develop methods for preparing cohesive diagrams that summarize the key aspects of a value chain. This article offers a generic approach for illustrating value chains that involves three parameters: functions, channels, and relative value. The functions and relative value columns are populated with information from the Value Map and the Modified Portfolio Purchasing Matrix illustrated in *Table 2* and *Figure 1*, respectively. The market channel column is used to differentiate related party activities from third party activities and will contain the entities involved with the corresponding function row. An illustrative example of a diagram developed based on this generic approach is shown below in *Figure 3*.

Figure 3: Generic Value Chain Diagram



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