12. Value Chain Analysis after BEPS - The Roadmap from "Staying out of Trouble" to "Being in Control"

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Introduction

Value Chain Analysis (VCA) has its origin dating back to 1985, when Michael Porter first introduced it in his book titled 'Competitive Advantage'. In simplest of terms, VCA refers to the entire performance process of a company, which begins with the research and development and ends with the delivery to the end consumer. Value chain of a company takes into account all support and core activities carried out by related or unrelated parties in making the company function.

From its conception as an area of interest for economists, VCA has gained the interest and attention of many, especially in light of the latest regulations governing Base Erosion and Profit Shifting (BEPS), which further regulates related party transactions within MNEs, which accounts for the majority share of global trade[1]. It is while interpreting the arm's length nature of related party transactions and ensuring that they are aligned with corporate operating, strategic and governance models that the concept of VCA becomes a boardroom agenda.

The next sections address how:

- Tax governance becomes a part of board's involvement;
- A CFO converts a re-active policy on tax ("staying out of trouble") to a more pro-active part of the agenda of the Boards ("being in control");
- How VCA has become an integrated workflow on any tax or transfer pricing agenda.

Corporate Governance Perspective of Looking at a VCA

OECD's Forum on Tax Administration (FTA) first conceptualized the idea of achieving an enhanced relationship between tax administrations and large business taxpayers during its meeting in Seoul in 2006. The global financial crisis of 2008 further reinforced the importance of good corporate governance. Because of the overpowering techniques used by corporate groups over the last few decades under the garb of tax planning that has led them to save millions in tax, the traditionally clear line between tax avoidance and tax evasion is blurring and the governments as well as the public at large is insistent on attributing individual liability for 'criminal' tax evasion to responsible persons within a corporate tax group.

An example of this thinning line can be seen in yet another dispute[2] between Google and the French tax authority, which is seeking more than €1 billion ($1.12 billion) from the search firm in back taxes. France's tax authority has been investigating Google since 2011 and is of the opinion that this high levy of tax is due to an aggressive tax evasion by the company over the years.

The increased focus on tax risk management also stems from emergence of new local regulations without a clear interpretation on application. Some such examples are listed hereinbelow:

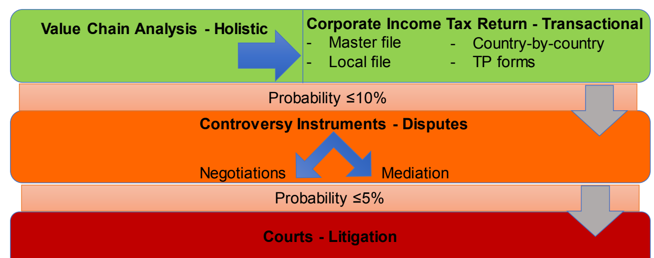
- New Zealand's Inland Revenue department has proposed to implement a new standard for exchanging cross-border information about tax rulings in 2016 in respect of high-risk transactions such as unexplained tax losses returned by foreign-owned groups, cash pooling arrangements, payment of royalties at levels that are not sustainable, controlled foreign companies etc.
- The Australian tax office has described a detailed process for case selection for an audit for companies engaged in the mining industry.
- The UK diverted profits tax is another such example enacted to curtail practices of tax avoidance and evasion.

CFO's Perspective on Tax

From a CFO's perspective, tax structures should allow for a/an:

- Easy entry;
- Easy exit; and
- No reputational risk.

Until 2015 tax often operated in silo's, e.g. international tax versus transfer pricing compliance, whereas during 2015 and 2016, the BEPS project effectively integrated international tax and transfer pricing and pushed economic reality to be prevailing. This led to Value Chain Analysis being used by tax authorities and MNE's to comply with the increasing demand for full transparency on "tax sensitive data". Thus, a holistic approach to taxation by MNEs is a "must-have". The following visual captures (in colour coding) this trend, where the holistic version of the VCA must be fully synchronised with the "local share of the total profit pie" (as reflected in the local tax return). Since Action 13 of BEPS has pre-defined that standard forms (such as masterfile, local file, CbCR and local TP forms) need to be seen as an appendix to the local tax return, tax inspectors suddenly have the total picture of "their local company". As such they have lot of VCA relevant data points to assess tax. This transparency is unprecedented.



How to be in Control

With the latest focus on VCA, being in control requires a company to align its strategy communicated to its stakeholders with operational conduct as well as their tax/transfer pricing reality. A few examples of steps involved in becoming fully in control are:

- Synchronisation of financial data analytics
- A global tax (CIT, VAT, MF, CbC) compliance approach
- Pro-active Risk Planning – Provisioning and ETR impact (APAs, tax rulings)
- Full alignment of governance and operational conduct (using RACI design)
- Efficient management of in-house challenges (HR, IT and succession planning)
- Clear/efficient communication to all internal and external stakeholders

Regulatory background of VCA

a. OECD Perspective[3)]

The OECD, in its BEPS project, has recognized that a value chain analysis may be helpful in the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used. For this purpose, the OECD states that a value chain analysis should consider where and how value is created in the business operations by considering:

(i) Economically significant functions, assets and risks and the persons contributing to the same;

(ii) The economic circumstances that create opportunities to increase profit;

(iii) Whether such value-creation is sustainable or short-term.

The following sub-sections b., c., and d., explain how some tax authorities are, through law and regulations, making a VCA approach a part of their local TP documentation:

b. China Perspective[4)]

China's State Administration of Taxation on June 29, 2016 issued a new transfer pricing regulation - Bulletin 42 on value chain analysis that stipulates the inclusion of the following into the local file:

(i) Flows of business, goods and materials, and capitals within the group, including design, development, manufacturing, marketing, sales, delivery, billing and payment, consumption, after-sale service, recycling, other processes related to goods, services or other relevant underlying targets of the related party transactions and all the parties involved;

(ii) Annual financial statements of each of the aforementioned parties for the immediately preceding fiscal year;

(iii) Measurement and attribution of value creation contributed by location specific factors;

(iv) Allocation policies and actual allocation results of the group's profits in the global value chain.

c. Germany Perspective[5)]

The German Ministry of Finance, in 2005, had issued a notification stating the a VCA with identification of individual business processes, their relative weighing and an analysis of the contribution made by various group companies should be a part of TP documentation. More recently, in 2016, the Ministry of Finance has issued another Discussion Draft of Profit Margin Recording Regulation, which states that functional and risk analysis should include:

(i) Information on the taxpayer and the persons performing functions and undertaking risks (as well as any changes in the same) within the framework of the business relations;

(ii) The agreed terms of the contract and the significant market and competition;

(iii) The names of the persons responsible for the business relations decisions (decision-making authority) and

(iv) Description of the value-added chain and presentation of the value-added.

d. South Africa Perspective[6)]

Following the global trend, the South African government has also issued the final notice of duty to keep records, books of account or documents ("Final Notice"), the scope of which includes intercompany transactions not only directly affiliated parties but also "connected persons" – companies that a part of the same group.

The Final Notice prescribes a company, that has entered into an intercompany transaction, to keep the records that essentially allow to perform a full value chain analysis, including:

(i) Summary of the business operations;

(ii) Segmentation of the revenues, costs, expenses and profits between transactions with connected persons and independent persons, including record of the application of the transfer pricing policy;

(iii) Description of the functions performed, risks assumed and the assets employed in the potentially affected transactions;

(iv) Operational and cash flows of the potentially affected transactions.

6. Lessons Learned

With the OECD's pressure on ensuring that a fair share of tax lands in the place of creation of value, local governments followed suit with local laws and regulations. This should put MNEs and their boards on a tax journey from "staying out of trouble" to "being in control" for which, a minimum set of steps need to be considered:

- Corporate governance should be read to also include 'corporate tax governance'. This will ensure proper communication of honest, transparent and compliant conduct to all internal and external stakeholders in respect of tax and transfer pricing policies;
- The local tax return should reflect the same legal, economic and financial reality and remuneration as reflected in the masterfile, local files and CbCR filed by the MNE (fully aligned compliance operations);
- The financial (tax) data analytics should become an essential part of risk planning and management by the boards of MNE's; and
- Managing in-house challenges such as succession planning, IT and HR challenges should be considered a primary agenda of boards in order to create standardization and harmonization of (tax) relevant processes. This in turn will ensure a smooth transition on the road to success and being in control of the global tax function.

1) https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC/WP(2010)27/FINAL&docLanguage=En. At present, an OECD estimate suggest that 70% of global cross-border trade is between related parties, which places transfer pricing (TP) at the centerstage of any tax risk mitigation strategy. Therefore, in this article 'tax risk management' is understood to include TP risk management as well

2) Schechner, Sam. "Google's French Headquarters Raided by Tax Investigators." The Wall Street Journal, 24 May 2016. Web. Available at: http://www.wsj.com/articles/googles-french-headquarters-raided-by-tax-investigators-1464096931

3) Discussion Draft on Revised Guidance on Profit Splits, published in July 2016; BEPS Report on Actions 8-10, published in October 2015

4) Public Notice Regarding Refining the Reporting of Related Party Transactions and Administration of Transfer Pricing Documentation (SAT Public Notice [2016] No. 42, dated 29 June, 2016)

5) Ministry of Finance Notification, April 2005; Discussion Draft, Profit Margin Recording Regulation 2016

6) SARS Final Notice 2016

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