8. Value Chain Analysis and The Quest for The Best Location

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Introduction

Multinational corporations (MNCs) represent a growing share of the world's GDP, with assets that are increasingly intangible. At the same time, their workforces are becoming smaller, better qualified and more mobile. This is causing a fiercer battle between countries to attract and retain key value drivers. New initiatives such as Base Erosion and Profit Shifting (BEPS) meanwhile force MNCs to review their value chains in order to align their business and tax models. MNCs can benefit from a holistic and comprehensive Value Chain Analysis (VCA) that sheds light on their global structures and profit allocations, providing the basis to realign business and tax models to be sustainable and scalable.

Such "future proofing" of the value chain is necessary for any MNC that is looking to transform its business with a view towards international expansion and/or the transfer of functions, assets and risk to another jurisdiction.

Location promotion agencies also need a granular understanding of MNCs' typical key value drivers, specific to the industries they are seeking to attract to their area. When competing with other locations they must demonstrate clearly why they are better suited to host one or several of a firm's key value drivers and how their location would fit the business and tax model of the MNC in question.

Combined, BEPS and the application of VCA will result in some historically popular jurisdictions losing MNC investments while others will become more attractive.

The BEPS initiative launched three years ago by the Organization for Economic Cooperation and Development (OECD) can be labeled truly disruptive to the way multinational companies structure their value chains across countries and continents. Standing for "Base Erosion and Profit Shifting", BEPS is the OECD's response to shrinking tax incomes from multinational companies to industrialized countries.

The Key Word is Substance

The main assets of MNCs are increasingly intellectual property (IP) and brands — in other words, intangible assets that can be easily shifted between locations and that are therefore instrumental in reducing the global effective tax rate (ETRs) of those who own or exploit them.

In order to counter the excessive use of special tax regimes (which often include special tax treatments for income from IP), the OECD has developed a BEPS action plan. This aims to reduce the arbitrage between varying tax rates and interpretations of tax principles that arise as a result of individual countries' tax sovereignties. The OECD's plan was outlined in detail in late 2015 and it is now down to the individual countries to amend their national tax laws accordingly.

In essence, BEPS requires that for MNCs to be able to allocate profit to a certain location, there must be sufficient qualifying substance located there. Merely holding assets (i.e. IP) without enough substance in a certain (tax beneficial) jurisdiction no longer qualifies for shifting profit to this jurisdiction. But how is substance defined? The OECD sees substance as a combination of functions (employees), assets (e.g. IP or manufacturing plants) and risks (e.g. contractual risks).

The OECD also suggests that its member states share information on MNC taxation through a so-called Country-by-Country Reporting (CbCR) system. MNCs with annual revenues above a threshold of EUR 750 million (approximately USD 845 million) will be required to report how much profit they generate in each country in which they are active and how much tax they pay in each jurisdiction. This transparency will help national tax authorities to challenge national tax filings of MNCs operating across various countries.

This is especially relevant as MNCs have been traditionally at the forefront of tax planning via the usage of low-tax jurisdictions and special tax regimes for the exploitation of IP. As BEPS is implemented in national tax codes, and as CbCR looms, MNCs are reviewing their use of low-tax jurisdictions for the management and exploitation of IP. Until now, management of intangible assets focused on cost sharing and economic risk, whereas BEPS will require a closer alignment of actual "value generation" (i.e. profit) with "economic activity."

In other words, the transfer of IP to low-tax jurisdictions such as Bermuda or the Cayman Islands with little or no substance is a model of the past.

Value Chain Analysis (VCA)

The OECD states that "it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation."

A holistic VCA therefore provides a solution to ensure that the business and tax models are aligned and in compliance with the OECD regulations. A value chain is a set of activities performed by a firm to deliver a valuable product or service to the market. VCA involves an in-depth assessment of a company's functions (value drivers), assets and risks and where they are located.

A VCA is especially critical when a business seeks transformational change to respond to a changing market environment, disruptive technologies and/or an evolving regulatory environment. It can help a business determine a possible reconfiguration of its international structures and business processes to create structures that align the business and tax models. The goal is to design a value chain model that is future-proofed and complies with relevant bodies' requirements such as the OECD's BEPS.

A Three-Step Approach

A structured VCA starts with mapping the existing value chain, evaluating the relative values of the individual value drivers and undertaking a profit contribution analysis. These analyses should be performed in close collaboration with key commercial professionals within the business.

Mapping involves analyzing functions, intangible assets, risks, substance/tangible assets and attributable profits. The outcome can be displayed in various formats, including a user-friendly color-coded map that denotes profits, functions and locations.

In the *evaluation process* that follows, industry comparables, interviews and a variety of tools such as the RACI model (to evaluate the importance of certain key functions) or the DEMPE approach (to evaluate where to locate IP income) are used to display the relative profit contribution of each value driver to total profit. The results can be displayed in the form of a heat map, system profit analysis, industry analysis or overview of key risks and assets.

The findings are applied to determine whether an existing value chain's structure/risk allocation is efficient and provides the right set-up for future growth or restructuring. Also whether it is supportable based on substance/decision-making accountability from a tax point of view or whether adjustments are needed. If an entire or partial redesign of the value chain is required, the relocation of values drivers, assets and their related risks and revenue streams might be considered.

From VCA to Site Selection

If a VCA reveals that it is necessary to relocate functions, assets and risks, a proper site selection process should be applied. Only such a multidimensional analysis that combines business, tax, technical and legal aspects and trends will lead to sustainable redesign of the existing value chain. This involves looking at general site selection factors such as the size of industry clusters, availability of workforce, reliability of infrastructure, possibility of collaboration with third parties, etc. Specific factors must be taken into account that are relevant to each value driver to be relocated (such as Big Data for sales and marketing, Industry 4.0 for manufacturing, collaboration for R&D).

Which Jurisdictions will Win or Lose?

Simply relocating IP or other passive income generating assets to a low-tax jurisdiction is no longer a sustainable tax planning strategy. This fact impacts both companies' value chains and the jurisdictions in which such structures were located. Jurisdictions face the reality that offering a stable legal and political environment, operational grade infrastructure and little to no taxation is insufficient to keep companies there. Classic offshore locations are already being hit by lower demand, affecting employment and GDP, among other factors.

The effects of BEPS on jurisdictions can lead us to classify three types of countries in terms of their attractiveness to foreign direct investment:

1) Countries with *strong clusters of companies that have most of their assets in the form of IP and have attractive tax and business environments:* The UK and Switzerland — and to a certain degree the Netherlands and Belgium — are examples. These countries can expect to be even more attractive in the future for MNCs from overseas, particularly from the US and Canada. It is possible for investors to locate regional HQs, manufacturing plants or research centers in these territories and staff them with locally available know-how. This is especially the case in sectors ranging from high tech to branded apparel and luxury goods to life sciences, medical devices and other IP-intensive industries. They will thereby fulfill the substance necessary to benefit from the tax advantages offered by these countries. In addition, flexible labor laws in the UK and in Switzerland offer benefits.
2) Countries with *significant domestic industries but that lack an attractive business environment* such as less flexible labor regulations and non-competitive tax systems. Germany, France and, to a lesser degree, Italy, Spain and the Nordics belong to this group. US and Canadian MNCs have traditionally shied away from transferring their IP or setting up larger centralized management functions in such countries, but in certain cases have located manufacturing and R&D plants there. These countries can expect to keep current business in terms of foreign direct investment. Some governments may even benefit from high tax incomes due to reduced base erosion opportunities from the MNCs companies doing business there.
3) The third type of countries are *the ones on the losing end, which have built their business models predominantly on attractive tax regimes* without a strong domestic industry that can support newcomers through a qualified workforce, strong universities and highly specialized service providers. Some of these countries have tried — sometimes successfully — to attract more substance in the form of manufacturing or R&D operations, but taxation was the main reason foreign companies came. These countries include Ireland and Luxembourg. They may need to rethink their investment promotion and industrial policy, and may wish to refocus their efforts on other core strengths such as competitive salaries or a highly international and well-trained workforce and flexible labor regulations combined with very competitive tax systems and top infrastructure. They should also try to use incentives (e.g. for R&D and for startups) to make best use of the huge potential of know-how and entrepreneurial spirit available.

Summary

It can be stated that BEPS has a disruptive impact on how MNCs structure and operate their businesses. Combined with the fact that assets are increasingly intangible and qualified workforces increasingly mobile, there is a momentum for realigning and streamlining existing value chains and selecting the most suitable locations from a business and tax perspective. Along with a few other countries, Switzerland is especially well positioned to host MNCs' key value drivers. It should therefore take current developments as a unique opportunity to further position itself as a leading global hub for MNCs looking for fast and sustainable growth.

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