VALUE CHAIN ANALYSIS AND TRANSFER PRICING: UNDERSTANDING WHERE VALUE IS CREATED TO PRICE IT CORRECTLY

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Abstract

Transfer pricing cannot be done well without first understanding how a multinational group actually creates value. This is the premise behind value chain analysis (VCA): a structured examination of which entities within the group perform which functions, employ which assets, and bear which risks – and what those contributions are worth in economic terms.

For transfer pricing specialists, VCA is the methodological foundation for the functional analysis, the identification of the tested party, and the selection of the most appropriate pricing method. For CFOs and business leaders, it raises a broader and equally important question: does the group's internal pricing structure accurately reflect the economic logic of the business, or has it drifted over time into a configuration that is difficult to justify operationally, financially, or before a tax authority?

This article examines value chain analysis from both perspectives. It discusses how VCA is conducted in practice, why its conclusions matter beyond the tax function, and what happens when the pricing structure diverges from the underlying economic substance of the business.

Keywords

Transfer Pricing; Value Chain Analysis; Functional Analysis; DEMPE Functions; Arm's Length Principle; BEPS Actions 8-10; Profit Attribution; Business Restructuring; Intangible Assets; Multinational Enterprises.

Value Is Not Created Equally Across the Group

Every multinational enterprise is, at its core, a network of entities that collectively generate economic value. Some entities develop the technologies or brands that make the group competitive. Others manufacture products, manage supplier relationships, or operate distribution channels. Still others provide shared services, financial support, or regional management. Each entity contributes something, but not all contributions are equal, and not all of them are unique.

This distinction matters enormously for transfer pricing. The OECD Transfer Pricing Guidelines [OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en.], and particularly the conclusions of the BEPS project on Actions 8 through 10 [OECD (2015), Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241244-en.], establish a clear principle: profits should be attributed to the entities that perform economically significant functions, employ valuable assets, and assume genuine risks. Legal ownership of an intangible, a favorable contractual arrangement, or a registration in a low-tax jurisdiction does not, by itself, justify a significant share of group profits if the corresponding economic substance is absent.

Value chain analysis is the tool used to map this economic substance. It answers the question that underlies every transfer pricing inquiry: who in this organization creates the value that we are trying to price?

The answer is rarely simple. In practice, value creation in a multinational group tends to be distributed across multiple entities and jurisdictions, shaped by historical development decisions, acquisition histories, and organizational changes that may no longer reflect the current strategic logic of the business. A rigorous VCA does not simply describe the current structure, it interrogates it.

What Value Chain Analysis Actually Involves

In transfer pricing practice, VCA begins with the functional analysis: a systematic assessment of the functions performed, assets employed, and risks assumed (the FAR analysis) by each entity involved in the controlled transaction. This is the foundation on which the rest of the pricing analysis is built.

Functions: beyond the organizational chart

Mapping functions means identifying not just what each entity does, but what decisions it makes. The OECD Guidelines draw a clear distinction between performing a function and controlling it. An entity that processes payroll, manages a local warehouse, or assembles products according to specifications

set elsewhere is performing functions, but the economic significance of those functions is limited if the key decisions are made at headquarters or in another jurisdiction.

For the transfer pricing specialist, the question is always: who decides? Who determines the product development roadmap? Who sets the pricing strategy in the market? Who approves the entry into a new supplier relationship? Decision-making authority, not operational execution, is what the arm's length standard is most concerned with when it comes to allocating the returns from significant value-creating activities.

For CFOs, this has an important implication. Organizational changes that shift decision-making authority from one entity to another, a centralization of procurement, a reorganization of the regional management structure, or the migration of a key function to a shared service center, are not only operational events. They are also transfer pricing events, because they change the functional profile of the entities involved and therefore the arm's length remuneration they should receive.

Assets: tangible and intangible

The asset analysis focuses on identifying which entities employ economically significant assets in the transaction. For tangible assets, manufacturing plants, logistics infrastructure, IT systems, the analysis is relatively straightforward. For intangible assets, it is considerably more complex.
The OECD Guidelines introduce the concept of DEMPE functions to address this complexity. DEMPE stands for Development, Enhancement, Maintenance, Protection, and Exploitation of intangible assets. The entity that performs and controls the DEMPE functions in relation to a valuable intangible, a proprietary technology, a brand, a customer database, a distribution network, is, under the Guidelines' framework, the entity economically entitled to the returns generated by that intangible, regardless of where legal ownership formally resides.

This principle has significant practical consequences. A group that has historically held intellectual property in a low-tax jurisdiction while performing the actual development and enhancement activities elsewhere may find that the DEMPE analysis produces a very different picture of where the economic ownership of the intangible lies, and therefore where the royalty income should reside.

Risks: contractual allocation versus economic reality

Risk analysis is perhaps the most contested area of transfer pricing practice. Multinational groups routinely allocate risks contractually, through intercompany agreements that assign market risk, credit risk, inventory risk, or development risk to particular entities. The transfer pricing consequences of these allocations can be substantial, since the entity that bears risk is entitled to the corresponding return when things go well.

The OECD Guidelines, however, do not accept contractual risk allocations at face value. They require the analyst to verify that the entity bearing the risk actually has the capacity to control it, meaning that it employs people who monitor and manage the risk exposure, and the financial capacity to bear the consequences if the risk materializes.

An entity with no employees, no treasury function, and no independent decision-making capacity cannot genuinely bear market risk or development risk, regardless of what the intercompany agreement says. This alignment between contractual risk allocation and operational substance is one of the central themes of the post-BEPS transfer pricing framework, and it is precisely what VCA is designed to evaluate.

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One of the most practically important functions of VCA is to identify situations where the group's internal pricing structure has become misaligned with the economic reality of the business. This misalignment can arise gradually, as the business evolves while the pricing framework remains static, or more abruptly, following an acquisition, a restructuring, or a significant change in the operating model.

The consequences of misalignment are felt across the organization, not only in the tax function. From a transfer pricing perspective, a pricing structure that does not reflect economic substance is vulnerable to challenge by tax authorities, particularly in jurisdictions that have implemented the BEPS recommendations and have the analytical capacity to conduct a detailed FAR analysis of the group's operations.

From a financial management perspective, the consequences are different but equally significant. If the internal pricing framework does not accurately reflect which entities create value, financial performance metrics will be distorted. An entity that creates significant value may report modest margins because its contribution is transferred to another entity through below-arm's-length pricing. Conversely, an entity with limited economic substance may report inflated profitability, creating a misleading picture for management.

For CFOs, this is the strategic dimension of value chain analysis. It is not just a question of whether the transfer pricing documentation will satisfy a tax inspector. It is a question of whether the internal financial architecture of the group accurately reflects the economic logic of the business – and whether the signals it generates are reliable inputs to strategic decision-making.

Value Chain Analysis in Practice: Common Challenges

Conducting a rigorous VCA is rarely straightforward. Several features of modern multinational organizations create genuine analytical difficulties that practitioners must navigate carefully.

Fragmented and distributed decision-making

In large multinationals, decision-making authority is rarely concentrated in a single entity or location. Strategic decisions about product development, market positioning, pricing, and supplier selection may involve multiple teams across multiple jurisdictions, with authority distributed across a matrix structure that defies clean functional mapping.

This complexity requires the analyst to look beyond formal governance documents and engage with the actual conduct of the parties – through interviews with operational management, review of internal approval processes, and examination of the decision trails embedded in emails, board materials, and project records. The goal is to identify where decisions are genuinely made, not simply where they are formally ratified.

Digital business models and data-driven value creation

Digital transformation has complicated VCA by introducing forms of value creation that do not map neatly onto traditional functional categories. In a platform-based or data-driven business model, value may emerge from the interaction of user-generated data, proprietary algorithms, and network effects in ways that are difficult to attribute to any single entity or jurisdiction.

The transfer pricing implications of digital value creation remain an area of active regulatory development. Pending the broader implementation of the Pillar One framework, which seeks to reallocate taxing rights over residual profits of large multinationals to market jurisdictions, practitioners must apply the existing OECD Guidelines with careful attention to the specific characteristics of each digital business model. Generic functional descriptions are insufficient; the analysis must identify the nature and significance of each contribution with precision sufficient to support a defensible pricing outcome.

Post-restructuring configurations

Business restructurings, the conversion of full-risk distributors to limited-risk agents, the centralization of procurement or manufacturing functions, the migration of intangible assets to a principal structure, create particular challenges for VCA because the pre- and post-restructuring value chains may differ substantially. Chapter IX of the OECD Guidelines requires the analyst to examine both the arm's length nature of the restructuring itself and the arm's length nature of the resulting intercompany transactions.

A key question in any post-restructuring VCA is whether the new functional profile of each entity is consistent with the transfer pricing treatment being applied. An entity that has been contractually converted to a limited-risk distributor but continues to perform significant market development functions, manage key customer relationships, and bear operational risk in practice is not, economically, a limited-risk entity. The contract is not the analysis.

Conclusion: A Shared Responsibility

Value chain analysis is the point at which transfer pricing, business strategy, and financial governance converge. It asks, in precise and operational terms, the question that every well-run multinational should already be able to answer: where in this organization does value actually come from?

For transfer pricing specialists, the answer determines the shape of the entire pricing analysis, the functional characterization of each entity, the selection of the tested party, and the choice of method. For CFOs and business leaders, it provides a diagnostic lens through which to evaluate whether the group's internal financial architecture is aligned with the economic substance of the business.

The post-BEPS regulatory environment has made this alignment more important, and more closely scrutinized, than at any previous point. Tax authorities around the world are increasingly equipped to look behind contractual structures and formal documentation to assess whether the transfer pricing outcomes of a multinational group are consistent with where value is genuinely created. Groups that can demonstrate this consistency, through rigorous, evidence-based, and regularly updated value chain analysis, are significantly better positioned to manage both their tax and reputational risks.

Value chain analysis, done well, is not a compliance exercise. It is a continuous inquiry into the economic logic of the business, one that belongs not only in the tax function, but at the center of the conversation between finance, strategy, and operations.