Global Transfer Pricing Conference
Using value chain analysis post-BEPS
October 2016
VCA Video

https://pwc.mediaspace.kaltura.com/media/t/1_x9l8yky6
Agenda

1. Why are we discussing VCA?
2. The internal approach
3. The empirical approach
4. VCA in practice: case studies
Today’s presenters

Andrew Casley
PwC UK

Sara Herstin
PwC US

Jonas Van de Gucht
PwC Belgium
Why are we discussing VCA?

1984

- Michael Porter’s VCA
- CbC reporting
- Masterfile

1984

- Demarcation
- DEMPE

2013

- The single firm
- OECD’s BEPS Project

- Activities are geographically dispersed
- Corporate structures matter less

- Flexibility
- Profit split for highly integrated operations

- Action 1: Digital Economy
- Action 13: TP Documentation
- Action 8-10: Aligning TP outcomes with value creation

- Two or more make unique and valuable contributions
Why are we discussing VCA?

“Members of the MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles”

Statement from article 8-10 BEPS paper – Aligning TP Outcomes with Value Creation

“The economist’s conception of a single firm operating in a co-ordinated fashion to maximize opportunities in a global economy”

Statement from article 1 BEPS paper – Addressing the Tax Challenges of the Digital Economy

“The sharing of profits or losses under a profit split may...reflect a fundamentally different commercial relationship between the parties in particular concerning risk allocation, to the paying of a [price] for goods or services”

Statement from article 8-10 BEPS paper – Aligning TP Outcomes with Value Creation

Why are we discussing VCA?

“Action 5 specifically requires substantial activity for any preferential regime..., which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the country where value is created”

Statement from article 8-10 BEPS paper – Aligning TP Outcomes with Value Creation
Why are we discussing VCA?

Traditional approach – One-sided transfer pricing

**Cost plus services**
- R&D Centres
- Procurement
- Manufacturing

**Return on sales**
- Limited Risk Distributors

**“Residual”**
- Principal / HQ
- IP, Group strategy, Group synergies and Management services
- Regional Hubs

Tax authorities’ focus historically
Post BEPS transfer pricing profit distribution should align to the group’s value chain

- Principal / HQ: IP, Group strategy, Group synergies and Management services
- R&D Centres
- Procurement: Supply risk
- Manufacturing: Product risk
- Regional Hubs: Risk of insufficient product development
- Distribution: Market risk
PwC VCA experience

Multi function for TP services

Overview of the value drivers of the business and profit location across the group

- Feasibility study prior to aligning international business model to BEPS; identify potential TP issues (40%)
- Identify substance requirements, e.g. for principal companies and profit allocation to PEs (10%)
- Corroborate internal economic analysis in Master file and CbC reporting (20%)
- Support local entity TP when dealing with tax authorities:
  - Tax audits
  - APA negotiations (30%)
**PwC VCA experience**

Number of approved and pending projects

- We have extensive experience in analysing value chains in a broad spectrum of industries
  - PwC has either completed or is currently carrying out 31 VCA projects worldwide
- There is a significant interest for VCA from the market
  - 44 VCA projects are pending to start or being considered by our clients
How to do it for tax purposes

The internal approach

OECD Profit Split Method

Outcome driven / What if management changes / What if someone challenges what you did?
Current situation
Current situation

Functional contribution analysis

Brand  Manufacturing  Sales  R&D  Marketing

25%

38%
Current situation (based on internal analysis)

Brand
- CH: 70%
- NL: 10%
- BEL: 10%
- US: 10%

Manufacturing
- CH: 20%
- NL: 10%
- BEL: 10%
- US: 60%

Sales
- CH: 5%
- NL: 10%
- BEL: 75%
- US: 10%

R&D
- CH: 25%
- NL: 25%
- BEL: 25%
- US: 25%

Marketing
- CH: 70%
- NL: 10%
- BEL: 10%
- US: 10%
Current situation
(based on internal analysis)

Per country

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Global Transfer Pricing Conference │ October 2016
**Current situation**
(based on internal analysis)

Functional contribution analysis

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<th>Per country</th>
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<tr>
<td><strong>Brand</strong></td>
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**Profits per country**
(in millions)

- CH profits: 51
- NL profits: 13
- BE profits: 19
- US profits: 17

**Functional contribution analysis**
**Challenge by the tax authorities**

- 25%
- 8%
- 8%
- 21%
- 38%

Functional contribution analysis

**Per country**

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<th>CH</th>
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<td>Sales</td>
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<td>R&amp;D</td>
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<td>Market</td>
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**Profits per country (in millions)**

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- Functional contribution analysis
Challenge by the tax authorities

Per country

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Profits per country (in millions)

- CH profits: 51
- NL profits: 13
- BE profits: 19
- US profits: 34

€17 m EBIT shifted from CH to US
**Profit split vs Empirical VCA**

The OECD promises that a value chain analysis can help identifying when a profit split is appropriate but ... VCA is not a profit split method, it is only a tool.

So a VCA does not replace any aspect of the traditional TP analysis, it is an overarching broad based analysis to put the TP into the right economic and group context.

To identify where and how value is created, whether the value creation is sustainable, the level of integration and economically relevant contributions.

1984 - 2013
How to do it for tax purposes

The empirical approach

1. Peer group analysis
   - Identify a representative peer group
   - Collect quantitative and qualitative information

2. Competency mapping
   - Identify and analyse the competencies of each peer
   - Compare peer competencies with profitability to identify premium returns attributable to specific competencies
Case studies

Luxury Retail

Pharma
VCA in practice – Luxury Retail

Background

Objective
1. Support and check the outcome of one-sided benchmark studies

Action
1. Peer group analysis
2. Competency analysis
3. Entity mapping

Result
1. Support in TP audits available
2. Weaknesses in TP policy identified

Peer group
We screened over 66 companies involved in the luxury and fashion industry.
We identified 29 companies (excluding Company Y) as relevant for the VCA for being involved in the fashion retail industry, 14 of them being categorised as luxury companies.
VCA in practice
Peer group analysis

Consolidated Operating Profit Margins - 2012-2014 average

- 5% Yoox
- 6% Boohoo
- 7% ASOS
- 7% Debenhams
- 9% Sports Direct
- 12% Primark
- 15% GAP
- 15% Tiffany & Co.
- 16% Ralph Lauren
- 18% Salvatore Ferragamo
- 18% H&M Hennes & Mauritz AB
- 19% Inditex
- 19% Hugo Boss
- 19% Tod’s SpA
- 20% Burberry
- 24% Richemont
- 24% The Swatch Group
- 28% Prada Group
- 28% Michael Kors
- 29% Coach Inc
- 29% Company Y
- 31% LVMH-FLG**
- 31% Hermes Consolidated
- 32% Hermes Consolidated

Consolidated Operating Profit Margins:
- 2012
- 2014 average
VCA in practice

Vertical integration

Company Y
Retail
Wholesale premium
Wholesale

6% peer 1
8% peer 2
17% peer 3
31%

Company Y
**VCA in practice**

**Vertical integration**

**Process**

1. Identification of vertically integrated value chain components:
   - players in this industry can be vertically integrated and combine both wholesale and retail competencies;

2. Identification of companies involved respectively in wholesale and retail competencies

3. Gathering of publically available financial information for both type of companies and determination of an average return

**Adjusted weighted average Operating Margins -- Wholesale business (2012-2014)**

- Adidas AG: 6%
- Gerry Weber: 10%
- Company Z: 11%
- Ted Baker: 13%
- Michael Kors: 14%

- **Avg**: 10.9%

**Vertically integrated peers**

- OPM Wholesale (adjusted): 14%
- OPM Retail: 17%
- OPM Total Company Y (as per AR): 31%

**Companies buying and selling**

- Procurement
- Sourcing
- Logistics
- Marketing
- Internet Platform
- Stores operation and architecture

**Companies involved in wholesale activities**

- Design and creative media
- Product Brand & Management
- Control over production

**Companies involved in wholesale activities**

- Procurement: Sourcing, Logistics, Marketing, Internet Platform, Stores operation and architecture

**Companies involved in wholesale activities**

- Design and creative media: Product Brand & Management, Control over production
VCA in practice
Horizontal integration

Company Y

Distinctive retailers

Stores operation

Online retail

peer 1 – peer 3

peer 4 – peer 5

peer 6 – peer 7

Company Y

6%

8%

12%

31%
VCA in practice
Horizontal integration – Focus on the retail segment

Process

2. Identification of horizontal value chain components
- Online retailers
- Retailers with stores operations
- Retailers with a higher operating margin

then a comparison amongst them could reveal sources of sustained competitive advantage and unique and valuable contributions.
For Industry 1, the split of profits between the retail and wholesale business is respectively 20%-80%.

For Industry 2, the split of profits varies depending on the level of sophistication of both retail and wholesale businesses:

- 60-40% for both basic or high-end activities;
- 35-65% for basic retail and high-end wholesale activities; and
- 50%-50% for high-end retail and basic wholesale activities.
VCA in practice
Vertical & Horizontal

Company Y
Wholesale premium
Wholesale
Retail “magic” for Company Y
Distinctive retailers
Stores operation
Online retail

6% 8% 12% 17% 23% 31%
VCA in practice – Pharma industry

Background

Objective
1. Identify the value creating activities in the principal and local distribution entities after the reorganisation.

Action
1. Peer group analysis
2. Competency analysis

Result
1. Identify value creating activities
2. Empirical assessment of local activities contra central activities

Peer group
We screened peers with similar activities as the company, i.e. branded pharma. To find data on returns attributable to patent and blue sky R&D we also analysed companies acting in the generic pharma industry.

We identified 30 companies as relevant for the VCA for being involved in the pharmaceutical industry, 11 of them being categorised as potentially relevant for the VCA.
**VCA in practice**

Peer group analysis

*Selected peers – average OPM* (2010-2014)

Average OPM 30.6%
VCA in practice
Vertical integration

Vertically integrated pharma company

R&D and Pattern

Marketing and Distribution

Sourcing and Manufacturing

Vertically integrated pharma company
**VCA in practice**

**Vertical integration**

**Process**

1. Identification of vertically integrated value chain components

- players in this industry are vertically integrated and sourcing directly from producers of raw materials

- third party sourcing companies can provide insight into contribution of value chain component

- where these parties operate as tollers for industry players, such margins can provide insight into manufacturing competency

![Diagram showing vertically integrated value chain components](image-url)
Taking action - so why consider doing one

- Support your residual

- Substance

- Transparency

- Requested by tax authorities

- APA, MAP, tax audit

- Corroborate one-sided methods
Panel Q&A
“When the facts change, I change my mind. What do you do, sir?”

John Keynes
In-session Q&A

To submit questions electronically, select the current session from the agenda (on the main menu), and tap on Participate and Q&A.
What did you think?

At the end of the session, tap Session Survey and provide your rating on any or all survey questions. Tap submit response.
Thank you