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Contract Manufacturing: Considerations for Transfer Pricing

Contract manufacturing is a popular business model in the manufacturing sector, as it is often employed by multinational entities (MNEs) in today's global economy. This issue of the Transfer Pricing Forum explores the transfer pricing implications of contract manufacturing and the impact on various stakeholders across jurisdictions.

Please respond to each question below from the perspective of your jurisdiction with, where applicable, a special consideration for any litigation issues/APAs as they pertain to each question.

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?
2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers? In your response, consider the following:
   a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;
   b. Adjustment for a contract manufacturer with capital intensive operations;
   c. Capacity utilization for the contract manufacturer and implications for transfer pricing;
   d. Any other considerations.
3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing? Include in your response the following:
   a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;
   b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;
   c. Other issues pertaining to government subsidies or grants.
4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

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Argentina

Cristian E. Rosso Alba and Juan Marcos Rougés

Rosso Alba & Rougés

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

To provide the relevant background for our response, we identify two transfer pricing models used by manufacturing MNEs with centralized headquarters operating as original equipment manufacturers ("OEMs") and contract manufacturing subsidiaries in multiple countries.

The first one is the so called "centralized" operating model, in which the local subsidiaries are deemed to be low-risk manufacturing affiliates, entitled to routine income (little but somewhat guaranteed profit), while the foreign headquarters pick up the full bulk of the residual profit, including full compensation for centrally developed intangibles. Under such a paradigm, only the foreign headquarters is exposed to the key entrepreneurial risk-taking functions.

The second model is the "decentralized" operating model, with results which may appear contradictory to the previous one. Under this model, regional subsidiaries are considered entrepreneurial entities that, despite sourcing their centralized supporting services and know-how from the MNE`s headquarters, are exposed to material risks and functions, such as inventory, foreign exchange, manufacturing, and procurement. Further, such subsidiaries may even license some technology to other affiliates and may also perform material functions in developing centralized MNE intangibles in a synergetic interaction with the foreign headquarters.

The Argentine tax authorities are certainly biased against the so called "centralized model," which is deemed to disregard the material risks and functions that the local MNE subsidiaries are usually exposed to. For this reason, such model is a regular source of conflict with the Argentine Revenue Service ("ARS"). This was the case during the Covid-19 pandemic, during which the tax authorities scrutinized whether there was actual consistency between tax losses attributed to low-risk or limited-risk domestic subsidiaries that could evidence a material incoherence with the original functional analysis (i.e., the one of "low but guaranteed profits"). For example, such a bias underlies the ARS document on recommendations for the transfer pricing analysis for the fiscal years impacted by the COVID-19 pandemic.

Conversely, the so called "decentralized" model that better preserves the materiality of the roles and functions performed by the domestic subs of the MNEs is the clear preference of the ARS. Nonetheless, in either case, proper implementation of the relevant transfer pricing model is the key to avoiding tax controversies. For example, while full-fledged contract manufacturing written agreements are usually

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avoided, such transfer pricing models are better implemented by means of a careful selection of target comparables, with a consistent elaboration as to their assets, risks, and functions vis a vis the tested party.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

As mentioned above, proper selection of the set of comparables is key to a successful implementation of the contract manufacturing approach. In Argentine tax practice, toll manufacturing is certainly not common in the cross-border context, as compared to the purely domestic one. However, there is a common practical denominator for both manufacturing models: even in such a local scenario, the tax authorities and the courts do preserve the materiality of the roles and functions performed by the toll manufacturer, as it is illustrated in state tax controversies.

The fact that the contract manufacturer provides the plant, machinery, equipment, and labor force and procures its own raw materials for the production process, requires pondering such roles and functions in the appropriate selection of comparables.

b. Adjustment for a contract manufacturer with capital intensive operations;

While the contract manufacturing approach is the choice of the car manufacturing industry in Argentina, and it is well tested in the courts after more than 20 years of tax controversies, the use of capital-intensive comparability adjustments has not been tested in the court. This is certainly not the case with capacity utilization, as will be explained below.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

The successful implementation of capacity utilization adjustments evidences how resident contract manufacturers are exposed to material risks, as mentioned above concerning the "decentralized" approach.

However, local courts have been somewhat erratic in accepting idle capacity adjustments, making robust documentation and proper implementation critical. For example, in the *Dart Sudamericana S.A.*[1] case ("*Dart*"), the Tax Court upheld the ARS assessment since the taxpayer argued that recurring losses were the result of an economic downturn cycle but did not provide proper evidence. In addition, while Argentine MNEs may be allowed to segregate extraordinary losses on their financial statements in special circumstances to ensure a better comparability with the market set, the Court ruled that the taxpayer had failed to substantiate it properly. In the Court's opinion, a grounded capacity adjustment requires evidencing the theoretical maximum production capacity, the regular production amount, and the actual production figure during the economic downturn, which should be properly compared with the set of comparables.

[1] *Federal Tax Court, Chamber "A", March 30, 2023.*

Conversely, grounded documentation supporting such loss-segregation adjustments was upheld for the car industry in a number of cases, like in the one involving *Scania Argentina S.A.*[2] ("*Scania*"), in which the Court fully sided with the company. The taxpayer properly elaborated its idle capacity adjustment in its transfer pricing study, which was subsequently defended in the Court through economic, accounting, and engineering witness experts' analysis. Such experts consistently concluded that the extraordinary losses were the consequence of material fixed costs that could not be set off against the reduced sales volume resulting from an unprofitable business cycle. For the Court, such a negative business cycle was properly evidenced, as well as the governmental policies that adversely affected the car manufacturing industry, in the context of a regional economic downturn.

The Tax Court also places a heavier burden of proof on the party that provides less substantiated transfer pricing reports. For example, in *Dart*, the Tax Court maintained that a taxpayer may not make unilateral loss-segregation adjustments unless it proves that the comparables did not experience similar extraordinary losses. The outcome is contrary to the one reached for the car industry, which has been historically more diligent at the time of substantiating idle capacity or similar loss-segregation adjustments.

d. Any other considerations.

The OECD Base Erosion and Profit Shifting (BEPS) Action Plans, as well as Pillars One and Two create new challenges that shift the perspective on how transfer pricing will be viewed going forward. The OECD's Pillar Two initiative, which aims to establish a global minimum effective tax rate of 15%, is a new deterrent for profit shifting. In fact, such initiatives are transforming transfer pricing from being a straightforward documentation compliance exercise to a strategic design that demands planning in anticipation of potential pitfalls for any MNE.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

As mentioned above, the car manufacturing industry has historically adopted the contract manufacturing approach but with a degree of business risks accruing on the local manufacturing entities that, under a decentralized model, are supposedly in control of such risks. In this case, in the presence of governmental subsidies there has been no discussion as to passing the subsidies on to the foreign consignor. Conversely, the local contract manufacturer has retained the upside and, consequently, the associated downside, as illustrated by Argentine case law.

In this regard, in the leading case Toyota Argentina SA vs. AFIP, Federal Supreme Court 9.2.14, the car manufacturing industry succeeded in excluding from the operating results tax subsidies promised by

[2] *Federal Tax Court, Chamber "A", April 17, 2023.*

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the government, who failed to comply with them, thus triggering extraordinary losses on the domestic manufacturing industry. In this regard, Toyota was allowed to segregate extraordinary losses in their financial statements to make them comparable with the market set. Toyota's first comparability adjustment was focused on idle capacity, i.e., losses resulting from fixed costs that could not be set off against the reduced sales volume resulting from an unprofitable business cycle. The ARS challenged the adjustment, arguing that the tested party may not make unilateral loss-segregation adjustments, unless it proves that its comparables did not experience similar extraordinary losses. However, like in the Scania case, the Court sided with Toyota, since the company`s expert witness was able to demonstrate the negative cycle that the company experienced and measure the magnitude of the resulting extraordinary loss by comparing actual production with the regular one, which was not achieved because of the economic downturn. As relevant to this question, the second adjustment made by the taxpayer consisted of segregating extraordinary losses resulting from a governmental subsidy that was not finally honored, thus burdening the manufacturing company with abnormal expenses. The Court sided with the taxpayer on this matter too, since it found that the company had demonstrated that the government had never paid the subsidies to the company, thus triggering extraordinary losses that would have rendered the tested party not comparable with the market set unless such losses were segregated in the tested party´s financial statements. Such extraordinary losses would be segregated to the extent that the comparables would either not have them or experience them in less material figures.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Foreign exchange risks resulting from financial expenses are typically borne by the domestic contract manufacturer, who must account for them mandatorily, in view of the Corporate Income Tax provisions. Foreign exchange expenses must be accounted on a cash basis when they result from related party financing or under the accrual principle, when they result from unrelated party financing. This ITL mandatory outcome is another example of the kind of risks accruing on the local manufacturing entities.

Being clear that such risk remains on the local manufacturing entity, recent case law illustrates that one car manufacturer, Volkswagen Argentina, went even further to improve its operating income by summing up discharge of indebtedness income from related-party financing. The Tax Court agreed with the taxpayer, on the basis that the loan proceeds were used to improve the local manufacturing plant. However, the Supreme Court recently took the side of the ARS, maintaining that such income has a financial nature, thus being improperly computed as operating income.

Contributors

Cristian E. Rosso Alba is Partner in Charge and Juan Marcos Rougés is a partner in the tax practice of Rosso & Rougés in Buenos Aires, Argentina.

They may be contacted at:

crossoalba@rafyalaw.com
jrouges@rafyalaw.com
www.rafyalaw.com

Australia

Benedicte Olrik

Andersen, Australia

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

In Australia a contract manufacturing operation would in general not be perceived as high risk by the Australian Taxation Office (ATO). However, where there is a mismatch between the functions performed, assets held, and/or risks assumed by the contract manufacturer and its contractual arrangement with its MNE group, then such misalignments will be perceived as high risk by the ATO.

Our experience is that the ATO would likely require a risk review of new contract manufacturing operations created as a result of a restructuring event of an MNE's supply chain. In particular, if such events lead to a change in the entity, such that it goes from being a full-fledged manufacturing operation to a contract manufacturer, this could be a red flag to the ATO regarding the migration of intellectual property (IP), profit erosion, etc.

To safeguard against such risks, it is essential to perform a functional analysis of the operations, assets, and risks of the value chain of the relevant entities involved. It is also highly recommended to document the commercial rationale for the restructuring event at the time of the event and support this motive with a robust economic analysis, including applying arm's length comparable benchmarks.

In summary, it is recommended that the entity prepare transfer pricing documentation that is cleverly tailored to the best solution to support the position that dealings between related parties are in accordance with the arm's length principle. To create such a solution, we suggest starting with the design of the transfer pricing structure of the group. The design will include the standard pillars (i.e., the business description, details of the international related party dealings (IRPDs), financial performance, industry/economy relevant factors, selection of the TP method, and benchmarking) required by the Australian TP documentation guidance and the OECD Guidelines. However, it is not recommended to rely on the traditional transfer pricing analysis alone, as the nature and quality of the surrounding commercial evidence of the transfer pricing position is crucial.

Accordingly, developing a smart transfer pricing design that is a true reflection of the commercial and financial relations of the taxpayer's arrangements and supported by robust transfer pricing and economic analysis is a solid safeguard to any ATO inquiry and future audits.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

In Australia and similar to the OECD TP Guidelines, the selection of the most appropriate transfer pricing method and the chosen profit level indicator depend on the actual commercial and financial relations of the tested party. For contract manufacturers, where the manufacturing process is more labor-intensive as opposed to capital-intensive, the cost-plus method would typically be selected as the best option by applying a mark-up on total costs, otherwise known as the ratio of operating profit to total costs.

For toll manufacturers assuming less risk, as they would not need to shoulder the responsibility for the sourcing materials, risks associated with holding inventory, the cost-plus method is likely to be the most appropriate. However, there would still need to be some economic analysis to support the idea that assuming less risk than a contract manufacturer would imply a smaller ratio of its profit to total costs.

For contract manufacturers with capital-intensive operations, return on assets (or capital) could be more appropriate. As a rule of thumb, this is similar to the rate of interest which could be earned if all the assets were converted into cash and placed on deposit. The levels of return on assets (ROA) will vary between industries: some industries require significant assets to generate profit (e.g., mining), while others probably do not need to acquire many assets. The key issue that arises is how to value the assets, for example, at book value, market value, or some other methodology (as discussed in paragraph 2.98 of the OECD Guidelines).

Alternatively, for more capital-intensive manufacturing processes, it is common to use the return on capital employed ("ROCE") as the most appropriate profit level indicator. Paragraph 2.97 of the OECD Guidelines states that ROCE can be an appropriate base "in cases where assets (rather than costs or sales) are a better indicator of the value added by the Tested Party, e.g., in certain manufacturing or other asset-intensive activities."

The shortcoming of applying either ROA or ROCE is that they are not reliable methods to test whether the selected comparable companies employed leased assets. Leased assets could lower the total assets on these companies' balance sheets and thus increase their ROA/ROCE relative to companies which employ assets that are fully owned, or which are recognized as under capital lease treatment.

In summary, when selecting the most appropriate method for capital-intensive operations, we normally would recommend using a combination of the above measures and evaluating through qualitative considerations the most reasonable arm's length outcome.

Other considerations for having a contract manufacturer in the value chain of an MNE include how to value capacity utilization for the manufacturer. It is likely that the MNE group would have exclusive rights to use the contract manufacturer, which would make the contract manufacturer reliant on the demand

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for its manufacturing services from the MNE group. This would directly impact whether it would be able to operate efficiently and at full capacity. Again, we always recommend employing an appropriate economic analysis that would support an arrangement that arm's length comparable parties would agree to. This could result in an intercompany arrangement that would guarantee the contract manufacturer an arm's length comparable profit regardless of the orders it would receive from the MNE group, and thereby pushing the risks to the principal or entrepreneur in the MNE for any shortfall in production.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

We would recommend first and foremost complying with the local rules and obligations on the grants or subsidies, and then employing economic analysis to demonstrate how the grants/subsidies would impact the intercompany arrangements if the parties involved were dealing at arm's length.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Incorporating the funding of the contract manufacturing operations into the intercompany arrangement would require the same transfer pricing considerations as discussed above. We reiterate the importance of commencing with the functional analysis of the value chain to ascertain how the finance arrangement can be incorporated to ensure that it would be in accordance with the arm's length principle.

The ATO released practical guidelines (PCGs) on finance arrangements a few years ago. The ATO has released these PCGs in areas where they perceive risk and also to provide taxpayers with their risk ranking from low to high for the ATO's expectation of the intercompany arrangements.

Finance arrangements using a currency other than Australian dollars can cause an otherwise low-risk in-bound intercompany loan to be perceived as a medium- or high-risk intercompany loan. Accordingly, in considering who should bear the foreign exchange risks in an intercompany finance arrangement, a risk-stripped contract manufacturer should not bear the foreign exchange risks in an intercompany finance arrangement, as it would be unlikely that an arm's length party would have agreed to such under similar circumstances.

Contributor

Benedicte Olrik is the Managing Director of Transfer Pricing at Andersen Australia.

She may be contacted at:

Benedicte.Olrik@au.andersen.com
au.andersen.com

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Austria

Alexandra Dolezel and Christoph Pelikan

BDO Austria GmBH

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Contract manufacturers are frequently found in practice to, in contrast to toll manufacturers, procure most of the raw materials required for production themselves and only transfer ownership of the finished product to the principal. They are therefore also at least partly responsible for the raw material procurement and thus bear, to some extent, also raw material and intermediate product storage risks. They further have a financing function of the raw materials. In the literature, this form is also considered to qualify as a so-called service provider; however, special attention must be paid to the risk-bearing of the raw material and semi-finished product stocks in order to ensure that the economic ownership of the stock is still held by the contract manufacturer on the one hand and that the risk-bearing is still economically compatible with a mere routine function on the other. In this case, it makes sense for the service recipient to bear the economic losses in this respect, provided that the contract manufacturer cannot be accused of intentional or grossly negligent behavior.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers? In your response, consider the following:

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

The Austrian tax authorities generally follow Chapter III Comparability Analysis of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (OECD Guidelines), which can basically be performed in the following two ways: deductive analysis or additive analysis (para. 3.40 et seq. of the OECD Guidelines). The taxpayers are allowed to choose on a case-by-case basis the most reliable approach to performing the comparability search ("benchmark"). Such a benchmark is, however, subject to the subsequent check by the tax authorities on its meeting the comparability criteria under the following five comparability factors: (1) the characteristics of property transferred or services provided; (2) the functions performed by the parties (taking into account assets used and risks assumed), including in the broader context of the value generation within the entire group; (3) the contractual terms; (4) the economic circumstances of the parties and of the market in which the parties operate; and (5) the business strategies pursued by the parties (para. 1.36 of the OECD Guidelines).

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Differences in the approach to benchmarking arise, if there are differences in the functions performed and risks assumed by the contract manufacturer. More specifically, in case the transactional net margin method, cost based is applied, it is to be further analyzed whether the cost of material also forms a basis for the mark-up. According to expert opinions, a distinction is to be made between strategic and operational purchasing functions. Strategic purchasing includes supplier selection, relationship management, quality determination, requirements planning, price and condition negotiations, and the determination of compliance with internal standards. In operational purchasing, raw materials and supplies are ordered and orders are processed. A purchasing function can have an exclusively operational character if it only relates to the ordering of materials based upon the specific quantities required. This tends to be associated with lower added value and involves little or no risk. However, if the purchasing function has elements of strategic purchasing, it is also associated with greater risks. In this respect, it is necessary to analyze which party makes the key decisions regarding risk assumption and has the ability to control and manage risks or has the financial capacity. It may be the case that the contract manufacturer assumes full risk control, provided that the purchasing function employs specialists with the decision-making authority, expertise, and information required for planning and selecting the material, or that appropriate material controls are carried out. In this case, the material costs represent value-adding costs. The risk control exercised by the contract manufacturer, and possibly also the bearing of risk, constitutes a separate value-added contribution that justifies the inclusion of material costs in the cost base for the profit mark-up.

The situation is different if the contract manufacturer acquires ownership of the material under civil law but does not exercise a purchasing function. This may be the case, on the one hand, if the sources of supply for the material are specified by the principal, and the contract manufacturer has no choice with regard to the material or, on the other hand, if the contract manufacturer purchases the material exclusively from the principal, which also means that it has no control over the material. A German federal fiscal court ruling as of 9th August 2023 indirectly shows that the mere ordering of the material is probably not sufficient to exercise a sufficient risk control function for the consideration of material costs in the profit mark-up.

According to the Austrian TP Guidelines 2021, if the transfer price is determined under a cost-based net mark-up, only those costs may be included in the cost base for the mark-up that are related to the specific business transaction. As a rule, only operating expenses are to be taken into account, while taxes, interest expenses, and extraordinary expenses are to be excluded from the cost base. No profit mark-up must be taken into account for pass-through costs ("at cost") if third parties calculate in the same way in comparable situations and would waive a profit mark-up on such cost components. The Austrian Ministry of Finance in Austria has just published a draft amendment to the Austrian TP Guidelines, which specifies hereto that the cost base shall only include those costs that are part of the actual value creation process of the service provider, and which are not merely costs that are passed on to the service provider.

b. Adjustment for a contract manufacturer with capital intensive operations;

The contract manufacturer is to be qualified as a service company, according to the OECD Guidelines, that only performs routine functions. It is more difficult to assess cases in which a relatively significant amount of capital is used (in operating facilities, etc.). The cost-plus method is sometimes supplemented by a compensation of interest expenses (at mere cost) or even replaced by a transactional net margin method with capital input-dependent indicators (such as return on capital employed (ROCE) or return on assets (ROA)) in order to avoid the need for frequent adjustments to the

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transfer price (for example, in the case of new investments in operating facilities). When drafting the contract, consideration must be given to the transfer of risk with regard to the operating facilities in order to prevent the economic ownership of the facilities from being attributed to the principal.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

In order to be recognized as a mere service provider, contract manufacturers must not be subject to material economic risks. Accordingly, a so-called capacity utilization guarantee is required under which the principal is compensating any cost of an underutilization of capacity.

d. Any other considerations.

Special constellations can arise if production units produce on behalf of or under the management of an entrepreneur and these production units do not sell the goods to the principal but instead sell them directly to external customers in their own name. In these cases, external sales to the external customer are initially recognized at the level of the production company and the principal will mostly receive its residual share of the profits via a service or license agreement. Any such scenario requires careful attention in respect to documentation in order to avoid the entrepreneurial influence of the principal being recognized by the tax authorities in the jurisdiction of the service and distribution entity.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing? Include in your response the following:

a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;

Investment subsidies and government incentives (such as the R & D premium) can lead to locational advantages in the form of location-related cost savings. It cannot be inferred from this that the benefit or premium must be passed on by the Austrian company to the foreign-affiliated company as a lump sum. Rather, it must be assessed on a case-by-case basis based on a functional and risk analysis and a consideration of the realistically available alternative courses of action, as well as the bargaining power of the parties—whether third parties would also have passed on the cost advantage to foreign principal via more favorable transfer prices. If contract manufacturing competition is high, the only reason for choosing an Austrian service provider may be the existence of any such location savings. This may imply that the advantage may have to be passed on to the foreign principal.

b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;

The relevant discussion in tax audits is primarily based on the fact that a tax loss can be generated if the benefit of the subsidy is attributed to the foreign principal (via a reduction in the cost base) while the tax subsidy is tax exempt (such as is the case for the Austrian R & D premium). However, this tax loss is not necessarily the result of a non-arm's length compensation agreement; under company law, profits are generated. Austrian tax authorities may rather have to accept that some grants are tax exempt.

c. Other issues pertaining to government subsidies or grants.

In order to assist companies affected by the COVID-19 crisis, various government aid measures have also been taken in Austria to enable companies to secure or restore their liquidity. These include, for example, the fixed cost subsidy, which includes staggered support to cover fixed costs depending on the extent of the decline in sales. The fixed cost subsidy has a direct impact on the company's earnings position (reported under other operating income or deducted from expenses in a preliminary column). As already mentioned under question 2(c), in order to be recognized as a contract manufacturer from a transfer pricing perspective, a so-called capacity utilization guarantee is currently necessary to be considered arm's length. This means that the foreign principal must bear idle capacity costs up to normal capacity utilization. If the transfer prices are applied at arm's length, the foreign principal would therefore already bear most of the fixed costs. Care must therefore be taken to ensure that it can really be declared that all reasonable measures are being taken to generate revenue (which should also include the compensation for vacancy costs). Fixed cost subsidies must be reclaimed if it later transpires that the circumstances on which the subsidy was based do not correspond to the actual circumstances.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

As outlined above, in order for the contract manufacturer to be classified as a service provider, it should not bear material risk. As such, the compensation mechanism (e.g., for any interest costs) have to be specifically agreed upon. Further, any FX cost should basically be borne by the principal.

Contributors

Alexandra Dolezel is a Partner, and Christoph Pelikan is a Senior Associate at BDO Austria GmbH in Vienna, Austria.

They may be contacted at:

Alexandra.Dolezel@bdo.at
Christoph.Pelikan@bdo.at
http://www.bdo.at

Belgium

Yves de Groote and Lavina Bansal

KPMG Belgium

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The primary focus of the Belgian tax authorities (BTA) is to ensure that multinational enterprises allocate profits in line with economic substance. Certain contract manufacturing operations are considered high risk, particularly in cases where the allocation of functions, risks, and profits between related entities does not align with the arm's length principle. Examples of high-risk scenarios include:

- **Limited-risk manufacturers with low operating margins**, especially if they assume significant risks (e.g., inventory or market risk) without appropriate compensation, which may indicate misaligned profit allocation.
- **Contract manufacturers that incur losses over an extended period** (even in a start-up phase) are considered high risk. These manufacturers should generate sufficient earnings to cover their overhead costs, such that where they fail to achieve an arm's length margin, their transfer pricing policies may be subject to scrutiny and challenge.
- **Companies engaged in extensive operations** (e.g., R&D, production, or marketing) that do not generate corresponding profits may be perceived by the BTA as engaging in profit shifting to the principal entity's jurisdiction.
- **Intangible asset development** (e.g., patents, trademarks, or know-how) by contract manufacturers at prices that do not reflect their appropriate market value may trigger scrutiny.
- **Important net financial expenses** borne by the contract manufacturer without a proper arm's length justification can also be questioned.

Additionally, contract manufacturers own the raw materials, work-in-progress, and finished goods, while toll manufacturers do not hold title to these materials but manage the manufacturing process. This functional difference affects remuneration. The BTA ensure that each type of manufacturer is compensated according to their respective functions, risks, and control, ensuring arm's length pricing based on economic substance.

The principal company bears all the costs, assumes control over relevant risks, and performs key functions related to the products produced by contract manufacturers or tollers. The BTA, including the Office for Advance Decisions in Tax Matters ("Rulings Commission"), are well aware of this framework.

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To mitigate the risks associated with transfer pricing audits and challenges, companies may consider the following:

- **Advance Rulings or Advance Pricing Agreements (APAs):** Companies can apply for APAs from the Belgian Ruling Commission to confirm that their transfer pricing complies with Belgian law. APAs provide certainty on how the tax law will apply to specific transactions. For contract manufacturing, the BTA generally prefer the Transactional Net Margin Method (TNMM) with net cost-plus (NCP) mark-up as the relevant profit level indicator, which is accepted if it falls within the interquartile range of the benchmarking studies.
- **Align functions, assets, risks with profit allocation:** Tax authorities assess whether the allocation of risks and functions in the transfer pricing analysis aligns with the company's actual activities. For contract manufacturers, the tax authorities ensure the manufacturer is not assuming risks or performing functions intended for the principal. Profitability must reflect the functions performed, assets used, and risks assumed.
- **Robust documentation:** Companies should maintain thorough documentation to support their pricing structure, including functional and economic analyses. Comprehensive intercompany agreements should specify roles, responsibilities, and financial terms, reflecting actual conduct and adjusting for any business changes.
- **Monitor the costs:** Companies should regularly monitor actual costs and remuneration to ensure that compensation for contract manufacturers falls within the interquartile range from benchmarking studies and adjust pricing as necessary to avoid challenges. Although the application of budgeted/standard costs could be acceptable, we do not recommend its application, as it often leads to important fluctuations and challenges.
- **Monitor and update transfer pricing models:** Companies should periodically revisit their transfer pricing policies to ensure they reflect changes in business operations, market conditions, and legislation, maintaining alignment with current transfer pricing arrangements.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

When conducting benchmarking studies for contract manufacturers in Belgium, the selection of comparable companies is based on several key criteria: the manufacturing functions performed, geographical region, legal status (e.g., active and unknown), independence status, availability of financial data, and the year of incorporation. According to the Belgian Circular Letter, companies must have been incorporated for at least four years, and at least three years of financial data should be used for comparable companies. For limited-risk entities like contract manufacturers, any company with two or more loss-making years should be excluded from the comparable set. Additionally, qualitative analysis is used to review the potential comparable companies' activities by analyzing websites to ensure they align with the controlled transaction.

A similar approach is applied to toll manufacturers in benchmarking studies. However, toll manufacturers, unlike contract manufacturers, do not assume responsibility for raw materials, work-in-progress, final products, or sales. Therefore, comparable uncontrolled transactions should reflect this by

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not taking ownership of inventory or possessing receivables/payables. Thus, the comparability adjustments in benchmarking studies related to toll manufacturers are often applied, where working capital adjustments (WCA) could be performed to account for the differences in the financial data between toll manufacturers and the independent comparables.

Contract/toll manufacturers are typically guaranteed a margin sufficient to cover their overhead costs. For example, if the NCP mark-up of a contract/toll manufacturer exceeds the upper quartile of the arm's length range, the manufacturer must reimburse the parent company for the excess profit beyond the upper quartile cap. Conversely, if the NCP mark-up falls below the lower quartile, the parent company must compensate the manufacturer to cover the shortfall in profit. This ensures that contract/toll manufacturers are remunerated in line with arm's length principles, reflecting their low-risk status but guaranteeing coverage of the overhead costs.

The key distinction between contract and toll manufacturers should be clearly reflected when conducting a benchmarking study. This distinction is outlined as follows:

Contract manufacturers: Own the raw materials, work-in-progress, and finished goods, and assume greater risks (e.g., inventory, product liability), resulting in higher remuneration.

Toll manufacturers: Only manage production and take no ownership of inventory or sales, justifying lower remuneration with working capital adjustments, as appropriate.

In both cases, the BTA prefer the TNMM, using NCP mark-ups to align profits with the risks, functions, and assets involved in the manufacturing process.

In practice, it is relatively difficult to find independent toll manufacturers in the database, and one should therefore start from a contract manufacturing benchmarking study and perform a number of adjustments, as will be detailed below. Discussions with the BTA on this approach are, however, not exceptional. There is sometimes an attempt by the BTA to calculate the net cost plus by taking as the cost basis, only the non-raw material costs of the contract manufacturing benchmarking study and therefore excluding the cost of goods sold line. This highly inflates the derived net cost plus percentage and is not considered to be an acceptable position.

b. Adjustment for a contract manufacturer with capital intensive operations;

Belgium adheres to the OECD guidelines regarding adjustments for contract manufacturers with capital-intensive operations. According to these guidelines, comparability adjustments may be necessary when applying the TNMM to capital-intensive manufacturing activities due to the significant investment risk involved. This risk is reflected in net profit indicators, such as return on assets, calculated within the TNMM framework. It is essential to recognize that the tested party may not bear this risk, which necessitates adjustments.

When conducting the benchmarking analysis for a contract manufacturer with capital-intensive operations in Belgium, several key factors could be considered from a transfer pricing standpoint to ensure that the remuneration reflects the functions performed, assets used, and risks assumed.

- Capital-intensive operations, requiring significant investments in fixed assets (e.g., machinery, equipment), influence the expected returns. In these cases, the remuneration for contract manufacturers should reflect higher returns to compensate for the increased risk and capital employed. When applying the TNMM, it may be necessary to adjust for

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depreciation differences between comparable companies and the tested party to align the analysis with industry norms.

- Since the manufacturer invests heavily in capital assets, the expected return on capital employed or other asset-based profit indicators may be used as corroborative indicators as opposed to the NCP margins alone. In these cases, the deployed assets or capital employed become decisive factors in determining profitability. One challenge in using a return on assets is determining the appropriate value of the assets (accounting value, acquisition value, market value) and considering whether the enterprise rents assets. However, when conducting benchmarking analysis, selecting comparable companies operating in capital-intensive industries (such as heavy manufacturing or industries with significant fixed asset investments) can help ensure that profit margins or returns accurately reflect the higher risks and capital requirements.
- Capital-intensive operations often require substantial working capital to support production cycles and maintain inventories. Therefore, benchmarking studies may need to incorporate working capital adjustments to better reflect the cash flow needs and financial structure of the contract manufacturer.

The suggested adjustment(s) considers that the risks borne affect companies' profits since higher risks typically demand an increased expected return in the open market. Thus, the allocation of risks in transfer pricing analyses significantly impacts the profits or losses of the involved parties. In the comparability analysis, it is vital to assess which risks were assumed in both the controlled and uncontrolled transactions. Moreover, comparability adjustments should only be implemented if they enhance the reliability of the comparability analysis and are appropriate when differences between controlled and uncontrolled transactions have a material effect on the comparison.

Having said this, the functional analysis should thoroughly examine the risks borne by the contract manufacturer, such as those related to machinery maintenance, technological obsolescence, and production processes. These risks should justify a higher remuneration compared to entities with lower capital involvement.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

Belgium adheres to OECD guidelines regarding capacity utilization for contract manufacturers, emphasizing the need for adjustments in transfer pricing when capacity utilization differs between the tested party (contract manufacturer) and comparable companies.

For example, underutilization of capacity may result in lower profitability for the contract manufacturer. The fixed costs, such as depreciation, rent, and salaries, remain constant regardless of production volume, leading to higher costs per unit and lower profit margins when capacity is underused. This can cause a misalignment with comparable companies in a benchmarking study, as those companies might operate at higher capacity levels. To address this, the BTA, following the OECD guidelines, allows for adjustments in transfer pricing when capacity utilization significantly deviates from the standard. Underutilized capacity often increases working capital requirements, especially in cases of higher inventory or idle resources. In such cases, working capital adjustments could be performed to align the financial data of comparables with the operational realities of the contract manufacturer.

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The OECD and the Belgian TP Circular recommend using the TNMM, as it captures indirect costs and reflects variations in capacity utilization within the margin. In contrast, methods based on gross margins may not adequately reflect these differences, as they do not account for indirect costs.

Also, if the contract manufacturer is not responsible for production volumes, the risks associated with capacity utilization should be borne by the principal company, not the contract manufacturer and must be compensated accordingly.

The BTA may scrutinize capacity utilization to ensure that profitability and transfer pricing reflect the true economic situation of the contract manufacturer. Documentation supporting capacity levels and the corresponding adjustments is essential to justify deviations from the profit margins observed in comparables.

d. Any other considerations.

In the Belgian TP Circular letter, it is specified that manufacturing activities do not constitute intra-group services of limited added value for the purposes of the simplified approach. Thus, the simplified approach of a 5% mark-up on costs without the need for a benchmarking study cannot be applied to transactions related to contract manufacturers.

Cost base

As explained above, in order to determine the arm's length nature of the intercompany transactions undertaken by the contract manufacturers/toll manufacturers in Belgium, the TNMM with NCP mark-up is used. In principle, the Belgian accounting standards serve as a reference to determine which costs form the cost base. In general, mark-up is applied on the total operating expenses, and financial costs are often recharged at cost to the principal by the contract/toll manufacturers.

Advance costs

The Belgian TP Circular stipulates that transfer pricing methods based on costs are only appropriate if the costs are a relevant factor in the value of the functions performed, assets used, and risks involved for the party tested. This means that the costs that are not a relevant factor for this value representation must be excluded from the cost basis for the calculation of the profit.

Advance costs refer to the expenses for services provided by third parties or affiliated companies to the intra-group service provider, provided that these services could be invoiced directly by the third parties to the group companies benefiting from the intra-group services. These third parties or affiliated companies invoice the intra-group service provider at a price that includes an arm's length profit margin.

A simple division of costs into "internal costs" and "external costs" is not sufficient to justify the exclusion of these external costs from the cost base, nor does it justify invoicing them without adding a margin. Many external costs contribute directly to the service provider's activities and add value to the operation. A detailed functional analysis is essential to justify the exclusion of certain external costs from the cost base. For example, a logistics company providing non-reusable packaging as part of its service to deliver goods to a customer cannot exclude the packaging costs from the cost base just because its supplier has already applied a profit margin. The packaging forms part of the logistics company's function and therefore is included in the cost base that determines its added value.

If all of the above conditions are met, no additional profit margin needs to be applied to the advance costs.

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However, one should remain conscious that when performing benchmarking studies, the comparable independent companies might also have a certain level of external costs included in their cost base. It will therefore be relevant to review whether the related party contract manufacturer has proportionally more external costs compared to the comparables included in the benchmarking study. This will be particularly important in case the non-application of a mark-up on pass-through costs would result in a position below the 25th percentile of the range compared to a cost base approach with full operating expenses.

Actual versus budgeted costs

Prices are generally determined in advance based on budgeted costs. The BTA monitor the impact of using budgeted costs on the transaction, the policy of aligning these costs with actual costs, and any consistent deviation between budgeted and actual costs over time. Adjustments may be made if the actual costs associated with the transactions deviate abnormally from the budgeted costs for any economic reason or if the use of budgeted costs fails to align the cost base with a market-based cost base.

Efficiency and inefficiency implications

Paragraph 48 of the TP Circular also indicates in the context of the cost-plus method that efficiencies or inefficiencies can be allocated to the services provider, insofar as these can be controlled by the latter party.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing? Include in your response the following:

a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;

When determining whether to pass on government subsidies or grants to the principal or retain them locally, the following should be considered.

A direct subsidy has a significant impact on the cost basis, which will be lower with the subsidy than without it. In other words, a contract manufacturer receiving a subsidy will have a lower cost base. When applying a cost-plus method or the TNMM based on a PLI, the remuneration allocated to the contract manufacturer will be lower due to the reduced cost base, as the remuneration (i.e., the mark-up or PLI) is dependent on cost.

The Belgian TP Circular normally allows for the fact that the subsidies are passed-on to the principal if they are directly related to the contract or toll manufacturing activity concerned (paragraph 17 of the TP Circular).

It should also be noted that the Belgian Ruling Commission sometimes applies a stricter approach, which deviates from the Belgian TP Circular.

b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;

The Belgian Circular letter implicitly states that subsidies can be passed on to the principal, since the Circular letter indicates that subsidies should be deducted from the cost base or turnover if there is a direct link between the subsidy and the production or turnover of goods or the provision of services.

For example, an exemption from withholding tax may be applicable. Conversely, if there is no direct link between the subsidy and the production or turnover of the goods or services provided, the subsidies will not be deducted from the cost base. Additionally, tax deductions, such as investment deductions, are also not deducted from the cost base.

If the tested party receives a subsidy directly linked to production, it should be deducted from the cost base in transfer pricing. When benchmarking, it is important to check if comparable companies have received similar subsidies and adjust their cost base accordingly. However, identifying such details for comparable companies can be quite challenging.

c. Other issues pertaining to government subsidies or grants.

The Belgian Circular letter highlights that grants and subsidies can significantly affect the pricing of goods and services. Therefore, they must be considered when determining transfer pricing. For more information, see the answers to questions 3.a. and 3.b.

The Belgian TP Circular stipulates that in some cases, the actions of local authorities can influence the prices of goods or services. Examples of such actions include subsidies, certain taxes, and government regulations. A notable government measure with a significant impact on transfer prices is the NIHDI levies on the turnover of reimbursable medicines, a type of sales tax on prescription drugs. The effects of government policy must be included in the determination of a transfer price. The BTA consider that companies with a limited functional and risk profile, which are subject to so called NIHDI levies, should ideally determine operating profit using the TNMM with PLI based on return on sales. It has been established that these levies are sometimes charged to turnover; however, in accordance with the CBN advice 2018/10, these levies must be recorded as expenses and not deducted from turnover.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

The BTA stipulate that the risks must be borne by those who control them and have the financial capacity to manage those risks. If the contract manufacturer is primarily responsible for production and has limited control over pricing and sales—operating under a fixed-price agreement with the principal—the principal company is typically responsible for managing foreign exchange risks. This is because the principal is more exposed to market fluctuations and customer pricing. The allocation of foreign exchange risks should reflect the economic realities of the parties involved, ensuring that the entity best positioned to manage such risks does so. The principal assumes control over risks, performs important functions, and possesses the financial capacity to bear these risks; thus, in transactions with contract manufacturers, the principals often bear the foreign exchange risks.

However, if the contract manufacturer is financed in a foreign currency, the associated interest expenses should be converted to the functional currency for the mark-up calculation. Any foreign exchange differences arising from such financing might also have to be factored into the cost base. If the contract manufacturer is not responsible for managing foreign exchange risks, any gains or losses should not adversely affect its profitability or cost base.

Certain rulings delivered by the Belgian Ruling Commission foresee a recharge of the net financial costs, “at cost” to the principal, and this is to avoid the discussion as to the appropriate level of financial

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expenses, to be borne by the contract manufacturer. The level of financial expenses of the comparables included in the benchmarking study might however be used as a reference point in certain circumstances.

Furthermore, the financial data of comparable companies and the tested party may differ regarding the accounting treatment of financing expenses and foreign currency exchange gains/losses. Such details are often not available in the databases used for conducting benchmarking analyses. Thus, when selecting comparable companies, it is essential to adopt the same approach as the tested party for a like-for-like comparison. If the total costs including financial expenses/forex losses—is considered for comparables, the same should be applied to the tested party.

Contributors

Yves de Groote is a Partner, and Lavina Bansal is a Director at KPMG Tax, Legal & Accountancy Belgium.

They may be contacted at:

ydegroote@kpmg.com
lbansal@kpmg.com
https://kpmg.com/be/en/home.html

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Brazil

Jerry Levers de Abreu, André Novaski, and Dora Pimentel

Demarest Advogados, Sao Paulo

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Law 14,596/23 instituted new transfer pricing ("TP") rules in Brazil, effective as of 2024. The new legislation completely reformulated the system in force for decades—based on specific methods with predetermined fixed margins—in favor of the arm's length principle and comparability tests compatible with the Organisation for Economic Co-operation and Development (OECD) TP Guidelines. However, neither the new Law nor the TP regulations, Normative Instruction (IN) no. 2161/23, explicitly define contract manufacturing, and there are still no official rulings, tax assessments, or decisions on the topic.

As a result, Brazil is currently at a peculiar stage where cross-border contract manufacturing arrangements were not targeted under the prior TP legislation, and it is not possible to determine with precision the operations tax authorities will scrutinize under the new TP rules.

This is not to say that Brazil is unfamiliar with contract manufacturing structures. For decades, there have been ongoing debates on whether contract and toll manufacturing structures should be classified as a provision of services or as manufacturing/sale of goods transactions. This debate is significant because each type of activity is subject to different tax treatments, leading to considerable litigation at the Federal, State, and Municipal levels.

In this regard, it is important to note that although case law has evolved to consider arrangements on a case-by-case basis, the focus has been on the functions performed and the assets contributed, with little regard for the risks assumed.

For example, when looking at the presumed profit regime for calculating corporate income taxes, which has different tax rates for revenue deriving from services or goods, federal tax authorities (responsible for applying TP rules) often rely on a functions-based analysis. Following the Federal Revenue of Brazil (RFB) Declaratory Interpretative Act, ADI RFB 1/15, the RFB looks at whether the activities performed by the contracted party fall under the definition of manufacturing provided by Decree 7,212/10 (Federal Excise Tax Regulations). For such purposes, manufacturing encompasses all operations that modify the good's nature, function, finishing, presentation, or purpose or improve it for consumption. The Decree provides that the process used to obtain the product and the location and conditions of the facilities or equipment used are irrelevant to qualify a transaction as manufacturing.

Based on this definition, federal tax authorities argued in Tax Ruling Cosit 29/24 that taxation is not determined by whether the manufacturer invests in the feedstock (raw material, semi-finished goods, or

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packaging) or receives it from third parties. The revenue will be taxed as manufacturing/sale of goods if they entail manufacturing and are not listed as "non-manufacturing activities" in the Decree (e.g., construction, craftsmanship, and other activities). This means that many contract, toll, and even full-fledged manufacturing structures are similarly taxed for corporate income tax purposes.

On the other hand, at the State level, tax authorities have been focusing on an assets-based analysis of who is "predominantly" responsible for investing in the feedstock to determine if the transaction comprises a toll or contract manufacturing arrangement. This is particularly relevant for mixed arrangements in which the contract manufacturer delivers the finished goods to the principal/full-fledged manufacturer and one party invests in the raw material and the other, for example, in packaging. If the contract manufacturer is deemed to be the one predominantly acquiring the feedstock, states like São Paulo argue that it is essentially a full-fledged manufacturer selling goods to the principal/full-fledged manufacturer. On the other hand, under a toll manufacturer arrangement, the principal/full-fledged manufacturer that retains ownership over most feedstock is deemed to be the effective manufacturer. The toll manufacturer is taxed only on the manufacturing compensation (costs and work) over the feedstock.

Further discussions exist on whether the toll manufacturer's compensation is taxed by the State Sales Tax (ICMS) or the Municipal Services Tax (ISS). In this regard, after years of debates on whether restoring, reconditioning, packaging, painting, cutting, and polishing activities were subject to the ISS or the ICMS, a binding precedent on the topic is pending a decision by the Brazilian Supreme Court (STF). According to the current voting score, the STF is moving toward qualifying toll manufacturing operations in which the principal/full-fledged manufacturer retains ownership over the feedstock and the goods are destined for subsequent industrialization or sale, as subject to the ICMS (Theme 816 - RE 882461). That is, when the toll operations are an intermediate part of the production or commercialization cycle, the toll manufacturer's compensation is taxed by the ICMS. On the other hand, if the goods are destined for a final consumer, the compensation is considered a service fee subject to the ISS.

This context may influence how federal tax authorities perceive contract manufacturing operations under TP rules.

That said, the new TP Law provides a comparability analysis established by the arm's length principle. It explicitly requires a complete functional analysis that includes an assessment of functions performed, assets contributed, and the risks assumed. In addition, IN no. 2161/23 provides for applying the 2022 OECD TP Guidelines and other supporting material as a supplementary means of interpreting the new TP Law. For this reason, international practice will likely guide Brazilian tax authorities in applying the new legislation.

Following the OECD TP Guidelines, one possibility is that Brazilian tax authorities will consider the typical examples of contract manufacturing structures in which the contract manufacturer bears low risks (e.g., the entire output will be purchased) as intragroup services. In these cases, MNEs should consider adopting the Cost-Plus Method (CPM) to safeguard their TP positions.

This is supported by the fact that Brazilian tax regulations explicitly state that the CPM tends to be the most appropriate method for the supply of semi-finished products or the provision of services. It is also derived from the generic references in IN no. 2161/23 that "manufacturing services" are not considered low-value adding intragroup services (art. 53, §4, IV) and that, when it comes to "intragroup services," the local file must explain the contract manufacturing structure (art. 60, IV, j).

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

Since the current Brazilian TP rules are relatively new (only entered into force in 2024), there is still significant uncertainty about how they will be applied. Under the prior regulations, most MNEs applied the Brazilian version of the Resale Price Method (RPM) or the CPM with fixed margins. There was no need for benchmarking studies.

As mentioned, the new rules provide a comparability analysis following the arm's length principle. There is a legal preference for applying the Comparable Uncontrolled Prices (CUP) method, with emphasis on the functional analysis and the assessment of contractual terms (warranties, credit, quantity, and transport), sales, marketing and advertising programs, market level (retail/wholesale), and currency risk.

However, tax regulations acknowledge that the CPM tends to be the most appropriate method for the supply of semi-finished products or services, which is consistent with the OECD's view regarding contract manufacturing arrangements. Following this approach, the Law provides specific rules for applying the CPM, clarifying that, among others, the following comparability factors should be considered:

(i) the functions performed, risks assumed, and assets used, including the complexity and type of industrialization or assembly process;

(ii) purchasing and inventory control activities;

(iii) testing functions; and

(iv) the contractual terms, especially the scope of the guarantees provided, the volumes of purchases and sales, the credits negotiated, and the transport conditions.

It is worth noting that IN no. 2161/23 established a safe harbor for low-value-adding services that provides a benchmark of costs (direct and indirect) plus a 5% markup. Still, it explicitly excludes "manufacturing services" from its scope.

In addition, there is currently a public consultation on new regulations to be enacted by the tax authorities to deal with intragroup services. It provides further details on the benefits test, broadens the definition of shareholder activities, and restricts the profit markup on intermediation services, services that include tangible and intangible assets, and services that do not imply the assumption of significant functions and risks. The proposed regulations would not allow taxpayers to claim more than one deduction for the same service (embedded fees), even when the values of the services are integrated into operations to transfer tangible or intangible goods.

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Finally, as mentioned, locally, discussions regarding the levy of ICMS and ISS have evolved to distinguish the manufacturer's remuneration depending on whether the arrangement is a toll or contract manufacturing arrangement, which is likely to influence how TP rules are to be applied in the future. If the contract manufacturer is deemed to be the one predominantly acquiring the feedstock, states like São Paulo argue that it is essentially a full-fledged manufacturer and will tax the entire amount of the finished product as a sale of goods. On the other hand, the toll manufacturer is taxed only on the manufacturing compensation (costs and work) over the feedstock under a toll manufacturer arrangement. However, there are discussions on whether the toll manufacturer's compensation is taxed as a manufacturing/sale of goods (subject to the ICMS) or a provision of services (subject to the ISS).

Thus, when looking at contract manufacturing arrangements, MNEs are advised to carefully consider the cost basis and the profit markup, as this will likely be the focus of tax disputes with the Brazilian tax authorities. It is also crucial to consider and distinguish which services are chargeable and differentiate them from incidental benefits and non-chargeable shareholder activities.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

From a domestic perspective, neither the new TP Law nor Brazilian tax authorities have provided any recommendations on how to consider government subsidies or grants for TP purposes. Regulations only require information on government subsidies in the local file when looking at the contributions of each related party under a cost contribution arrangement (art. 60, V, h of IN no. 2161/23).

That said, a decision to pass on or share the government subsidy can be significant in a country that levies corporate income taxes at a combined rate of 34%. As there are no guidelines on how government subsidies may affect comparability tests, taxpayers could potentially reduce the cost base by the amount of the government subsidy received. That is, even if there is no reliable evidence that independent parties would have contracted similarly under like circumstances.

However, considering the new TP rules are based on comparability tests and functional analysis of risks, assets, contractual terms and conditions, economic circumstances, and business strategy, it would generally be expected that subsidies granted to specific sectors are considered in determining the arm's length price, particularly under market conditions in the relevant jurisdiction. Furthermore, Brazilian tax authorities will probably look at international practice and evaluate the government subsidy system. Factors such as whether the recipient obtains market advantages, increased revenue or decreased costs, the extent and frequency of the subsidies, and even how independent comparable companies would allocate such benefits, will probably affect comparability tests.

In this regard, in Brazil, until 2023, tax legislation distinguished between funding or costing subsidies and investment subsidies. Funding subsidies were treated as taxable non-operating revenue. However, investment subsidies (including through tax exemptions or reductions granted as an incentive for the implementation or expansion of economic enterprises) were exempt from corporate income taxes (IRPJ/CSLL) and contributions on revenue (PIS/COFINS), provided they satisfied certain legal requirements. The Law also explicitly stated that ICMS tax benefits were considered investment subsidies, with no distinction as to which ICMS types would be considered.

The Brazilian tax regime is particularly complex, with different taxes, tax regimes, and tax rates. Tax benefits can also be granted by several means, including rate reductions, base reductions, exemptions, deferral, etc. Because of the specific treatment established by legislation regarding investment subsidies, many taxpayers accounted for ICMS tax benefits as subsidy revenue regardless of the nature of the tax incentive. However, as of 2024, Law 14,789/23 established taxation on revenue from tax incentives. As a result, MNEs are revisiting their accounting policies to record cost reductions in the ICMS.

Since there is currently an inclusive sales tax regime with recoverable and non-recoverable taxes, the shift in treating ICMS benefits as subsidy revenue or a sales tax cost reduction affects cost-based and net-margin methodologies. The new consumption tax system expected in 2026 will introduce VAT-like taxes and increase taxation on importing and selling goods, leading to additional tax uncertainties when applying comparability tests.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Under the new Brazilian TP rules, particular emphasis is placed on functional analysis. In assessing the economically significant risks undertaken by each party, tax regulations explicitly list financial risks, including foreign exchange currency risks and interest rates. They also establish that economically significant risks will be assumed by the party that exercises the functions related to its control and has the financial capacity to assume them and that the foreign exchange risk is an important comparability factor in applying the CPM.

While there are no explicit guidelines on applying the new TP rules to financing expenses in contract manufacturing arrangements, this overall functional approach is also reflected in regulations dealing with financial transactions. Article 29 of the new TP Law provides that when a controlled debt transaction is verified and the creditor:

- does not have the financial capacity or does not exercise control over the economically significant risks associated with the transaction, its remuneration cannot exceed the value of the remuneration determined based on a risk-free rate of return;
- has the financial capacity and exercises control over the economically significant risks associated with the transaction, its remuneration cannot exceed the value of the remuneration determined based on a risk-adjusted rate of return; or
- performs only intermediation functions so that the resources of the debt operation come from another party, its remuneration will be determined based on the arm's length principle to consider the functions performed, the assets used, and the risks assumed.

Contract manufacturers generally bear less risk than a licensed/full-fledged manufacturer. They generally own the plants, equipment, and feedstock. Still, the principal/fully-fledged manufacturer often directly bears the risk of demand and final customer prices. The principal/full-fledged manufacturer may even provide instructions about what goods to produce, quantity, and qualify and assure that the

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contract manufacturer's entire output will be purchased. Considering this inherent low risk of the activities carried out by the contract manufacturer, it would generally be assumed that the principal/full-fledged manufacturer would bear the financing and foreign exchange risks, except to the extent that these relate to the risks associated with owning the fixed assets and feedstock inventory.

Contributors

Jerry Levers de Abreu and André Novaski are Partners, and Dora Pimentel is a Senior Associate at Demarest Advogados, Sao Paulo.

They may be contacted at:

jabreu@demarest.com.br
anovaski@demarest.com.br
dpimentel@demarest.com.br
https://www.demarest.com.br/en/

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China

Cheng Chi, Choon Beng Teoh, and Josh Ma

KPMG, China

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The Chinese tax authorities often use various quantitative measures empowered by big data tools to scrutinize the transfer pricing ("TP") risks of companies in China, including contract manufacturers. Although the exact set of quantitative measures looked at by the tax authorities are not disclosed publicly, in our experience, contract manufacturers with volatile profit margins or sustained operating losses are more likely to be questioned by the tax authorities from a transfer pricing perspective, as the Chinese tax authorities commonly consider contract manufacturers to be low-risk, routine-functioned entities that should not bear significant risks in the value chain.

Furthermore, due to localized supply chains and the associated TP arrangements between local entities, many manufacturers of multinational groups accumulate excess profits in China that do not correspond to their functional profiles as contract manufacturers. They often face challenges in remitting these excess profits out of China. Paying royalties or service fees could be the only practical route to achieve this purpose due to China's foreign exchange control regulations. However, these entities that pay significant service fees or royalties are considered to be high risk and are prone to being challenged by the Chinese tax authorities. The tax authorities would use the amount and sales percentage of non-trade payments (i.e., royalties and service fees) as indicators for any activities of base erosion or profit shifting by taxpayers.

Having upfront informal communications with the in-charge tax authorities on tax and transfer pricing issues can help mitigate the risks of future disputes to some extent. However, any discussions held informally with the tax authorities are not considered binding in the event of a formal transfer pricing audit. Recent observations suggest that the in-charge authorities are becoming less willing to provide their opinions on matters related to transfer pricing during informal discussions with taxpayers to avert backfire in a potential formal transfer pricing audit in the future.

Taxpayers may also seek to obtain an advance pricing agreement ("APA") with the Chinese competent authorities. This option provides the highest degree of certainty when it comes to transfer pricing for those with a good record of compliance.

The APA may take the form of a unilateral, bilateral, or multilateral agreement (the multilateral agreement is not commonly seen in China). Ideally, a bilateral APA is more effective in resolving double taxation on both ends, and negotiations are made between competent authorities to reach agreements in a more cordial environment. Unilateral APAs, meanwhile, are negotiated between taxpayers and local tax authorities. Since local tax officials are more revenue driven, unilateral APAs can feel like an audit at times.

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While APAs can take a long time to resolve and conclude, the authors have seen improvements in the speed in which APAs are concluded in China. The latest statistics from the State Taxation Administration ("STA") show that more APAs are being settled at a quicker pace, and there have been cases where competent authorities reached agreement after just one competent authority meeting. As such, with a well-prepared APA analysis and package, the authorities would be able to conduct their negotiations more effectively and efficiently.

The simplified unilateral APA procedures, introduced by the STA through a regulation in July 2021, can further shorten the process from the normal six stages to just three stages. The regulation clarifies a definitive time schedule for the tax authorities to analyze and respond to taxpayers. As such, simplified unilateral APAs can potentially be concluded within nine to twelve months from the date of acceptance by the tax authorities.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

The transactional net margin method ("TNMM") is typically used for determining the remuneration of contract manufacturers. With respect to the benchmarking analysis, comparable companies with significant R&D or sales expenses, or companies with consecutive losses, are usually excluded from the comparable set. Nonetheless, in an APA or in an audit case, the STA will generally use various methods to evaluate whether a Chinese manufacturer's return is appropriate or sufficient. The STA is generally interested in understanding the profit allocation within a value chain before deciding on the most appropriate method, where a quantitative value chain analysis is often required. One can argue that this type of analysis could be similar to a profit split analysis, but it is not strictly one. If the Chinese entity's routine return shows that it already takes up a good portion of the profit, the STA might not argue for more. Our observation and experience demonstrate that, despite going through the value chain profit allocation analysis, the TNMM is adopted at the end as most appropriate in most of the concluded APA or audit cases. In the latest released APA statistics by the STA, the TNMM is predominantly the method selected by the authorities in concluded APAs.

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

In practice, the tax authorities normally hold the view that the cost structure of a toll manufacturer should be adjusted to include the value of materials in the calculation of the profit level indicators, and benchmark them using the same set of comparables as that for contract manufacturers, owing to the practical challenges in obtaining financial data from independent toll manufacturers in the public domain. In transfer pricing audit cases, taxpayers may sometimes argue that toll manufacturers and contract manufacturers are exposed to different risks, as toll manufacturers do not have to hold and manage inventory, and they require different levels of working capital. Working capital adjustments can be performed to adjust for such differences. However, according to the prevailing TP regulations, the adjustment on the benchmarking results should not exceed 10% of the result of the original benchmarking. There are restrictions in performing working capital adjustments in any other situations when conducting benchmarking analysis, and whether the approach is acceptable should be discussed with the tax authorities to obtain their approval.

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Use of the Berry ratio as a profit level indicator ("PLI") is an alternative approach to determine the remuneration for toll manufacturers, but in practice the tax authorities are often reluctant to accept the Berry ratio as the main PLI for manufacturers.

b. Adjustment for a contract manufacturer with capital intensive operations;

In practice, contract manufacturers with capital intensive operations are not specifically adjusted. The company may propose to apply a property, plant, and equipment ("PPE") over sales ratio as quantitative criteria for selecting comparable companies, or they may argue that a different PLI should be applied. An example of this could be return on asset or return on invested capital, which measures the return earned per unit of capital/asset invested. However, the use of these alternative PLIs is not always accepted by the Chinese tax authorities in transfer pricing audit cases unless there is strong evidence to claim that using the PLI is more appropriate.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

The Chinese tax authorities generally hold the view that pure contract manufacturers that only sell products to the business principals should not bear market risk over the long run, and the cost of idle capacity due to market reasons should be compensated by the principal. The tax authorities may tolerate the fact that the contract manufacturer operates at losses for the first two to three years of operations on the basis that the production capacity of the company has not reached a stable phase during the start-up period. Nonetheless, in situations where there is capacity underutilization, the reasons causing the capacity underutilization should be analyzed to determine who should bear the costs and explained to the tax authorities.

d. Any other considerations.

Most contract manufacturers in China within multinational groups operate a hybrid model (i.e., as contract manufacturers in the supply chain of overseas markets, but as licensed manufacturers in the supply chain of the domestic market), due to the strict foreign exchange control in China. Manufacturers supplying products to overseas markets have the option to first sell products to their overseas business principals, which then resell the products to overseas third-party customers. However, the model may not be practical for products supplied to the local market (i.e., for those intended to be routed overseas and then imported back into China). While there are solutions to the practicality of product physical flows, such as shipping products to a warehouse in a "logistic park" or a "special customs supervision zone" where the goods are technically exported out of China, this re-routing might not be feasible for products that attract import customs duties, and become cost prohibitive. As a practical alternative, manufacturers can operate a licensed manufacturing model, under which they would sell directly to local customers and profits are repatriated as a royalty. However, such payments are under close scrutiny by the tax authorities.

In addition, the tax authorities may require manufacturers to present the financial data under both licensed manufacturer and contract manufacturer models separately and assess them respectively. It will also trigger issues if the manufacturer earns different profit margins under the two business segments.

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3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing? Include in your response the following:

a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;

Although there is no clear regulatory guidance as to whether the subsidies should be taxed locally or pass on to the principal, in practice tax authorities in previous audit cases almost always take the position that the subsidies should be retained and taxed locally because the subsidies are considered to be a refund for part of the taxes paid locally. As subsidies are considered to be a location specific advantage by the tax authorities, they should not affect the calculation of the cost base or the product pricing or pass on to the principal. In addition, as financial auditors would reclassify the subsidies as a below-the-line non-operating item according to the local accounting standards, it is suggested that the taxpayers not treat them as an operating item and pass on to the principal through pricing.

b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;

The cost base should not be affected by the subsidies for the same reasons stated above.

c. Other issues pertaining to government subsidies or grants.

There are no other relevant issues to discuss.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

In practice, the tax authorities generally assess the profit margins of contract manufacturers before taking into account financial expenses. Financial expenses are treated as below the line. However, with regards to the tax treatment of interest expenses, the Chinese regulations have rules for thin capitalization. Interest for non-related party borrowing is not affected, as long as the earnings before interest and taxes fall within the arm's length range. For intercompany loans, taxpayers should also consider whether the interest rates between related parties are reasonable. Furthermore, according to the thin capitalization rules in China, the interest expense for intercompany loans exceeding the certain debt-to-equity ratio stipulated in the TP regulation is not tax deductible, unless thin capitalization documentation is prepared to demonstrate that the debt-to-equity ratio is reasonable and the interest rate is in line with the arm's length principle. The debt-to-equity ratio stipulated in the TP regulation is 5:1 for financial institutions and 2:1 for other entities (including contract manufacturers).

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The entity that should bear foreign exchange risks depends on the contractual arrangement between the contract manufacturers and the principals, and bearing the risk should not impact their characterization as contract manufacturers. The Chinese tax authorities generally accept that the calculation of profit level indicators for the contract manufacturers bearing foreign exchange risks should exclude the impact of foreign exchange gain or loss, whereas contract manufacturers that do not bear foreign exchange risks should obtain a stable profit margin after accounting for the foreign exchange gain or loss.

Contributors

Cheng Chi is a Transfer Pricing Partner at KPMG China and a member of the Steering Committee of the Global Transfer Pricing Services Practice of the KPMG global network, Choon Beng Teoh is a Director, and Josh Ma is a Senior Manager at KPMG China.

They may be contacted at:

cheng.chi@kpmg.com
choonbeng.teoh@kpmg.com
josh.ma@kpmg.com
https://kpmg.com/cn/en/home.html

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Denmark

Arne Møllin Ottosen and Lenni Hangaard Jensen

Kromann Reumert, Copenhagen

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

In Denmark, there are no official statements or guidelines from the Danish tax authorities that specify what kind of operations they perceive as high risk. A review of the limited publicly available case law on contract manufacturing setups, unfortunately, does not shed much light on specific operations other than the fact that it typically involves the production of certain products by an affiliated entity located outside of Denmark. Information on the types of products or the industry is anonymized before publishing. Additionally, Denmark generally applies the arm's length principle in accordance with the OECD Transfer Pricing Guidelines.

Perspectives on how to safeguard MNEs' transfer pricing positions can be deduced from transfer pricing rulings. The most important part of mitigating risks is that taxpayers have complete and adequate transfer pricing documentation in place. For this purpose, it is also extremely important that intercompany agreements are drawn up as if the transaction had been entered into with a third party and not just a typical "one-pager." MNEs engaged in contract manufacturing should ensure that their setup is properly tested and that all relevant documentation is stored since case law shows the Danish tax authorities will not hesitate to audit and challenge the contractual setup and the pricing.

Examples from case law show that an important step towards safeguarding the taxpayer's transfer pricing position is to have conducted a proper comparability analysis in accordance with the Transfer Pricing Guidelines, accounting for factors such as differences in depreciation periods, which can distort the basis for comparison if no adjustments are made. Another relevant factor to consider when discussing a contract manufacturing setup is who bears or controls the investment risk associated with the utilized production equipment.

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

In some cases of contract manufacturing, the producer may operate under extensive instruction from the counterparty about what to produce, in what quantity, and of what quality. In other cases, the counterparty may make raw materials or components available to the producer. The production company may be assured that its entire output will be purchased by the counterparty, assuming quality requirements are met. In such a case, the production company could be considered as performing a low-risk service to the counterparty, and the cost-plus method could be the most appropriate transfer pricing method (see paragraph 7.40, Transfer Pricing Guidelines 2022).

The transactional net margin method can be applied to a contract manufacturer that is provided with intangible assets, etc., by the principal and is not exposed to significant risks. When assessing the risk a contract manufacturer bears, consideration must be given to, inter alia, whether the company has only one customer, whether the contract term is short or long, and to what extent the contract manufacturer ensures utilization of its production capacity.

A ruling from the Danish National Tax Tribunal, dated 20 April 2018, on a transfer pricing case concerning controlled transactions between a Danish company and a foreign-affiliated contract manufacturing company, illustrates the choice of method and "profit level indicator" (PLI). According to the value chain analysis, the contract manufacturer's role was primarily limited to standard production, while the Danish company was responsible for production development, purchasing, daily production planning, quality control, marketing, sales, and distribution. Furthermore, the Danish company developed and owned all production-related intangibles and had to approve any new investments made by the contract manufacturer. The parties entered into a long-term agreement, with the Danish company being the sole customer of the contract manufacturer and obligated to purchase all manufactured products. To determine the arm's length compensation for the contract manufacturer, the parties chose the transactional net margin method, using Return on Capital Employed (ROCE) as the PLI.

However, the Danish tax authorities disagreed with the choice of PLI, arguing that the actual return depends too much on the book value of the assets. Instead, the tax authorities determined the arm's length compensation using the transactional net margin method with Return on Total Cost (ROTC) as the PLI. The Danish National Tax Tribunal approved this approach, referring to paragraph 7.40 of the OECD Transfer Pricing Guidelines (2010), which mentions contract manufacturing as an example where a cost-based method can be applied.

The distinction between toll manufacturing and contract manufacturing lies in the supply and utilization of raw materials during the production process. In contract manufacturing, the company is responsible for procuring and processing raw materials to create the final product. Consequently, the manufacturer assumes associated risks, including costs, inventory levels, and quality control of the raw materials used.

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The Danish Legal Guide (in Danish Den Juridiske Vejledning) does not contain any guidance on this distinction, nor does Danish published case law. However, it must be assumed that in determining the arm's length price, factors such as risk do affect how the price is adequately determined.

As briefly stated above, the Danish National Tax Tribunal ruling of 20 April 2018 touches on the issue regarding contract manufacturers with capital-intensive operations. The National Tax Tribunal stated that the foreign subsidiary could not be considered to have or control the investment risk associated with the utilized production equipment. The Danish parent company originally decided to invest in the subsidiary's production equipment and was to continue to approve any new investments. Since the subsidiary exclusively produced for the Danish company according to specific guidelines, the Danish parent company de facto bore the shutdown risk, regardless of the wording in the contract. There are thus significant differences in the assumed risks regarding investments in the production equipment between the subsidiary and the selected comparable companies. These differences have a significant impact when using the assets as a comparability indicator and therefore make the comparability analysis uncertain.

Furthermore, capacity utilization for the contract manufacturer is briefly discussed in relation to the applied method. The National Tax Tribunal also found that the method used by the Danish Tax Agency was in accordance with the arm's length principle, as the service provided by the subsidiary could be equated with a service provision, in accordance with OECD Transfer Pricing Guidelines. Hence, the subsidiary received, inter alia, a production plan and was guaranteed the sale of the produced products.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- **a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
- **b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
- **c. Other issues pertaining to government subsidies or grants.**

There is no published case law regarding the transfer pricing implications of government subsidies or grants in contract manufacturing, nor is there any guidance in the Danish Legal Guide issued by the Danish Tax Agency.

However, since Denmark follows the OECD Transfer Pricing Guidelines, government subsidies or grants may impact the choice of transfer pricing method, as stated in paragraph 2.77 of the Transfer Pricing Guidelines (2022). It follows that, inter alia, government subsidies may impact the application of traditional transaction methods. Each case must be determined according to its specific facts and circumstances.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

For internalization benefits resulting from passive cooperation, according to the OECD, no adjustment or payment should be made (see paragraph 1.158 of the 2022 Transfer Pricing Guidelines). This position can be endorsed if a benefit is obtained in an independent transaction. For example, a parent company

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cannot demand payment from a subsidiary that has secured favorable terms in a transaction with a third party due to the group relationship unless the parent company actively contributed to it. A company should also not be considered to receive a service from its parent company merely because the group relationship results in a higher credit rating and thus lower financing costs. If, on the other hand, a benefit is obtained in a controlled transaction, the application of market transactions and unilateral methods in the arm's length test will result in the benefit being fully allocated to the company that is not the tested party.

No specific Danish guidance can be found on handling foreign exchange risks in transactions involving contract manufacturers, so each case must be determined according to its own facts and circumstances, taking into account the Transfer Pricing Guidelines as guidance. Paragraph 2.88 of the 2022 Transfer Pricing Guidelines addresses the issue of whether foreign exchange gains and losses should be included or excluded from the determination of the net profit indicator. First, it needs to be considered whether the foreign exchange gains and losses are of a trading nature and whether or not the tested party is responsible for them. Second, any hedging of the foreign currency exposure on the underlying trade receivable or payable also needs to be considered and treated in the same way in determining the net profit. In effect, if a transactional net margin is applied to a transaction in which the tested party bears the foreign exchange risk, foreign exchange gains or losses should be consistently accounted for (either in the calculation of the net profit indicator or separately).

Contributors

Arne Møllin Ottosen is a Partner and Head of Tax at Kromann Reumert in Copenhagen, and Lenni Hangaard Jensen is a dedicated tax lawyer at Kromann Reumert and PhD fellow at Aarhus University.

They may be contacted at:

ao@kromannreumert.com
lehj@kromannreumert.com
www.kromannreumert.com

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France

Julien Monsenego and Emmanuel Llinares

Delsol Avocats and NERA Economic Consulting, Paris

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The French tax authorities will scrutinize any situation which could demonstrate a transfer pricing anomaly regarding contract manufacturing operations, such as drastic changes in profitability and/or recurring tax or accounting loss position. In such a situation, the French tax authorities may consider that a contract manufacturer should be structurally profitable, given its routine operations, and thus generate a low but guaranteed net margin from its operations, or be sheltered from profit variations.

It is therefore crucial to be able to explain such changes, particularly if they are justified by contractual documentation providing for certain adjustments or risk allocations explaining a temporary loss position or drop in profitability, or by market or other exceptional circumstances (such as an industrial incident on the manufacturing site or transport circuit, temporary rise in raw material costs, strikes, etc.).

The conversion of an entrepreneur or full-fledged manufacturer into a contract manufacturer, in the course of so-called “business restructuring” or similar operations. This situation can lead to two different types of risks. The French tax authorities may request an indemnification or characterize the taxable transfer of the clientele or business out of the French company to another related company, leading to a corporate income tax and registration duties reassessment at the respective rates of 25% and 5%, applied over the value which has been deemed transferred by the authorities.

As an illustration of this focus, Article 116 of the French 2024 Finance Act, in alignment with the OECD Transfer Pricing Guidelines, introduces new provisions for the valuation of intangible assets in transfers between associated enterprises by adding Article 238 bis-0 I ter to the French General Tax Code (“CGI”).

Consequently, the tax administration is authorized to adjust the transfer value of a hard-to-value intangible asset based on financial results obtained after the financial year in which the transaction took place (see new Article 238 bis-0 I ter of the CGI). The notion of hard-to-value intangible assets refers to the definition in E.2 of EU Council Directive 2011/16 (DAC 6) (see also: CGI, art. 1649 AH, II, E, 2°), which covers assets for which no reliable comparables exist at the time of transfer, and where the projections of future cash flows or expected revenues are marked by a high degree of uncertainty, making it difficult to assess their future success.

However, the tax administration is not entitled to challenge the value determined under the following circumstances:

- Where the taxpayer provides detailed information on the forecasts used at the time of the transfer to establish the pricing. This could include the consideration of risks and reasonably foreseeable events and their likelihood, and demonstrate that the significant variance between these forecasts and actual results is either due to unforeseen events at the time of pricing, or to foreseeable events whose probability was not significantly underestimated or overestimated at the time of the transaction;
- Where the transaction is covered by a bilateral or multilateral advance pricing agreement in effect for the relevant period between the states of the transferor and transferee;
- Where the discrepancy between the valuation based on forecasts made at the time of the transaction and the valuation based on actual results is less than 20%;
- Where a five-year commercialization period has elapsed since the year in which the asset or right first generated income from an unrelated entity and, during this period, the difference between the initial forecasts and actual results is less than 20%.

From a procedural point of view, Article 116 of the French 2024 Finance Act also extended the tax authorities' statutes of limitation for such disposals, which now extends to the end of the sixth year following the year in respect of which the tax is due (see new Article L.171 B of the French Tax Procedure Code). In addition, the tax authorities are authorized to verify such disposals without this being considered a repeat of a tax audit (as provided in the amendment to article L.51 of the French Tax Procedure Code).

These new rules apply to fiscal years beginning on or after January 1, 2024, and will enable the authorities to reassess any form of transfer of clientele, business or "hard-to-value IP," such as trademarks or patents to which a business is attached.

It is therefore crucial to investigate whether a formal or informal/de facto transfer of assets, functions, and/or risks has occurred and should be remunerated for the transferee and if so, to determine, usually using a mix of several valuation methods, a fair market value for this transfer.

The authorities may also consider that transfer to be not effective in the absence of major changes at the level of the former entrepreneur entity. This could be the case if the bulk of the workforce and key personnel remain with the parent company, and/or if the clientele are still mainly in contact with or are developed and managed by the former entrepreneur. In such a case, the authorities will reassess the company to increase its profits or profitability up to their former levels. This assessment will be dependent on the circumstances and which assets, functions, and/or risks have been considered transferred.

It is key to ensure that there is no mismatch between the contractual documentation justifying the qualification and the remuneration of the involved parties, on the one hand, and their actual roles in the operations on the other hand, to avoid or at least limit the risk of reassessment by the tax authorities.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

As a preliminary remark, it should be noted that the French authorities' approach to benchmarking and remuneration method for contract or toll manufacturing activities would not diverge from the OECD positions in this respect.

The French authorities would therefore determine whether a CUP method can be applied, in accordance with the OECD Guidelines (Part II, B.1, 2.18), before considering other methods, preferably the cost-plus method (Part II, D.1, 2.45). This is corroborated by the SME Guide to Transfer Pricing issued by the French tax authorities (page 16). This SME guide also emphasizes the fact that cost-plus methods are not appropriate in the case of sophisticated manufactured products or if IP (patents/know-how) are intensively used in the manufacturing operations. Therefore, a cost-plus method will, unsurprisingly, be considered appropriate for limited risk manufacturers only, contrary to manufacturing operations performed by entrepreneur entities or manufacturers using valuable IP or undertaking complex functions or bearing significant risks. Finally, these general principles are also confirmed by the French administrative guidelines (BOI-BIC-BASE-80-10-10).

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

The more limited functions and risks held by a toll manufacturer when compared to a contract manufacturer would imply a more limited remuneration level but should also prevent the toll manufacturer from any risk regarding raw materials (such as risks of loss, variations in purchase prices, and/or foreign exchange risks…).

In the context of this article, we consider the term "contract manufacturer" to refer to situations where the manufacturer purchases the essential inputs needed to manufacture the products and then sells the manufactured products to its client. The contract manufacturer also owns the manufacturing assets required for its production activities. Similarly, we consider the term "toll manufacturers" to refer to situations where the manufacturer does not purchase the essential inputs needed for its manufacturing activities but that such inputs needed to manufacture its products are made available by its principal/client. As compared to the contract manufacturer, we consider the toll manufacturer to own the manufacturing assets required for its production activities.

In practice, it is particularly difficult to identify toll manufacturers on commercial databases typically relied upon to perform comparable company searches. Based on experience, independent toll manufacturers are typically also involved in contract or full-fledged manufacturing activities, making it difficult to identify pure independent tollers on commercial databases. Absent the availability of internal comparable data accessible to the taxpayer where one would observe the remuneration of toll manufacturing activities, the approach to determine the remuneration of a toll manufacturer often entails relying on contract or full-fledged manufacturers and attempting to perform some adjustments.

The typical adjustment entails a working capital adjustment. Considering its profile, the toll manufacturer should not own significant inventory of input products required for its manufacturing process. This may be different from contract and full-fledged manufacturers, where we would expect them to have such inventory. Similarly, a working capital adjustment relating to the accounts payable and accounts receivable may also be considered to reflect any difference in terms of financial risks assumed by the toll manufacturer when compared to full-fledged or contract manufacturers.

A broader issue relates to the need to adjust for what one could refer to as functional intensity. To the extent that there are such differences, one may wish to contemplate an adjustment. We have seen taxpayers argue that the toll manufacturing status of the tested party may lead to targeting the lower end of the interquartile range of returns (where return on total costs is a commonly used profit level indicator (PLI)). While pragmatic, this approach may not be reliable in all circumstances. In particular, if

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the input costs are a significant part of the cost base of a contract or full-fledged manufacturer, considering that such costs would be absent from the toll manufacturer's cost base, applying a cost based PLI observed from the contract manufacturer may lead to under remunerating the toll manufacturer. This would particularly be the case in situations where the contract manufacturer and the toll manufacturer own similar industrial assets. In such a case, we would strongly encourage the taxpayer to consider an adjustment to the remuneration of the toll manufacturer in order to ensure suitable levels of comparability. In practice however, a solution would be to rely on an asset-based PLI, albeit not widely used in France at this stage. This is perhaps due to the fact that taxpayers and tax authorities may be reluctant to rely on statutory accounting data to determine such PLI, as balance sheet data in this form may not necessarily reflect the market value of the assets. Yet, from a comparability standpoint, this remains an issue that needs to be addressed when evaluating the remuneration of toll manufacturers.

b. Adjustment for a contract manufacturer with capital intensive operations;

The increased function and risks associated with capital intensive operations should be reflected in the remuneration of a contract manufacturer (higher remuneration for higher added value functions), as this would be expected to be reflected in a third-party arrangement.

Everything else being equal, capital-intensive operations should translate into higher levels of tangible assets in the balance sheet of the contract manufacturer, relative to manufacturers involved in less capital-intensive activities. In the case of a toll manufacturer, we believe that a possible answer lies in a careful review of the balance sheet data and considering an asset-based profit level indicator. While such asset-based indicators are commonly used in transfer pricing analyses in North America, they seem to be much less relied upon in France, perhaps for the reasons mentioned above.

At any rate, even if a profit and loss statement based PLI is relied upon (such as return on total costs), it is clearly worth checking the comparability of the comparable companies in terms of asset intensity, and we would strongly recommend the taxpayer to consider an adjustment if there are large differences in terms of asset intensity between the tested party and the comparable. While a detailed discussion of such adjustments is beyond the scope of this article, checking the return on assets of the comparable companies and testing the correlation between return on assets and return on total costs for the comparable may be a way to ensure that a profit and loss based PLI does not lead to overly distorted results.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

Capacity utilization can impact the pricing of certain transactions, for instance by way of discounts based upon product volumes ordered by the manufacturer's client or use of certain available production capacities of the manufacturer, as t would be reflected in a third-party transaction.

In our view, capacity utilization needs to be analyzed in the context of the risk framework developed in the OECD Transfer Pricing Guidelines (paragraphs 1.56 to 1.106). In our experience, capacity utilization is often a consequence of the materialization of strategic and marketplace risks. In this context, the OECD recommends ensuring that an entity that assumes such risks has the means to control such risks, as well as the financial means to assume those risks. The OECD risk framework was substantially revised in the 2017 version of the OECD Transfer Pricing Guidelines. It is certainly not the simplest part of the Guidelines, yet it does offer a detailed framework. In the (rare) instances where we have had to rely on this framework in the context of tax audits in France, it has proven very useful in framing the discussion

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with the tax authorities. As long as the risk related capacity utilization is borne by both the comparable companies and the tested party, then no adjustment is needed. Otherwise, an adjustment is needed to reflect the risk differential. Such an adjustment can, for example, be based on a measure of volatility whenever comparable companies are exposed to capacity utilization risk while the tested party is not.

d. Any other considerations.

We often witness situations where the application of the cost-plus method to related non-French manufacturers are challenged at the related French distributor end. In these situations, notably for limited-risk distributors, the French authorities are likely to require the application of a TNMM method to determine a distribution margin and therefore challenge a cost-plus method under which the non-French manufacturer will enjoy a structural profit position. This is notably the case for industries impacted by a general decrease in end-customer demand or prices, or higher/new regulations impacting the distribution functions profitability. A Supreme Court case in the medical devices industry illustrates this situation (French Supreme Court, June 6, 2018, n°409647, SCS General Electric Medical Systems). This position is likely to create a conflict between the use of a cost-plus method at the manufacturer's end, and a TNMM at the distributor's end, requiring the determination of which entity is the actual entrepreneur. These conflicts can be anticipated and resolved via bilateral or multilateral APAs but can also lead to double taxation and conflicted views between the tax authorities involved regarding the profiles of the parties and the appropriate remuneration method.

Also, for routine manufacturers, both the French tax authorities and courts will expect that a cost-plus method will apply to a full, direct and indirect cost base. This is illustrated by an Appeal Court decision (Bordeaux Administrative Appeal Court, October 29, 2020, n°18BX03395), which ruled that a so-called "marginal cost-plus" based upon variable costs and only a 25% of fixed costs should be challenged and replaced by a full cost base, including all direct and indirect manufacturing costs, given the routine nature of the operations held by the manufacturer and its lack of entrepreneur profile.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- **a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
- **b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
- **c. Other issues pertaining to government subsidies or grants.**

In third-party contractual relationships, the impact of such subsidies or grants to the manufacturer is likely to be considered when determining the pricing for the manufacturing operations. Therefore, in a transfer pricing intragroup context, this impact should also be considered. This approach has been illustrated by a recent case which, even if it relates to R&D services invoiced between related parties, should apply in a manufacturing context. Indeed, the Versailles Administrative Appeal Court ruled that the benefit of the French R&D tax credit, which is a form of public subsidy, should impact the level of R&D services to be recharged by a French service provider to a related service beneficiary (Versailles Administrative Appeal Court, March 29, 2022, STMicroelectronics Alps, n°20VE02081). In this case, the cost base used for the recharge of these services was reduced by the amount of R&D tax credit granted to the French service

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provider by the French State. This decrease in the cost base was challenged by the French tax authorities, but the Versailles Court ruled that this decrease was not, per se, an abnormal transfer of profit between the two companies, while the authorities had not demonstrated that third parties would not factor the impact of subventions or related tax credit in the pricing of their transactions. This position reiterates an older position from the French Supreme Court (Philips France, September 19, 2018, n°405779), which dealt with the impact of public subsidies over the cost base of intragroup services.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

It would be expected, notably for low-risk contract manufacturers and even more for toll manufacturers, that any financing or FX rate cost in relation to their activities would be reflected when their remuneration is determined. Since typically financing or FX costs are not included in the cost base when a cost based PLIs is relied upon, we would expect an adjustment to the PLI to be performed if the comparable companies relied upon to set the cost-based return were to incur significantly different financing or FX related costs.

Contributors

Julien Monsenego is a Partner – Co-head of Tax Law at Delsol Avocats, and Emmanuel Llinares, PhD is a Senior Managing Director at NERA Economic Consulting in Paris.

They may be contacted at:

jmonsenego@delsolavocats.com
emmanuel.llinares@nera.com
www.delsolavocats.com
https://www.nera.com/

Germany

Philip de Homont and Tom Braukmann

NERA Economic Consulting, Frankfurt

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The German tax authorities generally perceive contract manufacturing as having a high tax risk when used in the context of principal structures. In particular, such risk exists when group companies in Germany conduct both the manufacturing and distribution activities, while the residual is attributed to a low-tax jurisdiction. In these cases, the German tax authorities would pay special attention to the functional profile of the parties involved and assess whether the German production function is properly classified as (only) contract manufacturing in the first place.

In a wider sense, the German authorities can challenge a one-sided viewpoint, i.e., when operations are classified as routine contract manufacturing without at least a comparative view toward the other parties involved and their relative complexity. On a technical level, the tax authorities' concern is often whether German contract manufacturing activities are true contract manufacturing or whether there are elements of more entrepreneurial activities mixed in, such as production engineering or other factors that could be interpreted as a full-fledged production activity, particularly given that Germany is a relatively high-wage country.

Challenges can also arise when manufacturing operations in Germany are closed or moved abroad, often due to high labor costs and the tightly regulated environment in Germany. In such cases, the tax authorities closely scrutinize whether the case might constitute a "relocation of function," i.e., whether any exit tax payment might be due. While such exit tax payments should generally be limited in cases of pure "routine" functions such as contract manufacturing, tax authorities still closely observe whether any intangibles were transferred, such as production know-how or contractual rights. Similarly, if a German full-fledged production company were reduced to a contract manufacturer, the change would typically give rise to a relocation of function and thus potentially exit tax.

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

The first factor in any economic analysis is the functional profile of the tested party and its classification as either a contract or toll manufacturer or a full-fledged production company. Thus, the applicability and acceptance of the benchmarking analysis is largely driven by the functional analysis.

When benchmarking is deemed the correct approach, Germany follows the generally accepted Organisation for Economic Co-operation and Development (**OECD**) guidelines, although auditors might scrutinize the comparables more closely than in other countries and place particular emphasis on geographical and functional comparability factors.

Differences in toll and contract manufacturing activities should ideally be reflected by the choice of comparable companies, although in practice, it is often not possible to draw a sufficient level of distinction for the (potential) comparables. In practice, differences between toll and contract manufacturing are therefore reflected in the cost basis and/or inventory or cost of capital adjustments.

Adjustments for capital intensity would usually not be applied, since the aim is normally to find comparables that are sufficiently close in products, location, and function that their capital requirements would reflect that of the tested party. However, in capital-intensive industries, capacity adjustments and marginal productivity can be crucial factors, requiring a close look at capacity risks and scale, one or both of which might require adjustments.

For capacity adjustments in particular, the German authorities usually look at which entity effectively makes the decisions regarding the production volumes within the group. For example, if the foreign headquarter company decides which group factory produces how much, the German authorities would usually not accept high losses due to underutilization of a German plant. One challenge in this context can be that, historically, the German authorities were somewhat skeptical regarding ex-post adjustments, especially for physical products. This complicated the process for ensuring the appropriate return for contract manufacturers (in Germany or abroad) when capacity usage was different than originally expected. It should, however, be noted that German authorities are increasingly open to making ex-post adjustments, especially when such adjustments increase the German tax base.

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3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

Germany has practically adapted the OECD Transfer Pricing Guidelines into its administrative principles regarding transfer pricing as of 2023 and previously also supported the OECD's clarification on the treatment of subsidies following the COVID-19 pandemic. Thus, subsidies, grants, and other effects from government intervention should generally be reflected as market conditions in a transfer pricing analysis. This, in turn, implies the financial effects of such interventions should accrue to the entity or entities that are most instrumental in realizing them.

In practice, whether the subsidies would be available to *any* company operating in the relevant industry and country or whether circumstances *unique to the tested party* gave rise to the subsidy needs to be analyzed. If subsidies are generally available to any production company, competition would be expected to effectively lower the overall costs of the contract manufacturing, and thereby the savings would largely be passed on to the principal or distribution company. Conversely, if the subsidies are the result of a concerted and unique action of the manufacturing company, it could generally be expected to retain any such benefit.

In the context of contract manufacturing, whether subsidies or grants should be considered as part of the cost base typically should be aligned to their mechanism, i.e., whether they serve to reduce cost (and are granted on the basis of some costs, such as being tied to labor cost) or are more akin to a revenue. Notably, this is sometimes different in cases in which the manufacturing is considered a non-routine activity and a profit split is used; in such cases, it would depend on whether the costs are used as a proxy for valuable and unique functions, as in such cases even a government grant would usually not be seen as reducing the value of a function.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Contract manufacturing activities are generally tested with a profit level indicator based on operating profit (i.e., earnings before interest (and taxes)); therefore, financing expenses tend to be tested separately from the contract manufacturing activity itself. The German administrative guidelines on transfer pricing (which are binding on the tax authorities) specify that interest and similar financial items should generally not be considered for determining the tested net or operating profit.

Separate tests for the financing expenses have had a bumpy recent history in Germany. While the CUP method (i.e., a comparison of the interest rate with market rates of comparable loans) is typically applied by practitioners, tax authorities have tried applying other methods such as the Cost-Plus Method, especially when the overall setup was perceived as mainly tax-driven with the loan-granting entity in a low-tax jurisdiction. Different courts have ruled on these cases, sometimes inconsistently, but overall, the CUP method remains the dominant method.

Changes to the Foreign Tax Act in March 2024 have introduced explicit economic considerations that increase the focus on the interest basis (i.e., the extent of internal debt financing). As one of the main changes, taxpayers must now demonstrate the debt financing is economically required by the borrowing entity. Furthermore, the interest rate should normally not be higher than the overall group-level interest paid to third parties—unless the taxpayer can demonstrate other rates are more reliable.

Similar principles govern other financing expenses; their deductibility depends on (i) the economic need (or other benefit) for the contract manufacturer of the underlying activity and (ii) its correct pricing. A particular note should be taken regarding the capability of the respective entity to bear associated risks, both in terms of financial capability and risk control functions. This is often heavily contested for hedging results, as these can be very significant (ex-post) in either direction, and the external hedging is often conducted by central entities on behalf of the contract manufacturers. In these cases, it should be noted that risk control does not necessarily mean an in-depth day-to-day analysis of financial markets (which might nevertheless be conducted by the central entity) but can also be a strategic decision to generally conduct hedging activities for certain input materials precisely to externalize associated pricing risks.

Foreign exchange results of contract manufacturers can be a contentious topic too, especially when foreign contract manufacturers working on behalf of a German company and the transfer prices are denominated in euro or USD, as is often the case for Asian companies. While foreign exchange profits in individual tax years are often not challenged, when a foreign company earns more consistent positive foreign exchange returns, the German authorities often stipulate the pricing should be adjusted. It should be noted that markets often move unexpectedly and even a surprising foreign exchange result can be an arm's length outcome.

Contributors

Philip de Homont is a Partner, and Tom Braukmann is a Director at NERA Economic Consulting.

They may be contacted at:

Philip.De.Homont@nera.com
Tom.Braukmann@nera.com
www.nera.com

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Hong Kong

Irene Lee, Jeffrey Wong, and Jodi Yiu

KPMG, Hong Kong

Note from the Authors

We are pleased to present our response from the Hong Kong transfer pricing perspective. Firstly, we would like to highlight that manufacturing is not a predominant business activity in Hong Kong, contributing to only about 1% of Hong Kong's gross domestic product (GDP) in recent years. Therefore, our focus will be on Hong Kong's role as the principal entity in contract manufacturing arrangements (i.e., the contractor of the contract manufacturer). Our comments will be provided from this standpoint.

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Hong Kong adopts a territorial source principle of taxation, meaning only profits sourced in Hong Kong are taxable, while profits sourced elsewhere are not subject to the Hong Kong Profits Tax. Contract manufacturing operations involving offshore claims are perceived as high risk by the Hong Kong Inland Revenue Department ("HK IRD"), as these operations can be used to artificially shift profits offshore, thereby reducing taxable income in Hong Kong.

There are two types of manufacturing processing trade arrangements typically involving Hong Kong companies:

i. The Contract Processing Arrangement
   - The Hong Kong company supplies raw materials and machinery without consideration and provides technical know-how.
   - The manufacturer is responsible for providing factory premises, utilities, and labor.
   - The Hong Kong company pays a subcontracting fee to the manufacturer.
   - The legal title to the raw materials and finished goods remains with the Hong Kong company.

ii. The Import Processing Arrangement
   - The Hong Kong company sells raw materials to the manufacturer and then buys back the finished goods from the manufacturer.

Specific to contract processing arrangements, the HK IRD recognizes the involvement of the Hong Kong company in the processing activities performed by the offshore manufacturer and accepts that the profits on the sale of the goods can be apportioned on a 50:50 basis. This means a Hong Kong company under such a contract processing arrangement would be assessed only on 50% of its profits.

To support the profit apportionment, it is crucial to substantiate the involvement of the Hong Kong company in the offshore processing activities, such as through the provision of fixed assets, managerial

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know-how, continuous monitoring, etc. These issues are often scrutinized by the HK IRD in tax dispute cases. Additionally, it is also important to maintain sufficient substance and transfer pricing documentation to support the functional profile and the arm's length nature of the profit allocation under the contract processing arrangement. If the Hong Kong company has more than one business operation in addition to the contract processing arrangement (such as trading), transfer pricing considerations should be taken into account to ensure arm's length profit allocations amongst the onshore and offshore business segments.

To obtain tax certainty, taxpayers may consider reaching an agreement with the HK IRD and/or the counterparty tax authority(ies) on existing transfer pricing policies by entering into an advance pricing arrangement ("APA"). An APA provides certainty on an appropriate transfer pricing methodology in relation to the related party transactions. APAs concluded bilaterally or multilaterally with double tax agreement ("DTA") territories provide an increased level of certainty in Hong Kong and those territories, decreasing the likelihood of double taxation, as well as serving as a proactive means of avoiding transfer pricing disputes.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

- **a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
- **b. Adjustment for a contract manufacturer with capital intensive operations;**
- **c. Capacity utilization for the contract manufacturer and implications for transfer pricing;**
- **d. Any other considerations.**

In Hong Kong, there is no specific benchmarking approach for remunerating contract manufacturers. However, when testing the arm's length nature of the return earned by toll manufacturers, comparability adjustments are made to account for the difference in contract manufacturers versus toll manufacturers. Specifically, notional raw material and depreciation costs are added back to the toll manufacturer's cost base to align it with that of a contract manufacturer for transfer pricing purposes. This comparability adjustment is specifically required from a Chinese transfer pricing perspective.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- **a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
- **b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
- **c. Other issues pertaining to government subsidies or grants.**

From a Hong Kong transfer pricing perspective, there are no specific provisions directly targeting government subsidies or grants. Generally, these subsidies or grants in contract manufacturing are retained locally. The HK IRD has not specifically targeted the potential abuse of such subsidies or grants in contract manufacturing, so this is generally not a major concern for taxpayers at the moment.

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When calculating the net cost-plus mark-up return for benchmarking purposes, government subsidies or grants are generally excluded. This approach is taken to maintain an apples-to-apples comparison with selected comparables in the benchmarking analysis, as their financials also typically exclude such other income together with non-operating income.

In addition, to encourage more enterprises to conduct research and development ("R&D") activities in Hong Kong, the Hong Kong government provides enhanced tax deductions for expenditures incurred by enterprises on qualifying R&D activities. Enterprises can enjoy additional tax deductions for expenditures incurred on domestic R&D. The first HK$2 million spent on qualifying R&D activities qualify for a 300% deduction, and expenditures beyond that qualify for a 200% deduction. There is no cap on the amount of enhanced tax deduction.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Given that Hong Kong typically acts as the principal entity and sales platform between contract manufacturers and overseas customers, the transaction flow is typically structured as follows: Hong Kong purchases finished goods from contract manufacturers in the local currency of the manufacturer and then sells the finished goods to overseas customers in their respective local currencies. In this setup, Hong Kong naturally assumes the foreign exchange risk, reflecting its role as the intermediary within the supply chain.

Regarding the effect on the cost base of the contract manufacturer on which a net cost-plus mark-up is applied, financing expenses are generally excluded for similar reasons as those for government subsidies or grants for benchmarking purposes.

Contributors

Irene Lee is a Partner, Jeffrey Wong is a Senior Manager, and Jodi Yiu is a Manager of Global Transfer Pricing Services at KPMG in Hong Kong.

They may be contacted at:

irene.lee@kpmg.com
jeffrey.j.wong@kpmg.com
jodi.yiu@kpmg.com
www.kpmg.com/cn

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India

Rahul K. Mitra and Soumitra Chakraborty

Chartered Accountants, India

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The concept of plain vanilla contract manufacturing, wherein an entity manufactures goods on behalf of a principal company using technology and know-how provided by the latter is well cognized by the Indian Tax Authorities (ITA) and the judiciary in India. Contract manufacturing operates based on the premise that the manufacturing entity would not manufacture and sell the products to third-party customers on its own account; in other words, the contract manufacturer will not commercially exploit the intellectual property (IP) provided by the principal company.

In principle, the contract manufacturer is not required to deploy any non-routine IP owned by it for the rendition of contract manufacturing. There is considerable merit in this postulation as the advent of contract manufacturing in India (unlike in contract services) has not occurred at the same vintage, scale or pace as China, South Korea, or Taiwan so as to trigger any non-routine return owing to local expertise in niche manufacturing arenas like manufacturing of semi-conductors, aerospace equipment, high-end automotive components, precision equipment, etc.

The India Chapter of the United Nations Practical Manual on Transfer Pricing, 2017 further expounds on this, albeit in the context of location savings. The chapter highlights that the key issue involves the quantification and sharing of the incremental profits (location rent) arising in the supply chain due to location savings generated by the MNE from availing of location specific advantages (e.g., a skilled workforce, policy incentives) via contract manufacturing operations in India. In most cases, the location specific advantages are readily availed by other local comparables (if available) and are factored in the arm's length price. In most cases, contract manufacturers emulate a perfect competitive scenario where any cost savings generated from availing of location specific advantages are transient and are readily passed on to the principal.

In fact, the initial assertions made by the ITA about the contract manufacturer's entitlement to location savings generated in the supply chain were quickly quelled by several rulings, which held that any share of location savings was duly factored in the arm's length range derived from the analysis of independent companies.

It may be noteworthy that, unlike contract manufacturing, the ITA has been relatively more successful in staking a claim to the speculative supply chain surplus generated in the context of contract R&D service providers. Thus, the transfer pricing disputes in India within the realm of contract manufacturing have been mostly confined to the determination of an appropriate cost base for the contract manufacturer, and the corresponding arm's length mark-up to be applied to such cost base.

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The ITA has been quite emphatic against cost base erosion of cost plus entities due to services and/or assets being provided by the principal entity to the local entity at no or lower cost. Almost all advance pricing agreements and mutual agreements concluded by the ITA contain stipulations to safeguard the Indian cost plus entity against possible cost erosion.

The exercise of identification/allocation of the cost of such services/assets could be quite arduous if it is carried out by the MNE singularly for their Indian contract manufacturing operations. In this realm, it is important for MNEs to distinguish proprietary tools, stewardship, and IPs provided by the principal company on a fiduciary basis to the contract manufacturer from other costs or assets of the contract manufacturer that are picked up by the principal company. The costs of the former should not be included in the cost base of the contract manufacturer.

MNEs are expected to meticulously identify all services, software and other assets, and stock-based compensation that are provided to the contract manufacturer or its employees either on a pro-bono basis or at subsidized prices. Thereupon, the cost of these services and assets are to be included (at least notionally) in the cost base of the contract manufacturer for the application of an arm's length mark-up.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

Neither contract nor toll manufacturers exploit IP but only manufacture products for the principal company with the help of technology made available to it by the principal company. Thus, contract or toll manufacturers are in the nature of service providers for the principal company. Such service providers would deserve a routine but steady remuneration to cover costs and earn a profit thereon. The costs for a contract manufacturer usually include costs of raw materials purchased by it as well as any conversion costs incurred.

On the other hand, the cost of a toll manufacturer comprises conversion costs (also referred as value added expenses or VAE) only. It may be pertinent to highlight that the implementation of a pure toll manufacturing model in India is usually avoided by most taxpayers due to onerous indirect tax and regulatory compliance requirements. Instead, many MNEs operating in highly integrated or regulated supply chains (e.g., pharmaceuticals, automotive) establish contract manufacturers that have little or no raw materials functions apart from assuming title. The foreign principal remains responsible for identification of vendors, as well as negotiation of prices and specification of raw materials with such vendors. Thus, such contract manufacturers are effectively entitled to a return on conversion cost and on working capital blocked in the operation.

It is generally observed that Indian taxpayers and the ITA almost inevitably adopt the transactional net margin method (TNMM), whereby the operating profit on actual operating cost (OP/TC) of the contract manufacturer/toll manufacturer is compared of the arm's length range derived from the OP/TC of independent comparable companies to determine adherence with the arm's length principle. The benchmarking for the toll manufacturing model, if implemented, may require certain adjustments because comparable data for pure tollers are hard to come by in Indian databases. Taxpayers mostly consider the OP/VAE of low-risk manufacturers with some adjustments for no inventory as a proxy for toll manufacturing return.

This approach to testing the operating profit on actual operating cost of the contract manufacturer often beguiles taxpayers into inadvertently recognizing the task of contract manufacturing as a "no-risk" business model. The assumption is not without limitation as the proverbial "no-risk contract manufacturer" may not always be aligned with the underlying business model of contract manufacturing.

It is important to highlight a subtle difference between a contract manufacturer simpliciter and a captive contract manufacturer to draw out the nuances in the benchmarking approach to be adopted for each of these cases. A contract manufacturer simpliciter would merely provide its manufacturing facility to the principal company and manufacture products for the principal company.

Such a contract manufacturer may utilize its manufacturing facility for manufacturing products for more than one principal. A typical example would be where the taxpayer acts in the dual capacity of a licensed manufacturer and contract manufacturer.

In that scenario, the taxpayer, being ideally a subsidiary or a joint venture of a foreign MNE, gets a license from the foreign principal granting it the rights to exploit technology and trademark for manufacture and sale to third party customers in its own jurisdiction. At the same time, the foreign principal may also require the taxpayer to manufacture products, using such technology, and sell the same back to the principal company (or any other group entity) to sell globally by using its own distribution channels and network.

Where the foreign principal guarantees utilization of a certain portion of the manufacturing capacity of the Indian taxpayer, irrespective of whether such capacity is actually utilized, the foreign principal would bear the risk of such portion of the capacity. In such a case, the parties may agree to a reimbursement of full cost as the proportionate remuneration model for the guaranteed capacity, with an arm's length mark-up. In such a scenario, the Indian taxpayer would earn an arm's length return on the actual operating costs of the export segment for sale of goods to the foreign principal.

However, volume guarantees are increasingly becoming a passee in a fragmented post-Covid world, as it deters either party from making the most of imminent business opportunities or increases switching costs of reacting to the imposition of any trade embargos. Therefore, it may be quite likely that the foreign principals would not guarantee the utilization of any portion of the manufacturing capacity of the contract manufacturer. Thus, the risk of capacity utilization would be borne by the contract manufacturer and not by the foreign principal.

Such contract manufacturers would typically set the price of goods on a "per piece" basis by building in a rate of return on the costs, based on the estimated offtake of products by the foreign principal. The rate of return is usually a function of opportunity cost of the contract manufacturer. The rate of return for a contract manufacturer with an otherwise flourishing domestic business may be loosely based on the price/profit margin otherwise fetched by the Indian taxpayer from sale to third party customers, at most after factoring in certain abatements for being absolved of the selling and distribution functions and corresponding risks that are to be borne by the foreign principal. On the other hand, a contract manufacturer that has spare capacity may even be content with a basic return on its marginal cost.

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The contract manufacturer could earn more than the anticipated rate of return if it is able to garner more orders (i.e., manufacture and sell more products) than what it had initially anticipated. Conversely, the contract manufacturer could earn meager profits or even incur losses due to under absorption of fixed costs if the actual offtake plummets from the anticipated volumes or due to adverse foreign exchange fluctuations, for example. In either case, it would be incorrect for the contract manufacturer to test its operating profit on actual operating cost on an ex-post basis, as it would downplay the volume risk borne by the contract manufacturer.

Furthermore, it could also compel the contract manufacturer to undertake a plethora of adjustments where the actual outcome falls short of the arm's length range. It is pertinent to note that many of these economic adjustments (e.g., capacity utilization) adopted for contract manufacturers are fallacious since the taxpayer's adoption of TNMM as a transfer pricing method, with the PLI of full actual cost plus mark-up, is completely wrong at the very inception, being not aligned with the functional profile of the taxpayer.

Instead, the contract manufacturer would be better served if it maintains adequate documentation to demonstrate that the basis of determination of "per piece" rate based on standard costs and the reasons for variances thereon. This would also obviate the need for undertaking capacity utilization or other risk adjustments, which are not common in contract manufacturing.

On the other hand, captive contract manufacturers are engaged in manufacturing goods exclusively for a foreign principal. The exclusivity may be contractual or by actual conduct. A captive contract manufacturer would typically lack the wherewithal (e.g., marketing team) to woo third-party customers in the short run. Therefore, there is usually a volume guarantee (whether explicit or by conduct) provided by the foreign principal to such captive contract manufacturer. In such a scenario, ideally a remuneration model of actual full cost plus arm's length mark-up may be adopted such that the captive contract manufacturer would always earn an arm's length, albeit routine, return on its actual operating costs. Additionally, the remuneration policy for captive contract manufacturers may also be corroborated with a return on capital employed (ROCE).

In cases where the contract manufacturer (captive or otherwise) merely takes title of raw materials without any raw material functions, the contract manufacturer operates as a toll manufacturer in substance, except for taking title to the raw materials, possibly for administrative convenience. In such a case, the contract manufacturer may deserve a mark-up on its VAE and a reimbursement of the cost of raw materials (i.e., without a mark-up thereon). Furthermore, depending on the quantum of working capital locked on account of raw materials, the contract manufacturer would need to be rewarded with a return on such working capital. If the contract manufacturer receives the remuneration from the principal company well in advance, so as to consistently operate at a zero working capital, then no separate reward would be necessary on account of such working capital; and in such a case, the reward of the contract manufacturer would be similar to that of a toll manufacturer, with the cost of raw material being treated as a pass-through cost from the perspective of transfer pricing.

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It may be emphasized that even captive contract manufacturers are not unscathed by extraordinary circumstances like strikes, lockout, or punitive action by regulatory authorities, including production stoppages arising entirely due to its own ability or inability in such matters. Similarly, the foreign principal should not be expected to indemnify the captive contract manufacturer for product returns due to faults on account of manufacturing processes and not owing to technology related defects. Accordingly, such abnormal costs or losses would need to be excluded for the purposes of computing the PLI of actual full cost-plus mark-up of the captive contract manufacturer.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- **a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
- **b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
- **c. Other issues pertaining to government subsidies or grants.**

Government grants and fiscal incentives are important considerations for an MNE Group in adjudging the viability of establishing a contract manufacturing operation at any jurisdiction. These grants and incentives not only spruce the choice of locale for the MNE to set up the contract manufacturing operations but also partly offset the significant outlay made by the MNE for upskilling of labor, development of infrastructure, and incremental costs on logistics. Additionally, production linked incentives are also gaining centerstage, as these do not contravene the Pillar Two GloBE commitments made by countries.

The accounting treatment for government grants and incentives could vary from being outrightly considered as an income for the year to being set-off against the cost of assets of the contract manufacturer and thereby reducing the depreciation. The differences in nature of the grant and the corresponding accounting treatment could materially distort comparability analysis. Therefore, it is crucial for taxpayers to evaluate the impact of grants and incentives on the operating profits of the contract manufacturer and the comparable companies.

The identification of the rightful claimant to these grants and incentives is a vexed issue in India. The ITA is generally of the view that the grants and incentives are conferred to the contract manufacturer and should not be passed on to the foreign principal by way of subsidizing the compensation liable to be paid by the foreign principal. Conversely, there is evidence that shows that third party contract manufacturers are willing to share these grants with the principal if the projects are established entirely at the behest of the latter. Therefore, the key would be for taxpayers to emulate arm's length behavior through internal or external data.

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4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Financing of contract manufacturing operations (captive or otherwise) is generally considered an investment decision and is delineated from the operational activity of the contract manufacturers. Therefore, finance expenses incurred by contract manufacturers are excluded by the ITA when determining the profits of the contract manufacturer.

Unlike finance expenses, there are divergent views in India regarding the transfer pricing treatment of foreign exchange gains or losses emanating from contract manufacturing operations. Therefore, it is important to understand and analyze the nature of foreign exchange risk borne by the contract manufacturer to refrain from undertaking an arbitrary approach influenced by currency fluctuation. MNEs may be exposed to several types of foreign exchange risks, which include:

(i) **Financial risk:** The impact of foreign exchange movement on foreign currency held as wealth.

(ii) **Translation risk:** The impact of foreign exchange movement on historical values of assets, liabilities, and equity which are translated from a company's reported financial results from the company's functional currency to other currencies for informational or comparative purposes as of the end of a reporting period.

(iii) **Transactional risk:** The impact of foreign exchange movement from the date of purchase or sale of goods until the date of realization of the proceeds.

(iv) **Economic risk:** The impact of foreign exchange on the competitive position of an entity when income and expenditures are usually generated in different currencies. This risk is typically assumed on account of an adverse exchange movement between the date of actual setting of the price and the date of invoice.

The identification of the nature of the foreign exchange risk borne by the contract manufacturer and the party responsible for the discharge of the treasury function pertaining to the foreign exchange risk are key to unravelling the proper treatment of foreign exchange fluctuations. The foreign exchange gains or losses reported in the financial statements of a contract manufacturer are largely a manifestation of *transactional risk* (i.e., fluctuation in foreign exchange between the date of invoice and date of realization). Non-captive manufacturers may additionally report the impact of *financial risk* and *translational risk*, as well. More importantly, non-captive contract manufacturers operating on "per piece" pricing terms may be significantly exposed to *economic risk*. However, the impact of *economic risk* remains embedded in input costs or output prices and may only be discerned from the analysis of year-on-year price or gross margins. Captive contract manufacturers with limited treasury functions to manage the risks of forex should be reimbursed (without mark-up) by the foreign principal for any losses incurred from *transactional risk* as it should not be worse off than the comparable companies that mostly are not exposed to such risks. As a corollary, any gains arising from *transactional risk* should be passed on by the contract manufacturer to the foreign principal.

The impact and treatment of economic risk is more intrinsic to transfer pricing analysis, as it could potentially vitiate the functional profile of the non-captive contract manufacturer. Contract manufacturers operating on "per piece" pricing terms usually assume the foreign exchange risks that are managed through natural hedges or by availing explicit financial instruments (forwards, futures etc.,). The risks and rewards for the assumption of the economic risks are embedded in the prices/gross profit

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margin or operating profit margin of such contract manufacturers. Therefore, the contract manufacturer as well as the ITA should not make any primary adjustments due to the impact of economic risk, solely for ensuring conformity with the arm's length range derived based on comparable companies.

Contributors

Rahul K. Mitra is a Chartered Accountant and the former Transfer Pricing Leader of PwC and KPMG in India, and Soumitra Chakraborty is a Chartered Accountant based in India.

They may be contacted at:

mitrarahul@ymail.com
shomitra@gmail.com

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Ireland

Catherine O'Meara and Anna Crowley

Matheson

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The Irish tax authorities (Irish Revenue) have not issued specific guidance regarding risks in the context of contract manufacturing operations. That said, there are certain focus areas for compliance interventions by Irish Revenue that are relevant for contract manufacturing arrangements. These include accurately delineating transactions involving intellectual property and value creation, which is particularly relevant, as many contract manufacturing operations in Ireland are in the pharmaceutical industry. Irish Revenue will perform a detailed functional analysis to confirm if the functions align with the TP documentation. If MNEs make changes to their supply chain involving contract manufacturers, it is important to consider whether there is a potential business restructuring within the scope of Chapter IX of the 2022 OECD Transfer Pricing Guidelines (the OECD TP Guidelines), in particular where there is a reallocation of profit potential within the MNE group. In addition, risks can arise in contract manufacturing operations where losses are incurred by limited risk entities.

To safeguard the transfer pricing policies adopted and to mitigate audit risk, MNEs should carry out a robust economic analysis, which should be reviewed on a regular basis. Accurate records and detailed transfer pricing documentation should be kept in place to support the positions and pricing applied by the MNE group.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

Irish Revenue does not have specific guidance on the types of benchmarking typically accepted when remunerating contract manufacturing. Contract manufacturing is an example of the application of the cost-plus method (CPM) in the OECD TP Guidelines, and Irish Revenue will be familiar with the general use of the CPM method for contract manufacturing arrangements. The benchmarking studies utilized by

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a taxpayer should follow the approach provided for in the OECD TP Guidelines, having regard to the specific functional profile of the contract manufacturer, the assets it employs, and the risks it bears. For example, manufacturing businesses are often capital intensive and involve investments in physical assets, such as machinery, equipment, and facilities, all of which should be factored into the comparability analysis.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

Irish Revenue has not issued specific guidance on the treatment of government grants or subsidies in the context of transfer pricing. Generally, in line with the OECD TP Guidelines, government interventions such as subsidies should typically be treated as conditions of the market and should be considered in evaluating the taxpayer's transfer price in that market.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Irish Revenue has not issued specific guidance on the transfer pricing considerations for financing expenses relating to contract manufacturing transactions. Therefore, the general principles in the OECD TP Guidelines should be applied by MNEs operating in Ireland. The assumption of risks in the transaction should be determined by the actual conduct of the parties in the context of the contractual terms, rather than by aspects of written contractual terms which are not in practice applied. If, for example, the manufacturer's functional currency is U.S. dollars and the associated distributor's functional currency is in Euro, then the parties may determine that the distributor assumes the exchange rate risks in relation to the arrangement. Irish Revenue will carefully consider whether the comparables used in benchmarking approach foreign exchange risk in the same manner.

Contributors

Catherine O'Meara is a Partner, and Anna Crowley is a Senior Associate in the corporate tax department at Matheson in Dublin, Ireland.

They may be contacted at:

Catherine.O'Meara@matheson.com
Anna.Crowley@matheson.com
www.matheson.com

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Israel

Yariv Ben Dov

YBD Transfer Pricing and Valuation Services – TPA Global, Israel

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The Israeli Tax Authorities ("ITA") perceive a contract manufacturer's ("CM") activity to be considered high risk if:

- It contains technology of high value (as part of the manufacturing process) that can be allocated to the Israeli manufacturer;
- There is a sale of the Israeli intellectual property ("IP") to its related company abroad (which then owns the IP), turning the Israeli company, de facto, into a contract manufacturer. Hence, arguments with the ITA as to whether the technology was indeed sold and at what price (whether at arm's length) happen quite often whenever an Israeli company is acquired by a multinational;
- An Israeli company receives special grants from the government for manufacturing activity but in practice is characterized as a CM for transfer pricing purposes (see also response to the next question);
- An Israeli CM is involved in an additional activity, mainly research and development ("R&D") services. The fact that an Israeli CM is also performing R&D as a service is considered high risk.

The result of all this is that the ITA will challenge an Israeli entity with such characteristics as being a service provider altogether, arguing for other models, such as the "Profit Split."

MNEs can safeguard their transfer pricing positions to mitigate such risks by maintaining high level documentation that contains a transfer pricing study and an intercompany agreement (not any less important). In these documents, the taxpayer prepares a detailed functional analysis, demonstrating the characterization as a service activity. These facts and analysis are fully implemented into the intercompany agreement, thus transferring the "burden of proof" to the ITA.

It should be noted that these documents should be prepared in advance (from day one of the activity).

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

If the "Tested Party" is indeed the Israeli CM and if the TP method selected (under the "Best Method" or the "Most Appropriate Method" rule) requires a benchmark, we first have to locate local Israeli comparables (and demonstrate that we indeed searched for them). If there are no sufficient local comparables, then a search that involves both a pan-European benchmark and a North American benchmark is performed.

It is very important to exclude companies that own any sort of intangibles, or perform any activity in addition to the contract manufacturing (unless segmented data is available), etc. If it is a toll manufacturer that is in question, then we have to exclude comparables that have row materials in their balance sheet, etc.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

On December 29, 2016, the Knesset (the Israeli Parliament) passed the Economic Efficiency Law ("EEL"). The EEL is a key tool for encouraging capital investment in Israel, in order to increase competition in the economy and increase employment, with an emphasis on innovation and intensification of activity in development areas. This law was enacted with the understanding that the high-tech industry is one of the most important growth engines in the State of Israel, mainly due to the human capital existing in the country. Among other things, the EEL included 73 new routes toward tax benefits to which entities defined as "Preferred Technological Enterprises" and "Special Preferred Technological Enterprises" are entitled.

Section 51 of the EEL establishes a path to tax benefits for companies that contribute to the development of the production capacity of the Israeli economy, and such activities are encouraged by the law through a reduced tax. For example, Section 51 of the law defines an "industrial enterprise" as "an enterprise in Israel whose main activity in the tax year is manufacturing activity." In this definition, "manufacturing activity" includes the production of products. This law allows for a CM to enjoy the benefit of a reduced tax (if it meets, of course, all other relevant requirements). As the EEL and also grants from the Israeli government deal mainly with Israeli companies that own the IP of the products

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and thus perform R&D activities, this specific law allows Israeli companies to receive additional benefits for certain manufacturing activities, even if they are pure CM activities.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

As with most (if not all) Israeli service providers, it is fully expected for the IP holder related party that engages the CM to bear the foreign exchange risk. This is stated in the TP documentation and the intercompany agreement. This is very important as an additional factor in order for the ITA to accept the taxpayer's position to be characterized as a "service provider" in general and as a "contract manufacturer" specifically.

In most cases we have experienced, the IP holder finances the CM mainly via financial instruments, such as intercompany loans or capital notes.

Contributor

Yariv Ben Dov is the founding partner of YBD Transfer Pricing and Valuation Services – a global partner member of the TPA Global network.

He may be contacted at:

y.bendov@tpa-global.com
tpa-global.com

Italy

Aurelio Massimiano, Marco Valdonio, and Mirko Severi

Maisto e Associati, Milan

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Based on our experience, the Italian Revenue Agency ("RA") has primarily focused its audits on manufacturing activity on the following area:

- **Challenge of comparables:** As happens also with other types of transactions subject to transfer pricing rules, auditors often challenge the set of comparables selected by the taxpayer. Challenges regarding the comparability of the companies selected in the benchmark analysis may concern, for example, the impact that any additional activities beyond mere production activity (e.g., purchasing, shipping, etc.) may have on the comparability or the ownership of a trademark and the related value;
- **Selection of manufacturing costs:** Auditors often draw attention to how the company selects the costs to which the mark-up should be applied to determine the remuneration at arm's length. In this regard, auditors frequently examine whether all costs incurred by the manufacturer are taken into account in the application of the mark-up. This is the case, for example, of any inefficiency costs for which auditors may dispute whether they should be recharged. In this respect, another area of concern during the audit is the use of standard costs or actual costs in determining the cost basis. Based on the considerations above, auditors (especially when the manufacturer is tax resident in Italy) usually challenge the application of standard costs that can result in the manufacturer remaining affected by the cost related to any inefficiencies.
- **Anti-fragmentation:** The RA also focuses its attention on cases in which MNEs have various activities in Italy fragmented among different entities (e.g., manufacturing, distribution, and other ancillary activities). In these cases, the tax police may challenge the fragmentation of the activity allegedly aimed at qualifying the various Italian entities as low-risk entities. As a result of the challenge, the auditors may qualify all the activities carried out in Italy as high risk and therefore deserving a higher remuneration to be determined through the profit split.
- **Business restructuring:** One of the areas on which the Revenue Agency has mainly focused its audits is related to intangibles. In particular, tax authorities have focused intensely on business restructuring projects, especially where such projects consist of the redeployment of functions, risks, or assets out of Italy. In these cases, there have been various instances where the tax authorities have contended that, in situations where the taxpayer maintained that no intangibles were transferred, there was indeed a transfer of intangibles (e.g. know-how) associated with a transfer of production, contracts, an assignment of employees, or of customer lists.

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- **Royalty payment:** In many cases, the RA has challenged royalty payments and disregarded the deduction thereof, mainly because the RA is of the opinion that there is no benefit received by the taxpayer from the licensed intangible. Challenges may also involve reverse cases in which the manufacturer uses the principal's know-how to produce for the latter. In these cases, the RA may require payment of a royalty for the use of the know-how.
- **Value of additional functions:** Where the manufacturer carries on functions other than the production activities, such as selections of high value raw materials and negotiation with providers, coordination of external manufacturers and quality controls, production of prototypes, etc., the RA can challenge the functional profile and, in some cases, also the TP method adopted.

How can MNEs safeguard their transfer pricing positions to mitigate such risks?

The taxpayer's strategy may involve different steps depending on the level of comfort to be achieved. First of all, it would be advisable that MNEs define a transfer pricing policy that reflects the comparability analysis carried out, to manage in advance the transfer prices in compliance with the arm's length principle. This first step constitutes the minimum standard to avoid the situation where auditors during the audit, in the absence of a defined transfer pricing policy on which they could rely upon in their analysis, adopt unreasonable approaches. The second step may be the preparation of the transfer pricing documentation as provided by Article 1, para. 6 of the Legislative Decree of 18 December 1997, No. 471. The transfer pricing documentation is optional but provides penalty protection in case of a transfer pricing adjustment. The preparation of the transfer pricing documentation is relevant for MNE groups, as it also prevents possible criminal ramifications in case of challenges by auditors.

Furthermore, the absence of administrative penalties could make resolution of disputes through MAP more convenient. A third step that has been increasingly embraced by MNE groups is the use of advance pricing agreements ("APAs"), which provide the opportunity to agree in advance on transfer prices with the RA (unilaterally or bilaterally). The Italian legislative framework provides additional means of mitigating the risks of an audit even if not specifically provided for transfer pricing. The cooperative compliance regime, for example, set forth by the Legislative Decree of 5 August 2015, No. 128, allows for a constant dialogue between Italian taxpayers and the RA to prevent and resolve tax disputes. In a nutshell, the cooperative compliance procedure is open to taxpayers with turnover or revenue: (i) from 2024, of at least EUR 750 million; (ii) from 2026, of at least EUR 500 million; and (iii) from 2028, of at least EUR 100 million. Taxpayers participating in the regime must have an effective integrated system for detecting, measuring, managing, and controlling tax risks, embedded within the corporate governance and internal control system (the so-called "tax control framework"). The access to the regime provides several rewarding effects for taxpayers, such as, for example, a complete waiver of administrative penalties for tax risks reported in a timely and comprehensive manner, and a reduction of the penalties for conduct related to non-significant tax risks included in the risk/tax control framework, a ground for non-punishment for criminal offenses.

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

When it comes to the comparability analysis for an intercompany contract manufacturing arrangement, the transactional net margin method (TNMM) is the most used method, and the contract manufacturer is normally considered the tested party. The benchmark analysis in these situations often leads to a search on the target market of entities performing manufacturing activities. This often poses a comparability issue. Indeed, third-party contract manufacturers frequently undertake significantly more functions (e.g., sales and distribution) and assume critical risks (e.g., capacity risk or inventory risk) that are less frequently managed by intra-group manufacturers. While an intra-group manufacturer can be seen as a limited-risk entity within the multinational enterprise's value chain, the third-party contract manufacturer operates as an entrepreneur on its own. Therefore, directly comparing the margin or markup in an intercompany contract manufacturing arrangement with the margins earned by a third-party contract manufacturer would result in a comparability analysis that may be challenged by the RA. This may require comparability adjustments to be made on benchmarks in order to reduce the differences between the tested company and the comparable.

The adjustments most frequently carried out in these situations consider the working capital adjustments. Indeed, a third-party manufacturer may have different credit periods or inventory holding periods. Accordingly, a working capital adjustment may be considered to improve comparability. This is even more necessary in cases where the tested party operates as a toll manufacturer. Typically, a toll manufacturer does not perform any activity for procurement of raw materials and, in this regard, it does not bear any sales or warehouse risk because the activity is limited to the processing and assembly of raw materials into an output specified by the principal.

Other types of adjustments (e.g., asset-based adjustments or capacity adjustments) are less frequent than the working capital adjustment but can nevertheless be assessed by the taxpayer. If the taxpayer decides to perform such adjustments, it is worth considering whether to do so under procedures that involve an advance discussion with the RA, such as APAs.

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3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

Governments could provide for various support mechanisms to help companies, which may have implications for transfer pricing. Government assistance can be delivered through grants, subsidies, loan programs, forgivable loans, tax deductions, and other benefits. The RA has not issued any guidelines about their treatment in the transfer pricing scenario. The only support for this analysis has been provided by the TPG and the OECD's *Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic*.

According to the TPG, government assistance should be a qualified part of the market conditions and considered when evaluating transfer prices. Therefore, analyzing government assistance as a local market feature is crucial in determining its effect on controlled transactions. When assessing the impact of government assistance, it is crucial to examine the terms and conditions of the support. In this regard, the OECD's *Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic* suggests considering several factors, such as whether the assistance provides a market advantage, the extent of revenue increases or cost decreases compared to a reliable comparable, the duration of the assistance, and the degree to which benefits are passed on to independent customers or suppliers. Additionally, it is important to consider how independent enterprises would allocate such benefits under similar circumstances. Other factors include the availability and purpose of the support, any conditions imposed by the government, the allocation of economically significant risks, and the level of competition and demand within the relevant mark.

Having said that, based on our experience, for transactions using a cost-based transfer pricing methodology, it is important to determine whether government assistance should be deducted from the transfer price calculations. This involves establishing if there is a link between the government assistance and the specific intercompany transaction. If no link exists, the assistance should be excluded from the calculations. If a link is found to exist, the next step is to decide how to allocate the government assistance between the involved parties. This can be done by gathering evidence on how independent third parties act under similar circumstances and analyzing intercompany agreements to see what they establish regarding government assistance.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

The RA has not issued any clarification on this point. Based on our experience, the approach usually assumed is compliant with the provisions of para. 2.86 of the TPG, which excludes financial income/expense components from the calculation of the profit indicator. Exceptional cases that could lead to a chargeback of any financial costs could be those in which the tested party incurs these costs in

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order to implement large investments led by the principal. However, such cases are rare and should be regarded as exceptional.

No clarification has been provided by the RA on exchange rate-related revenues or costs. Again, based on our experience, the approach usually followed is the one provided by para. 2.88 of the TPG, according to which a net transactional margin is applied to a transaction in which foreign exchange risk is borne by the tested party. Foreign exchange gains or losses should be consistently accounted for (in the calculation of the net profit indicator or separately). However, our experience is that usually a contract/toll manufacturer, being a low-risk entity, is typically left unaffected by these costs, as they are unable to control the associated risk (e.g., for example by conducting the transaction in the local currency).

Contributors

Aurelio Massimiano and Marco Valdonio are Partners at Maisto e Associati, and Mirko Severi is a Senior Associate at Maisto e Associati.

They may be contacted at:

a.massimiano@maisto.it
m.valdonio@maisto.it
m.severi@maisto.it
www.maisto.it

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Japan

Takuma Mimura

Cosmos International Management

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

In this article, a "contract manufacturer" is defined as a company that engages in manufacturing work assigned by an affiliated company and purchases most of the raw materials from and sells the products to the affiliated company. More broadly, a toll manufacturer that does not buy/sell raw materials and products from an affiliated company, but only receives a service fee equivalent to its total operational costs plus a certain margin, could also be classified as a kind of contract manufacturer.

In Japan, there is no specific guidance on transfer pricing treatment for contract manufacturers. As described below, there is only a small mention of the contract manufacturer in the Transfer Pricing Reference Case Studies issued by the National Tax Agency ("NTA"). Therefore, most of the answers to the questions are based on the author's analyses of Japanese transfer pricing legislation conducted in the past and the knowledge he has gained from other sources. This article is not an exhaustive analysis of the Japanese transfer pricing practices for contract manufacturers.

A main characteristic of contract manufacturers is that their functions and risks are limited. Therefore, contract manufacturers are normally required to obtain a low but stable return, and it is necessary to adjust the prices of related party transactions to achieve this. Contract manufacturing companies that do not secure a low and stable profit margin might bear high taxation risk. Specifically, from the Japanese tax perspective, if a foreign contract manufacturing subsidiary of a Japanese parent company records a high profit margin, or if a Japanese contract manufacturing subsidiary of a foreign parent company records an operating loss, there will be a high risk of tax adjustments being made by the Japanese tax authorities.

The most important measure for multinational enterprises ("MNEs") to mitigate the risk is to stabilize the profit margin of the contract manufacturers and keep it at a low level. One of the factors that causes fluctuation in the profit margin of contract manufacturing subsidiaries is the assumption of risks such as foreign exchange rate risk and inventory risk. These risks should be borne by the consignor (usually the parent company), and contract manufacturers as consignee should not bear excessive risks.

Another factor that triggers a fluctuation of the profit margin for contract manufacturers is the absence of provisions to enable flexible changes in the prices in related party transactions in response to changes in foreign exchange rates and/or other economic circumstances. For example, assuming that the sales price of a product is set to earn a certain gross profit margin (e.g., 25%) on the subsidiary's direct manufacturing costs, if the economic situation worsens, followed by a decrease in product orders and a fall in the capacity utilization rate, the subsidiary's decreased gross margin would likely not cover

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its indirect operating expenses, the subsidiary thereby incurring an operating loss. To prevent such an outcome, MNEs should have a system that monitors the profits and losses of the contract manufacturer periodically (e.g., on a monthly basis) and that can make timely adjustments to change the prices of products sold to the consignor as necessary.

Further, there is also a tax adjustment risk when a full-fledged manufacturer is restructured into a contract manufacturer in form but in substance retains the characteristics of a full-fledged manufacturer. For example, where a Japanese manufacturing subsidiary changes from a full-fledged manufacturer to a contract manufacturer, and on the accounting flow its products are now sold to the foreign parent company. However, the products are still directly delivered from the subsidiary to the Japanese customers, with negotiations, including product pricing, still conducted between the subsidiary and the customers. In that case, the Japanese tax authorities are likely to disallow the transition to the contract manufacturing system, and the subsidiary's deemed income as the full-fledged manufacturer may be taxed.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

As for toll manufacturers, even though it is difficult to select independent toll manufacturers in a financial database, it is nonetheless necessary to look for comparable companies with as low risk as possible. For example, since it is usually not likely for a toll manufacturer to post an operating loss, comparable companies that post losses should be excluded. If using data from the most recent three years, companies that recognize operating losses within the three-year average period should be excluded. In addition, since toll manufacturers do not buy/sell raw materials and products, they are not expected to hold inventory and should record only small (if any) amounts of accounts receivable and accounts payable. Since the number of independent comparable companies is limited in some countries, the extent to which the search criteria could be narrowed down with respect to comparable companies depends on the situation. Nonetheless, to select companies comparable with toll manufacturers, companies with inventory, accounts receivable, and accounts payable below a certain level should be selected.

On the other hand, for the normal contract manufacturing subsidiaries, most of the transactions are made with related party consignors, so functions and risks are also limited. However, as mentioned above, contract manufacturers often bear more risks than toll manufacturers, such as market risk, inventory risk, and foreign exchange rate risk. In addition, raw materials purchased and finished products sold are recorded, so they should have a certain amount of inventory, accounts receivable, and accounts payable. Therefore, comparable companies with limited functional risk should be selected. For example, companies with incurring operating loss on three-year average are excluded. However, there is less need to screen out companies as strictly as would be the case with toll manufacturers.

b. Adjustment for a contract manufacturer with capital intensive operations;

In many cases contract manufacturers have labor-intensive manufacturing processes. It is clear that capital-intensive manufacturing companies are not comparable to labor-intensive manufacturing companies. For labor-intensive manufacturing companies, the amount of machinery and equipment is

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generally small compared to their sales revenue and assets, while the number of employees working on production lines is large. Thus, it can be said that profits are generated from the work done by these line workers. In contrast, capital-intensive companies are considered to generate profits from the capital invested in large-scale tangible fixed assets, such as machinery and robots. In other words, the optimal profit level indicator ("PLI") for labor-intensive companies is Net Cost Plus, defined as operating profit divided by total operating costs; while the optimal PLI for capital-intensive companies is Return on Operating Assets, defined as operating profit divided by operating assets. Consequently, capital-intensive companies need to be excluded from benchmark analysis testing for labor-intensive contract manufacturers.

While one possible way of excluding the capital-intensive companies is to exclude companies whose ratio of tangible fixed assets to total assets is above a certain level and is significantly higher than that of the tested company, there is a difficulty in setting an objective threshold ratio since the level of tangible fixed assets varies depending on the industry and the circumstances of individual companies (e.g., the number of years assets are held and the degree of depreciation). In practice, it is easier to exclude companies that belong to a certain industry or make certain products from the capital-intensive companies' class. For example, companies belonging to a capital-intensive industry. such as automotive (finished car makers such as Toyota), semiconductor, and steel (with blast furnaces), should not be selected as comparables to labor-intensive contract manufacturers.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

As mentioned above, even a contract manufacturer may experience a decline in its operating profit ratio or sometimes incur losses due to some external circumstances, such as a deteriorated economic situation, which causes a decrease in orders and the capacity utilization rate. In order to avoid such a situation, it is desirable to have a system that allows the related party transaction price to be changed flexibly.

However, when the capacity utilization rate drops rapidly in the short term, the change in the related party price tends to be delayed, and the fluctuation of profitability may not be avoidable. The profitability of the consignor (usually the parent company) may also be worsened by adjusting the purchase price from the consignee contract manufacturer too high. In such cases, there is a risk that the Japanese tax authorities may disallow such a large price increase by the foreign contract manufacturing subsidiary and insist that the combined operating profits (or losses) be divided between the Japanese parent company and the foreign subsidiary in accordance with the profit split method.

Therefore, where the capacity utilization rate drops significantly, the reason should first be clarified before making rapid price adjustments, and if the cause is purely an external factor not caused by transfer pricing manipulation, it should be treated as a special factor to justify the adjustments in the transfer pricing analysis. Then, adjustments should be made to remove the influence of such a special factor. Alternatively, if the profitability of the contract manufacturer in the single year is significantly affected by such a special factor, the use of the tested party's multiple years' financial data (normally three years) should be allowed to mitigate the impact by the special factor. Such analyses should be clearly stated to reasonably validate the external factor in the transfer pricing documentation.

d. Any other considerations.

Contract manufacturers usually manufacture using the technical know-how provided by the parent company that assigns the work and typically do not develop or hold valuable intangible assets

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themselves. However, on rare occasions, contract manufacturers do hold valuable intangible assets. Cited in the Supplement: Reference Case Studies on Application of Transfer Pricing Taxation, published by the NTA ("Case Studies"), Case No. 12 shows that "Company S" has come to possess valuable intangible assets over its 20 years' history as a contract manufacturing subsidiary. The following is a direct quote from the English translation of the Case Studies Case No. 12:

> *Company S has a separate quality control division from its manufacturing division, and over 10% of its workforce is engaged in checking products and inspecting production lines in order to maintain quality of product A. Company S's quality control division has accumulated know-how on dealing with and solving the quality problems that have arisen in the course of its 20 years of manufacturing experience. Using its developed unique inspection techniques and testing equipment, it checks quality and production lines at each of the key stages of production, and any problems that do occur during manufacturing are immediately rectified based on such know-how. This unique quality control setup dramatically increases inspection efficiency, and also reduces the cost of manufacture by reducing spoilage at company S and reduces product complaints from end users concerning product A, which has consequently acquired a reputation for reliability. As a result, a superior sales position has been achieved."*
>
> *Regarding the foreign-related transaction in this case, it was found that the attainment of high sales through the global distribution channels created by company P (resulting in higher profits as sales increase due to the high proportion of fixed costs in the cost of manufacture) and the establishment of a superior sales position (as a result of reduced loss due to spoilage in the cost of manufacture and the lower incidence of faults due to company S's original quality control know-how) served as a source of income in company P and company S's foreign-related transactions compared with in the cases of a corporation engaging solely in routine activities.*

As the above case indicates, if a contract manufacturer is found to hold valuable intangible assets, the residual profit split method may be chosen as the most appropriate transfer pricing method.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;

During the COVID-19 pandemic, especially in 2020 or 2021, many companies received various subsidies from the government of the country where they were located. The Japanese government also provided various subsidies to companies depending on the industry, company size, impact of losses, etc. These subsidies should basically be recorded as non-operating or extraordinary income, at least for the purpose of the transfer pricing analysis. This is because they are not profits generated from the business operations, nor are they profits that arise on an ongoing basis. Therefore, unlike a transfer pricing analysis that examines the amount of operating profits, subsidies are not subject to the same analysis and, if a contract manufacturer receives the subsidies, they should generally keep them. If it is something that the company formally received from the government where the company is located, it may be difficult to explain from an economically rational perspective that it should be passed on to the parent company.

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That said, if such subsidies significantly improve the profitability of the contract manufacturer, i.e., increase the contract manufacturer's profit margin not in proportion to its limited functions and risks, there might be a risk that the tax authorities of the country in which the parent company is located insist that they should be attributed to the parent company by deducting the amount of subsidies income from the product sales price or from the expenses that are the basis of the product sales price. In fact, in the case of a toll manufacturer, there is a higher risk that the tax authorities insist on transferring the subsidies to the parent company to stabilize its low profit margin. However, for contract manufacturers in general, the author's opinion is that it would be normally sufficient for them to receive the subsidies for themselves.

b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied.

In the case of contract manufacturers that receive a margin on total operating costs (e.g., toll manufacturers), even if the subsidy is non-operating or of an extraordinary nature, the Japanese tax authorities do not like to see a large increase in the profit margin of overseas contract manufacturing subsidiaries on a pre-tax basis. Therefore, for such a contract manufacturer with a guaranteed operating margin, there is a risk of tax adjustment to deduct the subsidy from the prices or fees paid by the related party consignor to the contract manufacturer.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Financial income and expenses, such as interest on loans and bank deposits, are recorded as non-operating income/loss for non-financial industry sectors. But if any other financial income and expenses are included in the operating income/loss in the financial statements, adjustments should be made to exclude them, just as capital adjustments are made to remove the financial impact of adjustments for differences in accounts receivable, inventory, and accounts payable. Hence, if the operating income and expenses of a contract manufacturer include foreign exchange gains/losses, such items should be treated as non-operating income/loss for the transfer pricing analysis. Alternatively, in the case of gains/losses from derivative transactions designed to hedge against foreign exchange rates or commodity price fluctuations, hedge accounting should be applied to match the gain/loss between the derivative transactions and the original instrument. Since the profit margin of a contract manufacturer with limited functional risk should be stable, foreign exchange risk should be generally borne by the parent company.

Contributor

Takuma Mimura is a Managing Director of Cosmos International Management Co., Ltd., an affiliate of Nagoya-based accounting firm, Cosmos Group. Cosmos International Management is also an Alliance Partner of Transfer Pricing Associates group.

He may be contacted at:

tmimura@cosmos-international.co.jp
www.cosmos-international.co.jp/english/index.html

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Luxembourg

Peter Moons, Sophie Ogden, and Katerina Benioudaki

Loyens & Loeff, Luxembourg

Note from the Authors

When planning to outsource the production of a product, companies always aim to employ the best approach to meet their needs and demands. Contract manufacturing, both inside and outside the group, is a popular business model in the manufacturing sector often employed by multinational enterprises (MNEs) across the board in today's economy.

In this article, we will try to respond to the questions posed to provide the readers with insight on how the business model of contract manufacturing is treated by the Luxembourg Tax Administration (LTA). However, to be able to respond to the questions, we deem it appropriate to first provide a general background on contract and toll manufacturing.

i. Definition of contract manufacturing

Contract manufacturing is the process of contracting the entire production of a product or material to a third or related party, i.e., the manufacturer, which is responsible for selecting, procuring, and processing the raw materials to produce the final product according to the contracting party's or principal's specifications. The contract manufacturer uses a plant and equipment that it owns and takes title to raw materials and work in progress. However, it generally does not own or utilize any valuable intellectual property.

ii. Difference from toll manufacturing

While toll manufacturing is quite similar to contract manufacturing, there is one key distinction between the two. Contrary to the contract manufacturer which, as previously mentioned, is responsible for the entire production process from beginning to end, including the procurement of raw materials, the toll manufacturer is responsible only for the processing of raw materials or semi-finished products into finished goods, without being responsible for the sourcing of the materials.

In other words, in toll manufacturing, the principal supplies the toll manufacturer with the materials and product design and often also owns all the related intellectual property, such as patents and trademarks. The toll manufacturer in turn provides the plant, machinery, and labor force necessary to manufacture the specified product and is responsible only for transforming the raw materials or provided sub-assemblies into finished goods. The toll manufacturer bears none of the risks or costs associated with holding raw materials, work in progress, or inventory, and at no point in time does the toll manufacturer take ownership of the raw materials. Accordingly, as no transfer of legal title is involved, the toll manufacturer simply provides a manufacturing service to the principal, which instructs

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the toll manufacturer as to specifications, quality, and quantity requirements. This, in addition to not owning or utilizing any valuable intellectual property, results in the toll manufacturer performing a relatively routine function that is expected to be reflected in a lower profit.

The distinction between the two business models is not always straightforward and requires a careful review of the underlying contracts.

iii. Functions, assets and risks associated with contract and toll manufacturing

Based on the above, the following table summarizes the main differences in the functions performed, assets deployed, and risks assumed by the contract and toll manufacturers:

	Contract Manufacturer	Toll Manufacturer
Transaction	Supply of finished goods	Provision of production services
Functions	Procurement of raw materials, manufacturing and supply of finished goods	Manufacturing only
Assets	Know-how, supplier relationships, raw materials, employees, machinery, technology, etc.	Know-how, employees, machinery, technology etc.
Risks	Inventory risk and work-in-progress risk	No inventory risk and no work-in-progress risk

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

To date, the LTA has not published any guidance in relation to the benchmarking process for contract manufacturing intragroup transactions, and the Luxembourg courts have not ruled on any such cases. This absence of guidance both from the LTA and the Luxembourg courts could be attributed to the nature of the Luxembourg market, which is well known for its strong financial and banking industry, and less known for its manufacturing industry as compared to larger European jurisdictions.

As a general remark, experience shows that the LTA can challenge easier taxpayers' intercompany transactions when no transfer pricing (TP) documentation is prepared. In an environment where tax scrutiny is increasingly observed, taxpayers should make sure that all controlled transactions are duly documented and supported by TP documentation.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

The analysis of functions performed, assets used, and risks assumed by the parties to the relevant transaction is the cornerstone of every transfer pricing study. From the above high-level description of the contract and the toll manufacturer, the economic effect of both business models lies in the separation of the manufacturing function in the supply chain between the principal and the manufacturer, as well as the ownership of the raw materials used in the production process. It can therefore be argued that a contract manufacturer has more responsibilities and more risks than a toll manufacturer for benchmarking and comparability purposes.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (**OECD Guidelines**) state that where it is possible to locate comparable uncontrolled transactions, the comparable uncontrolled price (**CUP**) method is the most direct and reliable way to apply the arm's length principle and should therefore be preferred.[3] Where the CUP method cannot be applied, the cost-plus method is usually applicable for both contract and toll manufacturers. This is also supported by the OECD Guidelines.[4] Practitioners usually deploy a cost-based transactional net margin method (**TNMM**) when benchmarking both business models.

The cost base and the mark-up are expected, however, to be different in both cases. While the cost base in the case of a contract manufacturer generally includes all costs, including the costs of raw materials in the costs of goods sold, the cost base for a toll manufacturer typically includes all costs without the costs of the raw materials.

b. Adjustment for a contract manufacturer with capital intensive operations;

See response below.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

As previously mentioned, contract manufacturers generally undertake more risks compared to toll manufacturers, namely inventory and work in progress risk. Although the manufacturer may be assured that its entire output will be purchased, assuming quality requirements are met,[5] the risk that the goods might not be sold cannot be completely dismissed, for example, due to a defect. This, combined with fluctuations in the market, especially in instances of volatile markets, may lead to significant exposure for the manufacturer. The same could be argued in cases where the principal decides to increase the quantity needed for its operations, thus resulting in a deterioration of the manufacturer's position, which might no longer have the capacity to serve the principal.

In some cases, a higher remuneration might be appropriate. Following a close case-by-case review of the activities and risks of a contract manufacturer, adjustments might be appropriate to reflect the economic reality of the risks associated with this business model. Such adjustments might include adjustments related to inventory or cost of goods sold, or even adjustments made, or parameters used during the search for comparables through various software available on the market.

The OECD Guidelines state in that respect that, based on the specific details and context of the situation and specifically on the proportion of fixed and variable costs:

[3] OECD Guidelines, paragraph 2.15, p.97.

[4] OECD Guidelines, paragraph 7.40, p.325.

[5] OECD Guidelines, paragraph 7.40, p.325.

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> *The TNMM may be more sensitive than the cost plus or resale price methods to differences in capacity utilization, because differences in the levels of absorption of indirect fixed costs (e.g. fixed manufacturing costs or fixed distribution costs) would affect the net profit indicator but may not affect the gross margin or gross mark-up on costs if not reflected in price differences.*[6]

Absent any guidance both from the LTA and the Luxembourg courts in this respect, the OECD Guidelines should be followed.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;

There is no stated policy from the Luxembourg tax authorities on how to deal with such subsidies. One may expect that where the subsidy is granted with the aim of expending manufacturing capacity locally, the subsidy would be allowed to be passed on in some form to the principal, as the principal makes decisions regarding the volume of the production from the contract manufacturer. More specific subsidies would not necessarily be expected to be passed on.

b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;

Again, there are no guidelines from the Luxembourg tax authorities in this respect. If the cost-plus method is applied, and the subsidy is meant to stimulate production capacity of the contract manufacturer, one would expect the subsidy to lower the cost base on which the net cost-plus is being applied. For more specific subsidies, this should be less obvious.

c. Other issues pertaining to government subsidies or grants.

The impact of the COVID-19 pandemic led to restrictions on travel and social contact and created unprecedented disruptions to the global economy and supply chain. Many businesses, small and large, as well as individuals, relied on government subsidies, loans, suspension of payment of taxes, and other state support. As a result, there was a need to address how any government grants or subsidies should be treated for transfer pricing purposes.

As a response, on December 18, 2020, the OECD published its Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic (the Guidance), which focuses on how the arm's length principle and the OECD Guidelines apply to issues that may arise in the context of the COVID-19 pandemic. Governments typically prefer that any assistance provided benefits their own citizens and businesses, rather than those in other countries. According to the Guidance:[7]

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[6] OECD Guidelines, paragraph 2.76, p.117.

[7] OECD Guidance, paragraph 79, p.21.

> *The potential effect of the receipt of government assistance on the pricing of a controlled transaction will depend on the economically relevant characteristics of the transaction, following an accurate delineation of the controlled transaction and the performance of a comparability analysis. Therefore, it would be contrary to the arm's length principle to assume that the mere receipt of government assistance would affect the price of the accurately delineated controlled transaction, without performing a careful comparability analysis (including an analysis of how the receipt of government assistance would affect the price of uncontrolled transactions, if at all, and the perspectives of both parties to the transaction).*

There are instances in which a taxpayer would consider that an arm's length price must be adjusted to account for government interventions, such as regarding price controls (even price cuts), interest rate controls, subsidies to particular sectors, etc. In principle, these government interventions should be considered as circumstances of the market of a specific jurisdiction and should be accounted for in assessing the transfer prices in that jurisdiction.[8]

As third parties might not enter into a transaction that is subject to government interventions, it is uncertain how the arm's length principle should apply.[9] Although there can be challenges in assessing the impact of a government policy in the determination of transfer prices, in principle, when government intervention equally affects transactions between both related and unrelated parties, the tax treatment for transactions between related enterprises should be the same as that for transactions between unrelated enterprises.[10]

Absent any specific guidance issued by the LTA and the Luxembourg courts in relation to contract manufacturing intragroup transactions, and the effect on government subsidies in the cost base of the contract manufacturer, the Guidance and the OECD Guidelines should be followed.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

As in all transfer pricing studies, the key is the assessment of the parties through the analysis of functions, assets, and risks. Contract manufacturers usually perform relatively routine functions and, as a result, one would first have to make the assessment of whether the contract manufacturer can attract financing on its own or with the help of its principal.

When applying the cost-plus method, in both cases, one would expect the financing expense for funding obtained to finance manufacturing plants and the acquisition of raw materials to be part of the cost base on which a cost plus is applied.

As to foreign exchange risk, one would expect a contract manufacturer to obtain funding for plant and machinery to be in its local currency, or otherwise hedged to its local currency. Where borrowing in local currency leads to higher interest rates than borrowing in the currency that is most relevant for the principal, the principal would bear the higher costs through the inclusion of such funding costs in the cost base. If such funding is attracted with the assistance of the principal and such assistance comes in a

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[8] OECD Guidance, paragraph 1.152, p.78.

[9] OECD Guidance, paragraph 1.156, p.80.

[10] OECD Guidance, paragraph 1.154, p.79.

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currency other than the currency that the contract manufacturer is calculating its profits in, with the potential lower interest rates benefitting the principal through a lower cost base, the foreign exchange risk involved should be borne by the principal.

When it comes to the financing expense of raw materials, the currencies that apply to their purchase would be expected to match the currency of the price for the finished goods to be charged to the principal. Borrowings for such purchases expectedly are then also denominated in such currencies, so that currency exposure may be limited. If another currency is chosen, the question of who should bear the foreign exchange risk should depend on whether the choice for such other currency is on the initiative of the contract manufacturer or of the principal. In the latter case, the principal should bear the foreign exchange risk, but in the former case one would expect the contract manufacturer to bear the foreign exchange risk. In any case, allocation of such risk should follow a detailed functional analysis.

Contributors

Peter Moons is a Partner, Sophie Ogden is a Senior Associate, and Katerina Benioudaki is an Associate within Loyens & Loeff's tax practice group in Luxembourg.

They may be contacted at:

peter.moons@loyensloeff.com
sophie.ogden@loyensloeff.com
katerina.benioudaki@loyensloeff.com
www.loyensloeff.com

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Mexico

Moises Curiel Garcia and Armando Cabrera-Nolasco

LATPG Advisors

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Margins of return outside the arm's length principle

Contract manufacturing companies, called maquiladoras (manufacturing and maquiladora export industry (IMMEX)) in Mexico, are fundamental in terms of employment, investment, and exports. They represent one of the central economic activities for the country. This foreign trade program (IMMEX) allows the foreign resident's goods (Inventory and Fixed Assets) to be introduced into Mexico without paying tariffs for the import of said goods, provided, they enter Mexico temporarily, and with the obligation to return them abroad at the end of the authorized period. It also offers security to the foreigner that presence in Mexico will not trigger the creation of a permanent establishment in the country if it complies with the transfer pricing rules stipulated in the applicable Income Tax Law (LISR).

The history of the IMMEX regime dates back to 1964, when the Mexico-United States Braceros Program which allowed Mexican farmers to work temporarily in the agricultural fields of the United States, ended. The cancellation of the Braceros program caused unemployment among Mexican farmers who were repatriated to the country's northern border. To address this high level of unemployment, the border industrialization program was implemented, which basically consisted of the installation of maquiladora companies using national labor to carry out assembly and transformation processes of imported products; the first of them was established in 1966 in Ciudad Juárez, Chihuahua. The contract manufacturing scheme maintained constant development, taking root in Mexican territory. Specific transfer pricing rules have been established for them since 1995, subject to more recent adjustments to the extant rules.

Since December 2021, the LISR was modified to provide that IMMEX companies have to comply with transfer pricing regulations in order to prevent their principal from being treated as a permanent establishment- the safe harbor provision for contract manufacturers. The condition to be fulfilled in each case by an applicable entity is that there must be a return on the assets used in the maquila operation at 6.9% (own and from abroad), or on the total costs and expenses of the operation plus 6.5%, whichever is greater of both options.

This leads to a situation (in some cases) where the IMMEX obtains profit margins of 20% or more, which may trigger double taxation if the country of the principal objects to said return being calculated outside the base in the arm's length principle.

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Advance Transfer Pricing Agreements with complications

There was a significant number of IMMEX companies that requested Advance Price Agreements (APAs) from 2018 to 2022. In those cases, and in the relevant periods, the inventory of the IMMEX Companies exceeded 700 requests. Also, the number of APAs procured by IMMEX companies did not decrease between 2022 to 2024 due to the promotion of the IMMEX by the tax authorities. However, problems arose due to the delay in the issuance of the APAs, since there have been cases in which the resolution issued by the authority recently had a higher profit margin than that requested by the taxpayer in previous years, a situation which poses an additional payment on fiscal years already closed. This tax must be paid with the inclusion of the inflation update and the respective surcharges, which has generated litigation in the Mexican courts, very few cases, but real.

Solution to avoid disputes under these rules

In practice, some companies and their advisors are choosing to leave the IMMEX regime and settling for the assumption of permanent establishment. This way, they fall into the general LISR regime that allows them to determine their income and deductions considering the principle of full competence (i.e., the general transfer pricing rules), and avoiding the risks explained above.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers? In your response, consider the following:

a. Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;

Although toll manufacturers and contract manufacturers are remunerated under the same transfer pricing approach, i.e., the transactional net margin method (TNMM), there are important differences in the benchmarking approach between both types of manufacturing operations.

On one hand, toll manufacturers operate under the special tax regime known as maquila operation or maquiladora. The toll manufacturer's arm's length remuneration is determined based on a formula pre-established in the Mexican tax provisions ("Safe Harbor or SH") or, where applicable, in an APA program methodology agreed on between the Mexican and U.S. tax authorities.

In both cases, SH or APAs, the remuneration formula takes into consideration a percentage of profit over the toll manufacturer's costs (ROTC) and another percentage of profit over the total operating assets (ROA) used in the maquila services in Mexico, including the assets owned by the principal entity resident abroad. These percentages of profit are fixed and remain unchanged over the years. Therefore, taxpayers are not required to conduct a particular benchmarking study to determine the arm's length remuneration of toll manufacturing services.

On the other hand, contract manufacturers operate under the general transfer pricing regime. These companies must conduct an annual benchmarking study to determine the arm's length compensation of contract manufacturing services. In general, the method applied is the TNMM, using as a profit indicator (PLI), the ROTC or ROA, rarely or never a combination of both financial parameters. And the percentage of profit applied is the one that results from the benchmarking study.

b. Adjustment for a contract manufacturer with capital intensive operations;

The remuneration formula for contract manufacturers with capital-intensive operations may include an economic adjustment that recognizes the higher level of investment and risk associated with the possession and use of capital assets.

The adjustment usually considers additional compensation for the capital-intensive contract manufacturers, based on the difference between the operating asset levels of contract manufacturers and comparable companies. The greater the difference, the greater the proposed additional adjustment or compensation could usually be.

In the case of Latin American countries, however, caution should be taken with the use (or abuse) of this type of adjustment, as it has been observed that the asset intensity levels of contract manufacturers are usually higher than the levels of comparable companies, due mainly to issues associated with (sub)utilization of capacity, (smaller) geographic market size or operational deficiencies or unproductive use of operative assets.

In the case of toll manufacturers, the APA program takes into consideration an additional adjustment or economic compensation for companies with capital-intensive operations. The magic ratio is 2.08 assets to cost. Any toll manufacturer at equal or above this ratio is classified as a capital-intensive company. In this way, toll manufacturers with capital-intensive operations will receive economic compensation higher than labor-intensive ones.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

Under the Mexican tax provisions, taxpayers may make transfer pricing adjustments to eliminate material differences with respect to comparable transactions, including adjustments for capacity utilization.

However, these types of adjustments are more commonly used in APA negotiations or in the resolution of transfer pricing disputes through local or international friendly mechanisms.

In practice, contract manufacturers are perceived as an operating model with limited risk and compensation, so it is not common to see adjustments to transfer pricing results for capacity utilization.

In the case of toll manufacturers, the tax provisions do provide for transfer pricing adjustments for capacity utilization. For example, under the SH option, toll manufacturers or maquiladoras will be able to consider the value of operating assets "in the proportion in which they are used." That is, the amount or proportion of assets that are not used in the maquila operation may be deducted from the operating base to calculate the portion of profit over the assets. Further, under the APA program, the remuneration formula also considers the possibility of reducing the operating asset base by up to 10% of the book value of machinery and equipment used in the maquila services in Mexico, due to issues like (sub)utilization of capacity.

d. Any other considerations.

It is important to remember that the maquila APA program was eliminated in 2021. As of 2022, toll manufacturers can only apply for the SH option, or they will have to leave the tax maquila regime, restructure their operations as contract or regular manufacturers, and adopt the general transfer pricing rules described above.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

Companies operating under the IMMEX program in Mexico have access to various benefits and tax incentives but are not generally granted a direct subsidy. However, they do enjoy certain tax and operational advantages that function as indirect incentives to facilitate the competitiveness of companies that export, among which are:

i. **Exemption from VAT and IEPS on temporary imports:** IMMEX companies can import inputs, raw materials, parts, and components without paying the Value Added Tax (VAT) and the Special Tax on Production and Services (IEPS), as long as the goods are exported within a certain period after being processed or assembled.

This benefit is key for maquiladoras, since it considerably reduces their costs by not having to pay these taxes on the import of goods that are used in their production for export. Manufacturing companies outside the regime would have to finance the time in which they recover import taxes, which makes the operation more expensive and therefore affects competitiveness.

ii. **Quick VAT refund:** For IMMEX companies, they obtain a refund on balances in favor of VAT more efficiently and even more so if said companies are certified. These companies can request quick VAT refunds on export operations, which favors their cash flow, ultimately benefiting the principal by having to spend less on daily operations.

iii. **Exemptions in tariffs and compensatory quotas:** IMMEX companies do not pay tariffs on goods they temporarily import for manufacturing or processing, as long as said products are subsequently exported.

iv. **Administrative facilities:** The IMMEX program provides administrative efficiencies in complying with customs regulations, reducing procedures and allowing companies to operate more efficiently.

v. **VAT-IEPS Certification:** Companies that are certified under this scheme can obtain additional benefits, such as the ease of not having to pay VAT and IEPS when temporarily importing inputs, in addition to enjoying simpler customs procedures.

Although these are not direct subsidies in the sense of money transfers, they function as tax incentives that reduce operating costs and improve cash flow, which significantly benefits companies participating in the IMMEX program and their principals when operating in Mexico, However, currently some of these advantages have become more difficult to apply due to bureaucratic issues.

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4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

In general, toll manufacturers are perceived as a risk-limited operating model. In this sense, the general understanding is that toll manufacturers' financial structure should be free of financial expenses and exchange risks. These risks are generally borne by the principal entity. Any capital expenditure required by the toll manufacturer, such as the construction or expansion of a manufacturing plant or the purchase of industrial machinery and equipment, must be financed by the principal with debt or equity, or a combination of both. Ultimately, any finance expense or exchange risk reported by the toll manufacturer is neutralized or reimbursed by the principal through the maquila remuneration formula under both the SF and APA programs. Therefore, toll manufacturers do not assume financing and exchange risks in practice.

On the other hand, contract manufacturers can assume or tolerate a certain level of financing and exchange risk. Depending on the circumstances, a contract manufacturer may temporarily resort to borrowing and assume financing obligations, such as a loan, mainly because they own the operating assets. However, the financing expenses and the foreign exchange loss derived from the debt must be appropriately justified; for example, the financing must have a commercial purpose; the contract manufacturer must have the financial capacity to assume the debt (creditworthiness); and the terms and conditions of the contracting of the debt, including the amount of the principal, the term, and the interest, must reflect arm's length conditions, among other considerations.

Contributors

Moises Curiel and Armando Cabrera-Nolasco are founding partners at LATPG Advisors who specialize in transfer pricing within Mexico and Latin America.

They may be contacted at:

moises.curiel@latpgadvisors.com
armando.cabrera@latpgadvisors.com
https://latpgadvisors.com/

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The Netherlands

Bo Wingerter, Kawish Kanhai, Jochem van Boom, and Ravenna Tomaz

Ernst & Young Netherlands

Note from the Authors

Before diving into the questions, it is important to note that we refer to the Dutch Decree dated June 14, 2022, or also commonly and hereinafter referred to as the "Dutch Transfer Pricing Decree." This decree outlines the viewpoints of the Dutch State Secretary of Finance and therefore the Dutch Ministry of Finance/Dutch tax authorities. While these viewpoints legally bind the Dutch tax authorities, it is important to note that these do not formally bind taxpayers. As such, the latter are not obligated to follow these viewpoints in practice.

In addition to the Dutch Transfer Pricing Decree, we refer throughout our answers to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, issued by the Organisation for Economic Co-operation and Development on January 7, 2022, or the "OECD TP Guidelines."

It is for completeness purposes noted all views expressed here are those of the authors and do not necessarily represent the views of EY globally or any of its member firms. The views outlined are of generic nature and do not constitute tax or transfer pricing advice in any way shape or form.

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

First of all, it is important to note that there is no legal definition of a "contract manufacturer." It is a label that is used in business (and by transfer pricing practitioners) for a party performing certain manufacturing activities under the guidance and oversight of a principal company. In this regard and in line with the OECD TP Guidelines, the Dutch Transfer Pricing Decree emphasizes that contract manufacturing services should be directed by the principal company, whereby the latter should also (ultimately) bear the related costs and risks of the contract manufacturing activities. The principal should in this respect perform risk control functions and have sufficient financial capacity to bear the related risks.

In determining who directs and controls the contract manufacturing activities and related risks, the Dutch Transfer Pricing Decree highlights, among others, the following:

- Decision-making and related capabilities/authority (e.g., making go/no-go decisions vis-à-vis manufactured samples);
- Planning (e.g., in relation to timing, product quantities);
- Budgeting (e.g., approving budgets/forecasts created by the contract manufacturer);
- Performance measurement/key performance indicator-setting;
- Remuneration (e.g., defining remuneration schedule and incentives); and
- Adjusting/redefining scope of work.

Under a contract manufacturing setup, the abovementioned activities are expected to be performed/controlled by the principal company as they ringfence the terms, scope, and expectations of the end-to-end manufacturing process. In addition to providing the framework in which the contract manufacturer operates, the principal company typically provides the contract manufacturer with the relevant technical specifications of the products to be manufactured, including technical drawings, dimensions, material specifications, and quality standards. As such, the principal company usually also grants the contract manufacturer a license of intellectual property to be used in the manufacturing process (e.g., patents, trademarks, copyrights). Procurement also plays an important role in the characterization of an entity as contract manufacturer. Procurement and related ownership of raw materials is one of the core factors distinguishing toll manufacturers from contract manufacturers.

Today's multinational enterprises are often characterized by highly complex and integrated supply and value chains in which contributions to business processes do not always consider specific legal and geographic boundaries. In light of these considerations, a question we increasingly observe arising in practice pertains to the extent to which manufacturing activities of the respective contract manufacturer can and should be bifurcated from other functions being performed for purposes of establishing and testing an appropriate transfer pricing policy. A prudent example in this respect is any (contract) research & development activities being performed by the contract manufacturer prior to commencing the manufacturing activities (e.g., in a so-called Contract Development and Manufacturing Organisation (CDMO) setup within the pharmaceutical industry). We especially see the aforementioned question arising in situations where one of the functions is transferred across the border whereas the other remains to be performed in the Netherlands.

As outlined above, the Dutch Transfer Pricing Decree stresses that the principal company should bear the related costs and risks of the contract manufacturing activities. In addition, the principal company should perform risk control functions and have sufficient financial capacity to assume the related risks. The Netherlands in this respect follows the six-step risk control framework as stipulated by the OECD TP Guidelines.[11] Important risks related to contract manufacturing, deemed to be assumed and controlled by the principal company, include among others, market risk, purchase price risk, and product liability &

[11] OECD TP Guidelines (2022), par. 1.56 – 1.126.

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warranty risk. [12,13,14] The importance of risk control in the context of contract manufacturing has recently also been emphasized in Dutch case law.

Safeguarding transfer pricing positions

As with any transfer pricing analysis, the contractual arrangement forms the starting point of an analysis pertaining to contract manufacturing. As such, MNEs can safeguard their contract manufacturing setup by clearly defining and allocating roles, responsibilities, and risks in their contractual arrangement. The contractual arrangement should ringfence the operations of the contract manufacturer as outlined above and provide governance vis-à-vis these operations (e.g., outlining which and when a party makes a go/no-go decision). Further to the contractual arrangement appointing the manufacturer as contract manufacturer, other (legal) documents related to the contract manufacturing operations may safeguard the contract manufacturing setup in an intercompany context. For example:

- Standard operating procedures outlining the principal's instructions for the manufacturing process (e.g., assembly, testing, packaging) to ensure consistency and compliance with the principal's requirements.
- Intellectual property agreement specifying the handling of intellectual property used in the manufacturing process.
- Purchase orders issued by the principal to authorize the manufacturing of specific quantities of products at agreed-upon prices and delivery dates.
- Inspection and test reports documenting the results of inspections and tests conducted by the contract manufacturer to verify that the products meet the required specifications, such as certificates of compliance.
- Change orders outlining modifications to the original contract (e.g., vis-à-vis design, materials, quantities).
- Shipping and logistics documents outlining the incoterms under which the products are delivered to the principal.
- Performance reports documenting production progress, quality controls, and other metrics to help the principal monitor the contract manufacturer's adherence to the agreement.

An example of the above documents in the pharmaceutical industry includes a so-called "quality technical agreement" which outlines the responsibilities vis-à-vis Good Manufacturing Practices of each party to the transaction.

Dutch case law, practice, and the Dutch tax authorities apply a so-called "substance over form" principle, encompassing that the economic reality of transactions and business activities take precedence over their legal form when assessing any tax implications. Accordingly, the contractual

[12] Market risk includes risks associated with adverse sales conditions due to either increased competition in the marketplace, adverse demand conditions within the market, or the inability to develop markets or position products and services to target customers.

[13] Product liability/warranty risks arise when a company's product fail to perform at accepted or advertised standards or fails to respect its intended use.

[14] Purchase price risk materializes when the cost of raw materials increase, thereby increasing the overall manufacturing costs.

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elements of the transaction may be disregarded if the actual conduct of the parties does not correspond thereto. In light thereof, taxpayers should operate in line with their contractual arrangements. The actual conduct of parties can be validated through amongst others, transfer pricing documentation which is a vital means of safeguarding the transfer pricing positions taken in relation to the contracting manufacturing setup. Recent Dutch case law has shown that high quality transfer pricing documentation, including detailed functional and economic analyses, is considered a must in sufficiently substantiating the positions taken in the corporate income tax return. The information embedded in the transfer pricing documentation should align with other information to the public (including the tax authorities), such as financial reports, press releases, job advertisements, LinkedIn profiles, interviews with the company's executives and employees, and internal business records (e.g., business presentation, e-mail correspondence, authorization matrices). In light of the above, taxpayers should be vigilant of the content of their transfer pricing documentation and other (publicly available) information in order to safeguard their transfer pricing positions.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

Selection of transfer pricing method

The Dutch Corporate Income Tax Act (in Dutch: Wet op de vennootschapsbelasting 1969) does not prescribe any type of economic analyses and/or benchmarking studies to be applied when determining an arm's length remuneration for contract manufacturing activities. As such, taxpayers may apply any transfer pricing method as long as the outcome of the applied methodology provides an at arm's length result in line with article 8b of the Dutch Corporate Income Tax Act. The liberty for taxpayers to elect any transfer pricing method for purposes of pricing and testing their intercompany transactions (including contract manufacturing services) has also been acknowledged in the Dutch Transfer Pricing Decree.

Further, the Dutch Transfer Pricing Decree emphasizes that some transfer pricing methods may be more suitable than others, depending on the facts and circumstances of the intercompany transaction under review. Generally, the Comparable Uncontrolled Price ("CUP") method is considered difficult to apply in practice (including for purposes of pricing contract manufacturing services) due to the limited availability of comparable third-party transactions. As such, the Transactional Net Margin Method ("TNMM") is often applied in practice, considering it relies less on transactional comparability than the CUP method – resulting in more comparable publicly available data that can be used for benchmarking purposes.

Application of the Transactional Net Margin Method

In line with the guidance issued in the Dutch Transfer Pricing Decree, the TNMM is typically utilized in practice to price and test intercompany contract manufacturing services. In applying the TNMM, the

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tested party is the least complex entity in the intercompany transaction (i.e., the entity performing the relatively less complex functions). This approach ensures the most reliable application of the TNMM and easier identification of comparable companies. By virtue of contract manufacturing activities, the least complex entity/tested party is typically the contract manufacturing service provider relative to the principal company. When testing the results of the contract manufacturing service provider, total costs are usually applied as profit level indicator (see below for more information regarding the cost base). The Dutch TP decree in this respect explicitly stipulates that a cost-based remuneration could be at arm's length for purposes of contract manufacturing services.

Cost basis

The Dutch Transfer Pricing Decree acknowledges that intercompany prices for contract manufacturing purposes will typically be set prospectively using budgeted costs. A transfer pricing adjustment may be warranted, depending on the reason for the differences in incurred and budgeted costs. In general, the Dutch Transfer Pricing Decree outlines that costs exceeding the budgeted costs resulting from inefficiencies in the manufacturing process should be borne by the contract manufacturer, as an independent principal company would not agree to absorb these costs.

In determining the cost base, it is important to establish the costs related to the contract manufacturing activities. Other unrelated costs should be bifurcated and not reimbursed by the principal company (e.g., shareholder costs and costs related to other unrelated functions such as contract R&D). Similarly, the contract manufacturer is not entitled to a mark-up on third-party costs without adding further value (i.e., pass-through costs).

Working capital adjustments for toll manufacturers

As acknowledged by the OECD TP Guidelines and as followed in Dutch transfer pricing practice, differences between the ways associated enterprises and independent enterprises carry on their business – including working capital levels and asset intensities – may necessitate an adjustment to the accepted comparables' profit level indicators. The purpose of such adjustments is to ensure that the analysis reflects operating results by accounting for any implicit interest contained in the sales revenue, cost of goods sold, or operating expenses of toll manufacturers and the accepted comparable contract manufacturers.

Given the functionality of the toll manufacturers, inventory adjustments are performed to account for potentially material differences between contract manufacturers and toll manufacturers. Inventory is a key element that affects asset intensity and, consequently, profitability. As toll manufacturers typically do not hold inventory and are difficult to find in the public domain, inventory adjustments are made to benchmarking studies that test contract manufacturing activities.

Inventory adjustments

Economic theory suggests that there are opportunity costs associated with holding an asset such as inventory. The effect of holding more or less inventory is multi-facted. In general, a company with higher average inventory levels bears greater risks associated with obsolescence or market price changes, greater operating risk resulting from higher working capital costs, and a greater trade-off associated with the decision to invest in inventory rather than some other asset. Thus, different inventory levels result in varying risk and cost profiles, the effects of which are reflected in a company's balance sheet and operating costs. Further, it could be argued that higher inventory levels offer customers more

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convenience through faster shipment, greater variety and so forth, and these conveniences may impact the sales price. However, on the other hand, sales price can very well be attributable to cost of goods, sold as the purchase price may be reduced by holding high levels of inventory. Thus, it is more conservative to attribute the opportunity cost of holding different levels of inventory to the cost of goods sold (being a component of total operating costs). Thus, an inventory adjustment is applied to costs of goods sold to ensure the risk and cost profiles of the comparable companies as they relate to inventory are consistent with that of the tested party.

To estimate this imputed value of holding different levels of inventory, the inventory intensity of toll manufacturers is compared with those of the accepted comparable contract manufacturers. This is measured as the ratio of inventory to sales. By applying the inventory to sales ratio of toll manufacturers to those of accepted comparable contract manufacturers, one can calculate an adjusted inventory for the accepted comparable company that reflects the tested party's inventory intensity.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

The Dutch State Secretary of Finance has explicitly stated in the Dutch Transfer Pricing Decree that, when applying the arm's length principle, it must be assessed whether the identified comparable independent enterprises equally receive government subsidies or grants and take this contribution into account in their terms and conditions, including the prices in their transactions. If subsidies or grants received (or expected to be received) play a role in the terms and conditions of the transaction between independent parties, this should equally apply to the terms and conditions of transactions between associated enterprises. The transaction should be comparable to what independent entities would have agreed upon under similar circumstances. For transactions with associate parties, the grant/subsidy can therefore also be a reason to adjust the conditions (including the price), taking into account the grant/measure that one or more parties may receive.

Subsidies or grants that effectively reduce the cost base of the contract manufacturer could lead to a lower (absolute) cost-plus mark-up. If the aid is considered non-operating or an extraordinary item (i.e., unrelated to the contract manufacturing operations), it may need to be excluded from the cost base for transfer pricing purposes to ensure that the net cost-plus mark-up is applied on an appropriate base (as outlined in response to the previous question).

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Contract manufacturers are expected to have little financing expenses by virtue of their cost-plus remuneration mechanism, which provides a steady positive cash flow. As such, significant financing expenses could indicate that the respective manufacturer has a broader functional (risk) profile than that of a mere contract manufacturer. From a benchmarking perspective, financing expenses are not considered when pricing or testing intercompany contract manufacturing services, as there is little insight into the financing expenses of comparable companies used in benchmarking studies. Accordingly, the arm's length remuneration of contract manufacturers is typically set at an Earnings Before Interest and Taxes ("EBIT") level.

As contract manufacturers typically do not have significant financing expenses, they equally do not have significant foreign exchange results. Besides foreign exchange results pertaining to financing expenses, contract manufacturers typically also do not absorb significant foreign exchange results stemming from other transactions (e.g., outsourcing certain processes within the contract manufacturing process), as they do not have the functional capabilities to manage the foreign exchange risks. Accordingly, the principal is deemed to absorb the foreign exchange results. Significant foreign exchange results could indicate that the respective manufacturer has a broader functional (risk) profile than that of a mere contract manufacturer.

In light of the above, the Dutch tax authorities typically expect that many non-operating items, such as interest expenses and/or foreign exchange results, of contract manufacturers are either immaterial or (re)allocated to the principal company, given the risk control capabilities within the group in relation to these items. We have also observed in certain circumstances that in the absence of (re)allocation of those items to the principal, an alternative approach is a gross-up of the non-operating items to the EBIT of the contract manufacturer, in order to align the financial profile of the contract manufacturer with that of the comparables used in benchmarking.

Contributors

Bo Wingerter is a Partner, Kawish Kanhai is a senior manager, Jochem van Boom is a senior consultant, and Ravenna Tomaz is a consultant at Ernst & Young Netherlands.

They may be contacted at:

bo.wingerter@nl.ey.com
kawish.kanhai@nl.ey.com
jochem.van.boom@nl.ey.com
ravenna.tomaz@nl.ey.com
https://www.ey.com/en_nl

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Portugal

Patrícia Matos and Marta Fidalgo

Deloitte Portugal

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

In Portugal, the tax authorities are particularly vigilant about contract manufacturing operations due to the potential for profit shifting and tax avoidance. In recent years, contract manufacturing arrangements are no longer a single definition operation and have become an undefined conceptual framework that is evolving, leading to a more curious and intrusive Tax Authority.

A new trend is emerging where the traditional contract manufacturing models are being adapted and modeled into the intragroup context. With this evolution, there is a growing appetite from the Portuguese Tax Authority ("PTA") to inquire on different structures that redefine the classic contract manufacturing operations. In this sense, stepping out of the traditional approach could raise red flags.

When it comes to litigation issues, one common problem is the PTA's challenge to the comparability of selected companies. In the context of Portuguese legislation, it is crucial to detail those differences in comparability factors and explain such, through appropriate adjustments. This is particularly important when dealing with a contract manufacturing model where its functionally is distinct from the best comparable models identified and Profit Level Indicators (PLI) analyzed.

The PTA may argue that the taxpayer's comparables are not appropriate, leading to adjustments to the arm's length range and consequently to the operating result registered by the taxpayer. From our experience, the PTA will react in one of two ways or both: either dismiss the study all together and provide a new study or make some adjustments. Where the taxpayer's PLI falls outside the range, an adjustment to median is proposed (as foreseen in the Portuguese law), which can be quite substantial.

Moreover, we have seen more recently capacity issues in some Portuguese companies. In this sense, if being a contract manufacturer is a sufficient reason for not operating at maximum capacity (by looking for third-party clients in the event that the group does not place orders that use all the available capacity), then the group should compensate to maintain full capacity. In this sense, if compensating production and remuneration levels is necessary, it should be shown to the PTA that the benchmark results falling short is not related to the group's lack of activity but due to specific business circumstances.

Similarly, we are experiencing tax authorities not only focusing on the transfer pricing documentation but typically scrutinizing the group's accounts, examining accruals, redundant costs or activities, cash flow, recurring financial needs, and working capital. The tax authorities may exclude and recalculate new adjustments based on these indicators. In this sense, companies are developing a more defensive approach and maintaining up-to-date analytical data that demonstrate the costs and revenues inherent to each function and the risks involved.

Furthermore, there is also notable concern from the PTA regarding reorganizations, for example situations where a group closes a factory and opens a new one, and possible discussions of compensation. It seems important to demonstrate that the parent company retains the client portfolio and that sales are conducted under pre-existing agreements with the parent company. Should compensation be warranted for such closures, it should be directed to the parent company, which must be reimbursed for its contributions. This has led to interesting conversations about the possibilities of renumeration in these operations.

Consequently, the lack of technical precision in the Economic Analysis documentation is common since Portuguese documentation is treated merely as a compliance exercise. Ensuring robust documentation that accurately reflects the unique risks and functions of Portuguese subsidiaries is essential.

In this sense, MNEs can enter Advance Pricing Agreements (APAs) with the Portuguese tax authorities to gain certainty on transfer pricing methods and avoid future disputes. Advance Pricing Agreements can be a valuable tool for avoiding disputes. By entering into an APA, taxpayers can agree in advance with the PTA on the transfer pricing methodology to be applied to their transactions, providing certainty and reducing the risk of future disputes. The process of obtaining an APA involves detailed negotiations with the PTA. Taxpayers must provide comprehensive information and analysis to support their proposed transfer pricing methodology. The PTA reviews this information and may request additional details before reaching an agreement. Once an APA is agreed upon, it is binding on both the taxpayer and the PTA for the specified period, provided the terms and conditions of the agreement are met. This can provide significant benefits in terms of tax certainty and compliance.

The main benefits of an Advance Pricing Agreement include:

- Getting prior approval from the Portuguese Tax Authorities for the transfer pricing methodology.
- Avoiding tax audits for transactions covered by the APA, which reduces related costs and efforts, and eliminates potential transfer pricing adjustments.
- Eliminating late payment interest and penalties for potential transfer pricing adjustments.
- Preventing double taxation.

For instance, the automotive sector in Portugal hosts numerous subsidiaries of multinational groups. Many companies operate under the contract manufacturing model, and several have opted to enter into an Advance Pricing Agreement.

2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

The choice of transfer pricing method depends on the specific functions, risks, and assets involved in each type of arrangement. Given these characteristics, the Cost-Plus Method (CPM) and the Transactional Net Margin Method (TNMM) are often suitable. In the previous decade, the approach for contract manufacturers focused on gross margin. However, aligned with some changes in the legislation, nowadays most analyses are performed with the net profit margin.

In this regard, it is evident that a crucial aspect often overlooked in the process of comparing contractual manufacturing arrangements is the fact that such arrangements do not assume the risks inherent to a fully-fledged entity. Furthermore, the comparables available in public databases normally are full-risk entities. This represents a trend that has consistently been advocated by taxpayers. However, the PTA has advanced an operational analysis in opposition to the focus on the global profitability of the company. Furthermore, the PTA has previously declined to accept the TNMM as a comprehensive comparison method, on the grounds that the global margin does not accurately reflect the profitability of a single operation. Consequently, this trend favors the TNMM, which is not supported by the PTA but by taxpayers, given that many times the PTA considers it to be an inadequate reflection of this type of reality.

This results from the problem that exists at the outset – the lack of comparability. However, to decide what comparability adjustments should be made, it is necessary to understand the type of contract manufacturing in question.

In this sense, capacity is also an important factor, as higher utilization often leads to lower per-unit costs, which can impact transfer pricing. The challenge we all face in transfer pricing is to ensure that transfer prices reflect the actual economic value of the services provided and to be able to conduct benchmarking studies that fully analyze capacity utilization rates and their effect on pricing strategies.

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In light of the aforementioned considerations, it becomes evident that adjustments may prove to be a valuable asset. To illustrate, the model for the contract with the standard factory stipulates production in accordance with the factory's capacity. For example, if a contract stipulates that 90% of the risk is retained, leaving 10%, the consignee should guarantee for the purchase of up to a certain capacity, covering fixed costs, and accounting for potential negative results. The contract should stipulate the identity of the purchaser, the agreed-upon price, and the party responsible for any potential loss of profit. This is of critical importance for purposes of comparison. It is not merely a contract manufacturer; rather, it is a manufacturer compensated for the risks incurred. In the event that an agent is involved, it is essential to establish a benchmark for the agent in question. To illustrate, in the context of a study, if a contract manufacturer exhibits a 1% profitability rate, and the comparables selected registered a 10% profitability rate, it is imperative to consider entities that have been assigned similar functions and risks, and perform the necessary adjustment to eliminate additional functions and risks, differences in the capital structure, and in working capital ratios.

When conducting benchmarking exercises, it is frequently observed that taxpayers tend to overlook the importance of comparability in this straightforward process.

For certain types of contract manufacturers like ones with capital intensive operations, it is important to evaluate the need to adjust for higher/accelerated depreciation and debt-to-equity ratio. These adjustments often start with working capital but could also involve capacity, compensation, and the utilization/benefit of intangibles. Another example is for instance, the fact that a contract manufacturer normally would not be involved in Group R&D functions.

To that end, market conditions, such as inflation rates, labor costs, and economic growth, also play a significant role in the benchmarking process. Compliance with local and international transfer pricing regulations is crucial, as well as aligning with guidelines set by the OECD and the Portuguese tax authorities.

By focusing on more robust benchmarking studies and ensuring thorough defensive documentation, taxpayers in Portugal can better navigate the complexities of transfer pricing for contract manufacturing, minimize litigation risks, and potentially benefit from the certainty if they decide to negotiate an APA.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- **a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
- **b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
- **c. Other issues pertaining to government subsidies or grants.**

A type of grant that triggers transfer pricing considerations is the Tax Incentive System for Corporate R&D (SIFIDE). SIFIDE was approved in the 2011 State Budget Law - Law no. 55/2010 of 31 December, establishing the conditions, criteria, and requirements that companies must fulfil to qualify for the SIFIDE.

To qualify for the SIFIDE, the taxpayer should not be a contract or service provider without risk. In fact, the taxpayer cannot operate on a cost-plus basis and then seek this incentive. The coexistence of limited-risk models is both risky and challenging.

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When it comes to government subsidies or grants in contract manufacturing, one of the first considerations is whether to pass these subsidies on to the principal or keep them locally. If the local entity is the one doing the heavy lifting and incurring the costs, it might make more sense for it to keep the subsidy.

Moreover, when the results of the R&D activity succeed, a royalty should be allocated to the Portuguese subsidiary. In fact, in Portugal, to benefit from the SIFIDE, the taxpayer along with the R&D activities must either bear risk or be able to use (free of charge) the results of the R&D (normally intangibles). This may explain why above, we started by mentioning that in Portugal there is special attention from the PTA to contract manufacturing with non-traditional models.

In Portugal, Tax Incentives (SIFIDE) are reflected in profit or loss accounts in the tax provision. Consequently, the decision as to whether the incentive passes to the principal or is retained locally will impact how profits are allocated among related entities. It is essential to ensure that this allocation reflects the actual economic activities and risks taken on by each entity.

As mentioned above, one way to get some certainty is by entering into an APA with the PTA. We have worked on APAs where different taxpayers negotiate different approaches, namely the inclusion of the incentive in the transfer pricing policy (passing it on to the principal) and non-inclusion (being retained locally). In these circumstances, the PTA includes different specificities to be accomplished in each of those APAs.

In terms of new challenges, it is important to consider the impact of the OECD Pillar 2 rules. Considering the nature of this specific tax incentive (SIFIDE), it will impact the computation of the effective corporate income tax rate (ETR), being a possible issue for low-remuneration companies. Indeed, if the SIFIDE has a high weighting in the pre-tax result, for example if it is 50% of the pre-tax result, the corporate income tax (for example 21%) would fall significantly (if no other adjustments are applied, in this example the ETR would fall to 10.5%) and would be below the ETR established in the Pillar 2 rules (15%).

If this applies to a contract manufacturer, the company/Group could find a solution to accommodate the SIFIDE, namely through a review of the functions and risks, and the consequent review of the transfer pricing remuneration.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

The tax authorities are suspicious of traditional models that are built and molded for intragroup operations and have an appetite to investigate those models. To that end, the concept of having finance expenses is a trigger for the PTA, since in the PTA´s perspective there is an apparent misalignment between the nature of the entity (contract manufacturer) and this type of expense.

In theory, the intragroup receivables (cash inflows) should be in line with the market payments (cash outflows); therefore, the PTA does not understand why a contract manufacturer would assume a cash flow deficit that obligates the entity to enter into a loan contract.

For foreign exchange risks in transactions with contract manufacturers, the allocation depends on the contract terms and the economic substance of the transactions. Generally, the entity that can manage and control the foreign exchange risks should bear them.

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The intragroup agreement should clearly state who bears these risks, whether it is the buyer, the seller, or both. The entity with the financial capacity and ability to manage the risks should take them on.

If the risks in question are assumed by the contract manufacturer, the definition of the contract manufacturer's remuneration must consider the impact of such risks when considering the remuneration held by companies without such risks. On the other hand, in case those risks are not assumed by the contract manufacturer, the PTA does not expect any associated financing costs.

Contributors

Patrícia Matos is a Transfer Pricing Lead Partner, and Marta Fidalgo is a Transfer Pricing Senior Consultant at Deloitte Portugal.

They may be contacted at:

pamatos@deloitte.pt
marfidalgo@deloitte.pt
https://www.deloitte.com/pt/pt.html

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Spain

Marcos Perez Rodriguez, Gabriel Suarez, and Begoña Rodríguez González

Ernst & Young Abogados, Spain

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Contract manufacturing operations perceived as high risk by the Spanish Tax Authorities ("STA") include: (i) those engaged by MNEs following a conversion and (ii) those with operating income results below market references (the STA may look at peers in the industry for risk assessment and audit selection, while this "secret comparable companies" method is not then used for TP audit assessment purposes).

Regarding post-conversion contract manufacturers, the STA especially focuses on the following aspects:

- Strategic functions: relevant decision-making processes for strategic activities, such as long-term production planning and procurement;
- Inventory: materiality of stock related risks when exceeding contract manufacturer control capability;
- Research and development: local contract manufacturer involvement in R&D activities; and
- Intangible assets: DEMPE ownership of relevant intangible assets.

As such, post-conversion MNEs are recommended to gather the relevant information contemporaneously and prepare and maintain robust documentation. This documentation should explain business changes and support functional profiles (pre- and post-conversion) to be aligned with legal arrangements and parties' behavior, with thorough examination of functions performed and risks assumed. Documentation should also explain and support the timing for the conversion, its reasonableness, and issues faced during the restructuring (e.g., delays, system issues). MNEs should also monitor relevant companies' performance to ensure alignment with the transfer pricing policy set up upon the benchmarking analysis.

Common benchmarking issues (as discussed below) are also a focus for audit review, and Advance Pricing Agreements ("APAs") are highly recommended as the best risk mitigation strategy. With the STA is currently promoting APAs, these are becoming increasingly popular, and help taxpayers avoid long audit processes that usually end in both internal claims and Mutual Agreement Procedures ("MAPs").

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

Contract manufacturing operations are commonly assessed on the basis of the Transactional Net Margin Method ("TNMM"), which is the most appropriate transfer pricing method to assess an arm's length remuneration. The TNMM is applied through a comparison of the profitability of the tested party against third-party comparable companies, usually the mark-up on total costs ("MTC"), although other profit level indicators ("PLIs") such as a return on assets ("ROA") may be preferred when procurement costs are also influenced by intercompany transactions.

Working capital adjustments are particularly relevant to assess comparability when applying the TNMM for contract manufacturing operations in order to factor into the transfer pricing analysis differences that may be observed between the tested party and the third-party comparable companies. When contract manufacturers assume inventory functions, similar functional and risk profiles are less typical in the market, or are not as easy to find in databases. Therefore, specific screening criteria should be relied on for search strategy purposes in addition to comparability adjustments applied later.

However, the STA is raising comparability common issues to support that an adjustment to the median value of the benchmarked range must apply whenever the contract manufacturer (assessed) profit is found to deviate from benchmarked interquartile results.

On the other hand, capacity utilization adjustments are less common in practice due to the limited exposure to capacity utilization risks by contract manufacturers.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

The ultimate beneficiary of the subsidy or grant should be assessed on a case-by-case basis to determine the group company entitled to that subsidy or grant. Facts to consider for the transfer pricing analysis include: (i) the team(s) involved and responsible for the application for the subsidy or grant; (ii) the specific nature and purpose of the subsidy or grant, e.g., whether it is fostering environmental, social, and governance ("ESG") objectives or reducing financing costs; and (iii) the impact the subsidy or grant may have on the industry and the benchmarking results.

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For instance, whenever the subsidy is aimed at reducing financing costs and the business principal entity is assuming financing costs, the STA is more likely to treat the principal entity as the appropriate owner. Passthroughs of subsidies or grants that are aimed at reducing costs and improving low margin levels in the industry are more likely to be challenged by the STA.

On the other hand, if third-party comparable companies considered for benchmarking purposes are expected to benefit from similar subsidies or grants, the transfer pricing policy assessed through that benchmarking analysis may already be factoring that in and, as such, a net cost-plus approach may be considered more appropriate.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

The general accepted view is that the manufacturing principal should bear foreign exchange risks along with market risks, especially when these are found to be material to the intercompany transaction. Again, the contract manufacturer's risk control capabilities will be reviewed and assessed otherwise. This is seen to be in line with the more limited risk profile commonly expected for contract manufacturers for which the principal entity takes care of procurement strategies. The higher the risks assumed by the contract manufacturer, the more likely the STA will consider intercompany pricing to be low.

Contributors

Marcos Perez Rodriguez is a Partner, Gabriel Suarez is a Senior Manager, and Begoña Rodríguez González is a Junior at Ernst & Young Abogados in Spain.

They may be contacted at:

Marcos.PerezRodriguez@es.ey.com
Gabriel.Suarez@es.ey.com
Begona.Rodriguez.Gonzalez@es.ey.com
www.ey.com/es_es

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Turkey

Akif Tunc
EY, Turkey

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

Even though the Turkish Revenue Administration (the "Tax Authority") is familiar with the concept of a residual or target profit mechanism, or any similar payment made by a Turkish entity that directly reduces the profit margin to a predetermined rate, the tax inspector may question similar payments during a tax audit, especially if they are designed as a transfer pricing adjustment.

In other words, although the Turkish transfer pricing legislation generally follows the OECD principles, Turkish tax inspectors have not yet fully comprehended and accepted the global transfer pricing approaches and applications that may justify the profit target mechanism. During tax audits, tax inspectors tend to look at each invoice or transaction and try to analyze the deductibility of that particular payment separately from a corporate tax perspective.

In terms of contract manufacturing, there are some instances in which the contract manufacturer operating in Turkey may end up with a significant profit margin, especially in cases where the manufacturer's goods are sold directly to Turkish customers. In those scenarios the "excess/residual profit" (the profit margin above the targeted profit margin) of the Turkish contract manufacturer flows to the Principal (which can be characterized as entrepreneur), with a transfer pricing adjustment or a royalty mechanism.

Those structures are risky because the Tax Authority may criticize the payment of a transfer pricing adjustment or a similar royalty/service charge fee when that payment reduces the profit margin of the Turkish contract manufacturer to a predetermined target rate.

In such cases, as mentioned above, the tax inspectors may characterize the residual profit payment as a royalty and claim withholding tax and other indirect taxes. In the alternative, tax inspectors may characterize the residual profit payment as profit distribution through transfer pricing and criticize the deductibility from a corporate tax perspective.

To mitigate the risk of criticism, the raw materials or semi-finished goods purchased by the Turkish contract manufacturer from the Group can be priced so as not to leave a significant residual profit at the contract manufacturer level.

Additionally, in case of a residual profit payment, that payment (or invoice received from the entrepreneur) should be linked to the goods purchased or sold throughout the year to decrease the risk of criticism.

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

The Turkish Revenue Administration has not explicitly accepted or rejected benchmarking studies carried out with pan-European databases, and the transfer pricing legislation is silent on this issue. However, in the event of a tax audit, the tax inspectors tend to disregard the documentation (and thus the benchmarks identified by the taxpayer), and they may use some secret comparables. It should be noted that the use of secret comparables by the tax inspectors is losing popularity, as most of the time the taxpayers win the court cases when the Tax Authority uses a secret comparable.

Further, there is no clear definition of a contract manufacturer in Turkish transfer pricing legislation. In a more general sense, the notion of "entity characterization" is not yet very sophisticated. Therefore, in the event of a tax audit, the tax inspectors may utilize data from comparable companies that carry out manufacturing activities but cannot be regarded as contract manufacturers.

Accordingly, to mitigate that risk, there should be a clear definition of the Turkish contract manufacturer's functions and risks, and the operational profile of the entity as a contract manufacturer should be justified with solid transfer pricing documentation.

It should also be noted that the benchmarking studies that include Turkish companies have greater reliability in the eyes of Turkish tax inspectors.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

a. **Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
b. **The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
c. **Other issues pertaining to government subsidies or grants.**

The main government subsidies or grants for a contract manufacturing entity operating in Turkey are:

- Reduced corporate tax rate
- Social security premium support
- VAT exemption for imported machinery
- Customs duty exemption

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In case a net cost plus is being applied, the effects of the subsidy on the cost base can be realized. However, passing the subsidies/grants directly to the principal would be risky from a tax perspective.

In Turkey all related party transactions should be carried out with an invoice and during tax audits the inspectors tend to question invoices received from other Group companies. To pass the subsidies/grants to the principal, the Turkish entity should receive an invoice from the principal and in case that invoice coming from the principal is detected in a tax audit, the deductibility of that invoice can be criticized with the claim that the subsidy/grant was obtained by the Turkish entity and should be regarded as an income of the Turkish entity.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

Despite there being no specific provision in Turkey's legislation regarding which party should bear the foreign exchange risks, it is common practice that the Turkish contract manufacturers incur the foreign exchange risks. However, per legislation, financial expenses including foreign exchange losses are not associated with the cost of production.

Contributor

Akif Tunc is a Partner at EY Turkey.

He may be contacted at:

akif.tunc@tr.ey.com
www.ey.com/en_tr

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United States

Steven Wrappe

Grant Thornton LLP

1. What kind of contract manufacturing operations do the tax authorities in your jurisdiction perceive as high risk, and how can MNEs safeguard their transfer pricing positions to mitigate such risks?

The United States ("U.S.") does not have a defined position with regard to transfer pricing for contract manufacturing transactions. As a relatively high-cost manufacturing location, few industries find the U.S. a favorable location for contract manufacturing, with the notable exception of the manufacturing and assembly of parts and components for inclusion in finished big-ticket items, like automobiles, for consumption in the U.S. However, many U.S.-based MNEs have contract manufacturing performed by affiliates in lower-cost countries.

Much of the concentrated experience of the Internal Revenue Service ("IRS") with contract manufacturing in other countries involves the Mexican "maquiladora" industry, which performs mostly toll manufacturing in Mexico for U.S. and other-country affiliates of goods generally intended for U.S. consumption. Over 3,000 maquilas serving many industries are located near the U.S.-Mexico border.

The main opportunity for MNEs to safeguard their transfer pricing positions with regard to maquila operations in Mexico is the Mexican safe harbor regime or a "Qualified Maquila Approach Agreement" ("QMA"). The recently renewed QMA procedure allows a U.S. taxpayer to avoid double taxation on the contract manufacturing and assembly functions performed by its maquiladora if the Mexican taxpayer enters into a unilateral advance pricing agreement (APA) with the Large Taxpayer Division of the Servicio de Administracion Tributeria ("SAT") under terms negotiated in advance between the U.S. and Mexico competent authorities. Bilateral APAs are available but relatively expensive for the issue.

The main concern of the IRS with regard to contract manufacturing in other countries in the supply chains of U.S.-based MNEs is that taxpayers might exaggerate the risks or intangibles attributed to the contract manufacturer to justify a return to that manufacturer in excess of a functional return. In recent U.S. Tax Court cases, the IRS has asserted a Comparable Profits Method ("CPM")/Transactional Net Margin Method ("TNMM") in circumstances where the taxpayer's position would allocate profit in excess of a CPM/TNMM return to the contract manufacturer due to alleged risks or intangibles of that contract manufacturer.

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2. In your jurisdiction, what types of benchmarking studies (economic analyses) are accepted or typically applied when remunerating contract manufacturers?

In your response, consider the following:

a. **Differences in the approach to benchmarking for contract manufacturers versus toll manufacturers;**
b. **Adjustment for a contract manufacturer with capital intensive operations;**
c. **Capacity utilization for the contract manufacturer and implications for transfer pricing;**
d. **Any other considerations.**

In the U.S., the benchmarking studies differ for contract manufacturing versus toll manufacturing, due to greater breadth of function and opportunity for risk in contract manufacturing. Contract manufacturing, which includes sourcing of components and raw materials, is usually evaluated under a Cost-Plus Method or a CPM/TNMM with a markup on total cost ("ROTC") profit level indicator, depending on the quality of comparables information. Toll manufacturing, where the components and raw materials are provided to the manufacturer by a related party, is usually evaluated under a CPM/TNMM with a return on assets profit level indicator or a CPM/TNMM using a ROTC profit level indicator. The choice of profit level indicator is dependent on the asset intensity and availability of similarly situated comparables.

It is worth noting that any benchmarking with capital intensive operations is sensitive to differences in age of property, plant, and equipment. For example, a new tested party-owned plant would bear substantial depreciation costs, while comparables with decades-old, fully depreciated plants would not. Some adjustment would be needed to increase comparability of results.

Issues regarding which party bears the risk of under-utilization can be particularly difficult to resolve. The U.S. rules are quite flexible regarding assignment of risk:

Identification of taxpayer that bears risk.

In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the provisions of § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms). Thus, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance. In considering the economic substance of the transaction, the following facts are relevant:

(1) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

(2) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(3) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

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Based on this broad language, it appears that MNEs could assign the risk of under-utilization to the contract manufacturer. However, in the circumstance where the ultimate parent of the MNE directed a captive contract manufacturer regarding plant size and the expected allocation of manufacturing volume, the parent company may be held responsible for under-utilization issues.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider the following:

- **a. Considerations involved in the decision to pass on the subsidies/grants to the principal or having them retained locally;**
- **b. The effect of the subsidy on the cost base of the contract manufacturer on which a net cost plus is being applied;**
- **c. Other issues pertaining to government subsidies or grants.**

The main transfer pricing issue for subsidies/grants in the context of contract manufacturing is whether subsidies/grants should be deducted from the cost base, in which case the benefit of the subsidy would be shared with related parties through a reduced transfer price. Although a number of countries have put forth specific guidance regarding the transfer pricing treatment for government subsidies/grants, the U.S. has not done this.

4. What are the transfer pricing considerations for financing expenses as they relate to transactions involving contract manufacturers and who should bear the foreign exchange risks in these transactions? Please explain your reasoning.

The U.S. generally treats financing expenses as outside of the transfer pricing determinations which focus on operational results; however, foreign exchange risk in transactions can impact net operating income.

As mentioned above, the taxpayer's allocation of risks will generally be respected if that allocation is consistent with the economic substance of the transaction. Since neither the manufacturer nor the distributor in a related party transaction can control the currency fluctuation, the treatment would be influenced mostly by the ability of the parties to bear that risk and the historical behavior of the parties consistent with that risk. It is worth mentioning that a toll arrangement with limited risk and function might be inconsistent with the manufacturer bearing the currency fluctuation risk.

Contributor

Steven Wrappe is the National Technical Leader of Transfer Pricing in Grant Thornton LLP's Washington, DC National Tax Office.

He may be contacted at:

steven.wrappe@us.gt.com
grantthornton.com

Editorial Board and Country Panelists

Editorial Board Members

Yves de Groote

Editorial Board Member and Panelist for Belgium
Partner, Global Transfer Pricing Services, KPMG, Antwerp

Yves de Groote has an LL.M from King's College London, MSc. HUB; he joined KPMG in 2004 and has over 10 years of experience in advising multinational organizations on transfer pricing issues. He has been involved in and conducted various tax planning and transfer pricing assignments, ranging from the preparation of European and global transfer pricing documentation (including functional and economic analyses and comparables searches) and domestic and international transfer pricing audit defense to the negotiation of (uni-, bi-, and multilateral) rulings and advance pricing arrangements (APAs).

Mayra Lucas Mas

Editorial Board Member
Senior Advisor, Tax Treaty, Transfer Pricing & Financial Transactions Division, Centre for Tax Policy and Administration, OECD, Paris

Mayra Lucas Mas has been an advisor at the Centre for Tax Policy and Administration, Tax Treaty, Transfer Pricing and Financial Transactions Division of the OECD since June 2008. She is responsible for chairing bilateral and multilateral transfer pricing events at OECD for the development of the OECD Transfer Pricing Guidelines, for the update of OECD Transfer Pricing Country Developments and for OECD accession review in the field of Transfer Pricing. She also provides technical assistance to non-OECD economies. In the past she has worked as a senior consultant for the transfer pricing group of a leading accounting firm and in the Taxation and Customs Union unit of the European Commission.

Mayra is a graduate of New York University School of Law (LLM), the University of Barcelona (Ph.D in Tax Law and Law Degree.) She has been a lecturer in tax law at the University of Barcelona, and a Research Fellow at the European Tax College at K.U. Leuven.

Rahul K. Mitra

Editorial Board Member and Panelist for India
Chartered Accountant, India

Rahul Mitra is a Chartered Accountant with 30 years of experience in handling taxation matters in India. He specializes in transfer pricing, supply chain management projects, international taxation, attribution of profits to permanent establishments, etc. Rahul was a tax partner with PwC and KPMG in India for an aggregate period of 20 years, including having served as the leader of national transfer pricing practices with both organizations.

He was nominated by Financier Expert Worldwide as among the leading global corporate tax experts in its directory for 2021. Rahul received the "International Tax Contributing Author of the Year" award in the subject of transfer pricing in 2019 from Bloomberg Tax. He was invited by the OECD to speak at the 2012 Paris roundtable conference on developing countries' perspective on APAs. Rahul was also the country reporter on the topic "Non-discrimination in international tax matters" for the

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International Fiscal Association Congress held in Brussels in 2008.

Rahul is a member of the global Editorial Board of the international tax publication *Bloomberg Tax Transfer Pricing Forum*. He has been consistently rated as a leading transfer pricing professional and tax litigator in India by *Euromoney* and *International Tax Review* since 2010. Rahul was nominated as among the "International Who's Who of Professionals" by the Who's Who Historical Society for the year 2012. He has authored a book on transfer pricing titled *Decoding Transfer Pricing for Selling (Distribution and Agency) Functions*. He has also authored individual chapters for various books on transfer pricing published by the Vienna University of Business and Economics.

Rahul was invited by the Tax Tribunal and the Indian Revenue Board on several occasions to impart training on the topic of transfer pricing to members of the Tax Tribunal and Senior Officials of the Indian Revenue, respectively. He has also been a visiting faculty member at the Indian Institute of Management.

Benedicte Olrik

Editorial Board Member and Panelist for Australia
Managing Director, Andersen, Australia

Benedicte is the Managing Director of Transfer Pricing at Andersen Australia. She co-leads Andersen's Asia Pacific Transfer region and is a member of the global Andersen Transfer Pricing leadership team.

Benedicte is passionate about putting clients first; always aspiring to deliver optimal client value by building simple yet sophisticated solutions, minimizing risk and ensuring technically complex information is understandable.

With over 16 years of experience working with global firms such as EY, Duff & Phelps & KPMG, she has amassed a wealth of expertise and developed Transfer Pricing strategies and solutions for several globally recognized brands.

Benedicte's strategic and rounded business approach, and dedication to her client's best interest, is informed by the experience gained operating her own companies in the retail and fashion industries. Benedicte has significant experience with:

- APAs;
- Transfer Pricing compliance, planning & policy
- Complex global TP compliance/controversy
- Intellectual property planning
- Conducting royalty analysis using DEMPE
- Supporting the Australian transfer pricing position for financing arrangements to the Australian Taxation Office (ATO).

Dirk van Stappen

Editorial Board Member
Partner, KPMG, Antwerp/Brussels

Dirk van Stappen is a partner with KPMG and leads KPMG's transfer pricing practice in Belgium. He joined KPMG in 1988 and has over 28 years of experience in advising multinational companies on corporate tax (both domestic and international) and transfer pricing issues. He leads KPMG's transfer pricing practice in Belgium. Furthermore, Dirk is a former member of the EU Joint Transfer Pricing Forum (2002-2015).

Since 1996, Dirk has been a visiting professor at the University of Antwerp (Faculty Applied Economics, UA) teaching Tax to Master students. He has been named in International Tax Review's "World Tax –The comprehensive guide to the world's leading tax firms," Euromoney's (Legal Media Group) "Guide to the World's Leading Transfer Pricing Advisers," and Euromoney's "Guide to the World's Leading Tax Advisers."

He is a certified tax adviser and member of the Belgian Institute for Accountants and Tax Advisers and of the International Fiscal Association.

Country Contributors

ARGENTINA

Cristian Rosso Alba

Rosso Alba & Rougès, Buenos Aires

Cristian Rosso Alba heads the tax law practice of Rosso Alba & Rougès. He has a well-recognized expertise in tax law, with particular emphasis on domestic and international tax matters. Mr. Rosso Alba has served as professor of Tax Law at the Pontifical Catholic University of Argentina; visiting professor at the University of Buenos Aires, School of Economics; professor of Tax Law at Austral University; and professor of postgraduate courses at the Torcuato Di Tella University. Additionally, he has been a regular lecturer in the United States and speaker in domestic and international tax conferences and is the author of more than 80 articles appearing in specialized publications. Cristian Rosso Alba holds an LL.M. from Harvard Law School and a Certificate in International Taxation jointly from Harvard Law School and the J.F. Kennedy School of Government at Harvard, a Masters in Taxation from Buenos Aires University School of Economics, and the degree of Abogado from the University of Buenos Aires Law School. He is a member of the American Bar Association (ABA), the Canadian Tax Foundation, and the Advisory Board of the Argentine Chamber of Commerce. He has been recommended as one of the "Leaders in their Field" (Tax – Argentina) by Chambers Latin America.

Juan Marcos Rougès

Rosso Alba & Rougès, Buenos Aires

Juan Marcos Rougès is a partner in the tax law practice of Rosso Alba & Rougès. He has extensive experience in Tax and Customs Law, particularly in reorganizations, transfer pricing, customs valuation and litigation. Mr. Rougès is a deputy professor of Tax Law at the Universities of Buenos Aires, Palermo, and Austral. He has written many articles published in international and national publications. He has also been appointed by International Tax Review as one of the "Tax Controversy Leaders" of Argentina for the years 2017, 2018, and 2019.

AUSTRALIA

Benedicte Olrik

Managing Director, Andersen, Australia

Benedicte is the Managing Director of Transfer Pricing at Andersen Australia.

She co-leads Andersen's Asia Pacific Transfer region and is a member of the global Andersen Transfer Pricing leadership team.

Benedicte is passionate about putting clients first; always aspiring to deliver optimal client value by building simple yet sophisticated solutions, minimizing risk and ensuring technically complex information is understandable.

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- Supporting the Australian transfer pricing position for financing arrangements to the Australian Taxation Office (ATO).

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AUSTRIA

Alexandra Dolezel

Tax Director, BDO Austria GmbH, Vienna

Alexandra Dolezel is a tax director at BDO Austria GmbH in Vienna, Austria. She has over 22 years of experience and specializes in international taxation and transfer pricing. Her expertise includes the conceptual design of international tax structures and business models, defense in tax audits, litigation and mutual agreement procedures, as well as the optimization of value chains from a transfer pricing point of view. In addition, she is a lecturer on European Union tax law and comparative tax law at FH Campus Wien, the largest university in Austria. Prior to joining BDO, Alexandra was a tax director at PricewaterhouseCoopers, where she specialized in transfer pricing, international tax structuring and value chain transformation, and mergers and acquisitions. Prior to that, she was Head of Corporate Taxes for Borealis AG, where she had overall responsibility for group corporate tax, including matters affecting tax risk management, transfer pricing, and international structures. Alexandra received her education at the Vienna University of Economics and Business Administration, and she is also a member of the Austrian Chamber of Accountants.

Christoph Pelikan

Senior Associate, BDO Austria GmbH, Vienna

Christoph Pelikan is a senior associate at BDO Austria GmbH in Vienna. He graduated from the Vienna University of Economics and Business with a Master's degree in Finance and Accounting and has over five years of work experience at BDO. His professional focus is on Transfer Pricing. He regularly assists multinational corporations in preparing their Transfer Pricing Documentation – Benchmark Studies, during tax audits and tax rulings.

BELGIUM

Yves de Groote

Partner, KPMG, Belgium

Yves de Groote has an LL.M from King's College London, MSc. HUB; he joined KPMG in 2004 and has over 10 years of experience in advising multinational organizations on transfer pricing issues. He has been involved in and conducted various tax planning and transfer pricing assignments, ranging from the preparation of European and global transfer pricing documentation (including functional and economic analyses and comparables searches) and domestic and international transfer pricing audit defense to the negotiation of (uni-, bi-, and multilateral) rulings and advance pricing arrangements (APAs).

Lavina Bansal

Director, KPMG, Belgium

Lavina Bansal offers extensive expertise across a wide array of industries, including Chemicals, Pharmaceuticals, Consumer Goods, Information Technology, Automotive, Logistics, Telecommunications, Liquor, Heavy Machinery, Design and Engineering, and Waste Management, among others. Her proficiency covers all facets of Transfer Pricing, including documentation, compliance, and strategic planning across multiple jurisdictions. She has a proven track record of managing TP audits and court cases, advising clients on operational transfer pricing matters, and leading Transfer Pricing Due Diligence assessments during mergers and acquisitions. Her efforts have been instrumental in mitigating risks and ensuring smooth integration processes.

In addition, Lavina has substantial experience with Advance Rulings/Advance Pricing Arrangements (APAs) and Mutual Agreement Procedures (MAPs) for leading multinational corporations. Her expertise encompasses the preparation and submission of applications, negotiation with APA authorities, and the successful resolution of complex APAs and MAPs. Lavina has also ventured into addressing emerging TP complexities, including but not limited to areas such as marketing intangibles, financial transactions, cost-sharing arrangements, management fees, restructuring, royalty matters, innovation income deduction, and tackling the challenges posed by Base Erosion and Profit Shifting (BEPS) 2.0 in the context of the digitalized economy, among other noteworthy areas of expertise.

In addition to her practical experience, Lavina has made significant contributions to the field through the drafting of white papers on APAs and the publication of articles in esteemed outlets such as International Tax Notes and Bloomberg BNA. She has also been a featured speaker at various industry seminars, sharing her insights with clients and peers alike. Lavina's commitment to thought leadership extends to her collaboration with the Ministry of Finance in India, where she contributed her expertise/insights to the design and implementation of the Goods and Services Tax (GST)

BRAZIL

Jerry Levers de Abreu

Partner, Demarest Advogados, Sao Paulo

Jerry Levers de Abreu is a Partner at Demarest Advogados, Sao Paulo. A specialist in tax law, Jerry has over 20 years of experience in tax consulting and administrative litigation. He counsels both domestic and foreign clients, with an emphasis on indirect taxes and taxation in the automotive, information technology, telecommunications, intellectual property, food, and consumer products sectors. Jerry has worked as a tax manager in global audit and consulting companies. He is recognized as an Indirect Tax Leader by the International Tax Review and recommended by Chambers Global, The Legal 500, Latin Lawyer 250, and Best Lawyers. He is also LACCA Approved – recognizing Latin America's top private practitioners. Jerry's education includes a law degree from Universidade São Francisco and a specialized degree in Tax Law from Pontifícia Universidade Católica de São Paulo. He frequently publishes articles on tax law in major national publications.

André Novaski

Partner, Demarest Advogados, Sao Paulo

André Novaski is a partner at Demarest Advogados, São Paulo. He has 20 years of experience advising clients in federal administrative litigation, transfer pricing, tax aspects of mergers and acquisitions, financial and capital markets taxation, electricity sector taxation, wealth planning, international tax law, and third sector taxation. André has also worked as secondee in several financial institutions. He has a master´s degree in tax law from Fundação Getúlio Vargas (FGV), holds a Postgraduate degree in Business Administration from Fundação Getulio Vargas (FGV), and holds a bachelor´s degree in Law from the University of São Paulo (USP).

Dora Pimentel

Senior Associate, Demarest Advogados, Sao Paulo

Dora Pimentel is a senior associate at Demarest Advogados, Sao Paulo. She has over eight years of experience advising clients with domestic taxation at different federative levels and international taxation, including corporate and M&A transactions, foreign and private equity investment, and cross-border inbound and outbound transactions. She also works on strategic administrative litigation and transfer pricing. Dora specializes in direct taxation and has expertise in the financial services, real estate, infrastructure, agribusiness, mining, and technology fields. She has a master's degree and holds specializations in both Brazilian taxation and international taxation at the Instituto Brasileiro de Direito Tributário and holds a bachelor's degree in Law from the University of São Paulo.

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CHINA

Cheng Chi

Transfer Pricing Partner, KPMG China

Cheng Chi is a transfer pricing partner at KPMG China and a member of the Steering Committee of the Global Transfer Pricing Services Practice of KPMG's global network. Mr. Chi has led many transfer pricing and tax efficient supply chain projects in Asia and Europe, involving advance pricing arrangement negotiations, cost contribution arrangements, Pan-Asia documentation, controversy resolution, global procurement structuring, and headquarters services recharges for clients in the industrial market including automobile, chemical, and machinery industries, as well as the consumer market, logistic, communication, electronics, and financial services industries. In addition to lecturing at many national and local training events organized by the Chinese tax authorities, Mr. Chi has provided technical advice on a number of recent transfer pricing legislative initiatives in China. A frequent speaker on transfer pricing and other matters, his analyses are regularly featured in tax and transfer pricing publications around the world (i.e., *International Tax Review*). Mr. Chi has been recommended as a leading transfer pricing advisor in China by the Legal Media Group. Mr. Chi started his transfer pricing career in Europe with another leading accounting firm, covering many of Europe's major jurisdictions while based in Amsterdam until returning to China in 2004.

Choon Beng Teoh

Director, KPMG China

Choon Beng Teoh is a director at KPMG China. Choon Beng has experience in multi-jurisdictional planning studies, dispute resolution, value chain analysis, and restructuring of operating models, as well as leading and managing global transfer pricing documentation projects. His client portfolio includes top-tier multinational companies across a variety of industries, including the pharmaceutical, retail, and IT industries. He also occasionally co-authors articles on China-related transfer pricing topics for publications.

Choon Beng graduated with a law degree from the London School of Economics and is a chartered accountant with the Institute of Chartered Accountants in England and Wales. Prior to joining KPMG China, Choon Beng practiced in another leading accounting firm in London in the area of international tax and transfer pricing.

Josh Ma

Senior Manager, KPMG China

Josh is a senior manager at KPMG China. Josh joined KPMG's Global Transfer Pricing Services team in 2013, and his client portfolio includes market leaders in the electronics, automotive, consumer goods, and life sciences sectors. Josh has experience in a wide range of transfer pricing cases, including reorganization of business and transaction models, tax valuation of intellectual property, and equity, and he is experienced in managing transfer pricing documentation for multinational companies.

Josh holds a Master of Applied Finance from Monash University, is a CFA Charter holder, and has been practicing as a transfer pricing consultant with KPMG China since graduation.

DENMARK

Arne Møllin Ottosen

Partner and Head of Tax Law, Kromann Reumert, Copenhagen

Arne Møllin Ottosen is the Head of Kromann Reumert's tax law group. He specializes in contentious tax, including transfer pricing, tax litigation, and business taxation advisory work. Arne is the author of numerous Danish and international articles on tax and company law. Arne is listed in the *International Tax Review*, *European Legal 500*, and *Chambers*. He holds a law degree from Aarhus University (cand.jur. 1993) and an LL.M. from King's College, University of London (1999).

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Lenni Hangaard Jensen
Attorney, Kromann Reumert, Aarhus

Lenni Hangaard Jensen is a dedicated tax lawyer at Kromann Reumert and PhD fellow at Aarhus University. Lenni specializes in corporate taxation, international tax law, and general commercial law. In addition to his work as a legal advisor, he is also a knowledge ambassador within the tax law practice area. As such, he is responsible for strengthening internal and external knowledge sharing and for optimizing workflows. Furthermore, Lenni is a PhD fellow at Aarhus University conducting research within the field of tax law.

FRANCE

Julien Monsenego
Tax Partner, Delsol Avocats, Paris

Julien Monsenego specializes in international taxation, tax treatment of M&A, and restructurings. He assists French and foreign companies in their international investments, as well as in the course of their tax audits and litigations. He has extended the practice of transfer pricing and has intervened for French and non-French groups in setting up intragroup flows, IP companies, and business restructuring. Before joining Delsol Avocats, Julien worked at Gowling WLG, Olswang, Arthur Andersen International, Ernst & Young, Coudert Brothers, and Dechert LLP. He is a member of the Paris Bar.

Emmanuel Llinares, PhD
Senior Managing Director, NERA Economic Consulting, Paris

Emmanuel Llinares, PhD is an economist and Chair of NERA's Global Transfer Pricing Practice, specializing in transaction pricing, asset and business valuations, and intellectual property analyses in an international tax context. He has over 20 years of experience advising multinational companies and their legal advisors on defining and implementing their intra-group pricing policies, valuing assets, including notably the pricing of complex transactions (intellectual property, financing, etc.). Emmanuel holds a PhD in economics from the University of Delaware as well as a Doctorate in economics from the University of Lyon.

GERMANY

Philip de Homont
Partner, NERA Economic Consulting, Frankfurt

Philip de Homont is an expert in NERA's global Transfer Pricing practice, where he provides transfer pricing advice to international corporations and law firms. He specializes in the transfer pricing of intellectual property in tax audits and litigation cases, as well as in the digital economy. His recent projects have focused on DEMPE analysis and relocations of functions (Funktionsverlagerung), and he has extensive experience in the defense of licensing and valuation arrangements for intangibles. Philip is a frequent speaker at international tax conferences and regularly publishes articles on transfer pricing developments and on defense and planning cases. He authored two chapters on valuation for leading German textbooks on Transfer Pricing and Intellectual Property. He has repeatedly been listed as a "Rising Star" in transfer pricing by Euromoney's Expert Guides.

Tom Braukmann
Director, NERA Economic Consulting, Frankfurt

Tom Braukmann is a Director at NERA Economic Consulting in Germany.

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HONG KONG

Irene Lee

Partner, KPMG Global Transfer Pricing Services, Hong Kong

Irene Lee has practiced tax for 11 years, the last 7 specializing in transfer pricing matters involving the financial services sector. She joined KPMG in Hong Kong in 2013 and advises banking, asset management, and insurance clients on transfer pricing policies, documentation, and risk management in the Asia region. She earned a Bachelor of Business Administration (B.B.A.) degree from the Chinese University of Hong Kong and has studied at the University of North Carolina (Chapel Hill).

Jeffrey Wong

Senior Manager, KPMG Global Transfer Pricing Services, Hong Kong

Jeffrey Wong is a senior manager of Global Transfer Pricing Services at KPMG in Hong Kong. He is an experienced financial services transfer pricing advisor and works with clients from the banking, insurance, and asset management sectors. Jeffrey joined KPMG in Hong Kong in 2014 and has been based in Hong Kong for over seven years. He also worked as a transfer pricing specialist in New York for over two years. He holds a Bachelor of Science in Finance and International Business (Magna Cum Laude) from the NYU Stern School of Business.

Jodi Yiu

Manager, KPMG Global Transfer Pricing Services, Hong Kong

Jodi is a manager in the Global Transfer Pricing Services group of KPMG in Hong Kong with over 8 years of corporate tax and transfer pricing experience. Prior to joining KPMG in 2020, she worked in the corporate tax team of another Big 4 firm and also worked in a leading Hong Kong-based multinational textile and apparel group. She has served multinational companies in a broad spectrum of industries, including airlines, manufacturing, consumer products, property development, and industrial products, as well as financial services. Her work focuses on transfer pricing compliance and planning, risk assessment and optimization, and audit resolution. She earned a Bachelor of Science in Accounting and Finance from the Kelley School of Business, Indiana University.

INDIA

Rahul K. Mitra

Chartered Accountant and Advisor, India

Rahul Mitra is a Chartered Accountant with 30 years of experience in handling taxation matters in India. He specializes in transfer pricing, supply chain management projects, international taxation, attribution of profits to permanent establishments, etc. Rahul was a tax partner with PwC and KPMG in India for an aggregate period of 20 years, including having served as the leader of national transfer pricing practices with both organizations.

He was nominated by Financier Expert Worldwide as among the leading global corporate tax experts in its directory for 2021. Rahul received the "International Tax Contributing Author of the Year" award in the subject of transfer pricing in 2019 from Bloomberg Tax. He was invited by the OECD to speak at the 2012 Paris roundtable conference on developing countries' perspective on APAs. Rahul was also the country reporter on the topic "Non-discrimination in international tax matters" for the International Fiscal Association Congress held in Brussels in 2008.

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Rahul was invited by the Tax Tribunal and the Indian Revenue Board on several occasions to impart training on the topic of transfer pricing to members of the Tax Tribunal and Senior Officials of the Indian Revenue, respectively. He has also been a visiting faculty member at the Indian Institute of Management.

Soumitra Chakraborty

Chartered Accountant, India

Soumitra Chakraborty is a Chartered Accountant based out of India. Soumitra advises clients in strategizing profit portability planning; valuation reviews & migration of intangibles; supply chain management projects; business restructuring; and profit attribution to permanent establishments.

IRELAND

Catherine O'Meara

Partner, Matheson, Dublin

Catherine is a partner in the corporate tax department at Matheson and is chairperson of the Irish branch of the International Fiscal Association.

Catherine has a particular interest in transfer pricing, competent authority matters and business restructurings and also has extensive experience in mergers and acquisitions and corporate re-organizations. Catherine also advises on State aid in the context of taxation matters. Catherine's clients include many of the leading multinational corporations established in Ireland, primarily in the pharmaceutical, healthcare, ICT, and consumer brand sector.

Catherine has published articles in leading tax journals, is co-author on the Ireland section of the Bloomberg Tax Transfer Pricing Forum and is co-author of the Ireland chapter of the International Fiscal Association Cahiers on Cross Border Business Restructuring.

Anna Crowley

Senior Associate, Matheson, Dublin

Anna Crowley is a senior associate in the corporate tax department at Matheson. Anna regularly advises Irish and multinational clients on corporate and international tax and transfer pricing. Anna also advises clients in relation to tax-effective structures for inbound and outbound investment and has advised on numerous cross-border reorganizations. Anna assists leading multinational corporations with tax authority audits, tax risk management and multi-jurisdictional tax controversies.

Anna is a member of the Irish branch of the Young International Fiscal Association and regularly speaks on international tax and transfer pricing matters.

ISRAEL

Yariv Ben Dov

Partner, YDB Transfer Pricing and Valuation Services – TPA Global, Israel

Yariv Ben Dov is the founding partner of YDB Transfer Pricing and Valuation Services, a global partner member of the TPA Global network. Prior to that, he was Head of Transfer Pricing at Lion Orlitzky & Co. – Moore Stephens Israel and Head of Transfer Pricing and Valuations Department at Herzog, Fox & Neeman. He is an expert in drafting and defending transfer pricing studies and intercompany agreements, with over 15 years of experience. Yariv counsels both multinational conglomerates and small start-ups on their transfer pricing matters, including multinationals which have no activity in Israel. Before working at HFN, Yariv was a co-founder of Bar-Zvi & Ben-Dov, a boutique law firm specializing in transfer pricing and high-tech and, before that, Yariv served as the Head of the Transfer Pricing Unit at Teva Pharmaceuticals. Yariv has published articles on the subject of transfer pricing and has been asked to keynote as an expert in transfer pricing at several conventions in Israel, Europe, and the U.S. Yariv is a member of Transfer Pricing Associates, the world's largest network of independent transfer pricing experts;

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the Israeli Bar Tax Committee; and the Board of the Israeli-LATAM Chamber of Commerce. Yariv is also a Board member of the Arthur Rubinstein Music Society and the head of the Society's NYC branch. Yariv provides counsel (pro bono) to the Israeli Navy Association. Yariv speaks Hebrew, English, French, and Italian and has often advised global clients in their local language.

ITALY

Marco Valdonio

Partner, Maisto e Associati, Milan

Marco Valdonio is a partner in the Transfer Pricing team of Maisto e Associati. Marco has been with Maisto e Associati since 2000 after working for another tax law firm. He headed the London office from 2002 to 2004 and has been a partner in the firm since 2011. He has received numerous awards as an adviser and has frequently been ranked as a leading tax professional. Marco's areas of expertise include transfer pricing, tax controversies and settlements, mergers and acquisitions, financial instruments, and international taxation.

Aurelio Massimiano

Partner, Maisto e Associati, Milan

Aurelio Massimiano is a partner in the Transfer Pricing team of Maisto e Associati. Aurelio has been with Maisto e Associati since 2005, after having worked for the International Tax Office of the Italian Revenue Agency and, prior to that, for a Big 4 accounting firm. He is the permanent assistant to Professor Guglielmo Maisto at the EU Joint Transfer Pricing Forum. Aurelio holds an LL.M. from the University of Leiden in the Netherlands in International Taxation. He has received numerous awards as a transfer pricing adviser, and his areas of expertise are international taxation and transfer pricing.

Mirko Severi

Senior Associate, Maisto e Associati, Milan

Mirko Severi is a senior associate in the Transfer Pricing team of Maisto e Associati. Mirko has been with Maisto e Associati since 2011. He has obtained a Master in Tax Law and has completed the Executive Program in Transfer Pricing (EPTP) at the Université de Lausanne (Switzerland). His areas of expertise include international taxation and transfer pricing.

JAPAN

Takuma Mimura

Managing Director, Cosmos International Management Co., Ltd, Nagoya

Takuma Mimura is the managing director of Cosmos International Management, a transfer pricing boutique consulting firm in Japan. He has more than 20 years of transfer pricing experience, including 6 years at Deloitte Touche Tohmatsu (both Tokyo and New York) and international banking experience prior to transfer pricing. He has worked extensively on transfer pricing issues worldwide and is especially experienced in Japan, U.S., and China TP matters. He has also worked with a broad range of clients in manufacturing, financial services, and telecommunications and has assisted many taxpayers in negotiations with the Japanese tax authorities on transfer pricing audit examinations. Takuma has authored articles for professional journals, including BNA's Transfer Pricing Report and Monthly International Taxation of Japan and is a frequent speaker on transfer pricing topics.

LUXEMBOURG

Peter Moons

Partner, Loyens & Loeff, Luxembourg

Peter Moons is a partner in Loyens & Loeff's tax practice group and heads the Luxembourg transfer pricing team. He specializes in cross border corporate tax advice for multinationals and funds, in particular private equity, private debt and real estate funds, their initiators and their investors. Peter also co-chairs the Luxembourg tax litigation team. He regularly speaks on the topics of international tax structuring, transfer pricing and tax litigation.

Sophie Ogden
Senior Associate, Loyens & Loeff, Luxembourg

Sophie Ogden is a senior associate in Loyens & Loeff's tax practice group in the firm's Luxembourg office. Sophie specializes in transfer pricing, European, and international tax law. Since joining the firm in 2017, Sophie has advised clients on financial transactions, international tax planning, and intra-group restructuring.

Katerina Benioudaki
Associate, Loyens & Loeff, Luxembourg

Katerina Benioudaki is an associate and member of the Loyens & Loeff's tax practice group in the firm's Luxembourg office. She focuses on transfer pricing related matters and cross-border transactions. Since joining the Luxembourg tax practice group in 2022, she has advised clients on financial transactions, intra-group restructurings, and operational transfer pricing.

MEXICO

Moises Curiel Garcia
Partner, LA TPG, SC, Mexico

Moises Curiel Garcia is a distinguished public accountant with over 30 years of extensive experience in international taxes and transfer pricing throughout Mexico and Latin America. As a partner at LATPG, SC, Moises specializes in audit defense, tax dispute resolution, and various agreements, including Advance Pricing Agreements (APAs) and Mutual Agreement Procedures (MAPs). He is recognized as a certified transfer pricing adviser before the Mexican tax courts and offers expertise in documentation, financial valuation, consulting, and the maquiladora industry. His prior roles include leading the transfer pricing practices at Baker McKenzie and EY across Mexico and Latin America, as well as serving as the Central Administrator of the transfer pricing department at Mexico's Tax Administration Service (SAT). In addition to his professional endeavors, Moises is a passionate educator and author, actively engaging in public and private forums and contributing to national and international journals on transfer pricing topics. He serves as an external advisor to tax authorities, judges, and magistrates across Latin America, as well as to the maquiladora industry association. Moises has received numerous accolades for his leadership and contributions to transfer pricing in Mexico and Latin America, solidifying his reputation as a leading adviser in the field.

Armando Cabrera-Nolasco
Partner, LA TPG, SC, Mexico

Armando Cabrera-Nolasco is a seasoned economist with over 27 years of experience specializing in international taxes and transfer pricing across Mexico and Latin America. As a partner at LATPG, SC, Armando's practice focuses on audit defense, tax dispute resolution, and various agreements including Advance Pricing Agreements (APAs) and Mutual Agreement Procedures (MAPs). He is also well versed in documentation, financial valuation, and consulting for the maquiladora industry. Previously, Armando led the transfer pricing team at Baker McKenzie México and served as a senior associate at EY Mexico. He was also the head of the transfer pricing department at Mexico's Tax Administration Service (SAT). Beyond his professional roles, Armando is a dedicated educator and author, actively promoting transfer pricing issues in public and private forums, as well as in national and international journals. His expertise extends to serving as an external advisor to tax authorities, judges, and magistrates throughout Latin America, as well as to the maquiladora industry association. Recognized as a leader in his field, Armando has received numerous accolades for his contributions to transfer pricing in Mexico and Latin America.

THE NETHERLANDS

Bo Wingerter

Partner, Ernst & Young, Netherlands

Bo Wingerter is a partner and leads EY's Rotterdam Transfer Pricing & Operating Model Effectiveness practice. Bo's background and roles within EY's Dutch and US firms have given him extensive experience in bilateral and multilateral controversy, analyzing and developing international transfer pricing solutions and documentation, feasibility, design, and implementation of transfer pricing models across a wide variety of industries, including different sectors within technology, telecom, agriculture and chemicals.

Kawish Kanhai

Senior Manager, Ernst & Young, Netherlands

Kawish Kanhai is a senior manager in EY's Amsterdam Transfer Pricing & Operating Model Effectiveness practice. With over eight years of experience in international tax and transfer pricing, Kawish has extensive experience in international tax and transfer pricing planning, controversy, and projects covering direct tax, mergers & acquisitions, and financial & accounting aspects.

Jochem van Boom

Senior Consultant, Ernst & Young, Netherlands

Jochem van Boom is a senior consultant in EY's Amsterdam Transfer Pricing & Operating Model Effectiveness practice. Jochem specializes in international tax and transfer pricing controversy, business restructurings and transformations, financial transactions, transfer pricing model design, and implementation across various industries and sectors. Jochem holds bachelor's and master's degrees in tax law from the Erasmus University Rotterdam.

Ravenna Tomaz

Consultant, Ernst & Young, Netherlands

Ravenna Tomaz is a consultant in EY's Amsterdam Transfer Pricing & Operating Model Effectiveness practice. Ravenna is part of EY's dedicated Financial Transaction Transfer Pricing practice and has experience working on cross-disciplinary projects covering transfer pricing, direct tax and legal aspects, including operating model design. Ravenna also has experience in business restructurings, advance pricing agreements, and TP controversy. Ravenna holds a bachelor's degree in law from Vrije University Amsterdam and a master's degree in international and European tax law from the University of Amsterdam.

PORTUGAL

Patrícia Matos

Lead Partner, Deloitte Tax, Lisbon

Patrícia Matos is the Lead Partner in Deloitte's Lisbon office in the Transfer Pricing Department.

Patrícia has a business degree and is a chartered accountant. She started her professional career at Arthur Andersen in 1997 (presently Deloitte & Touche, as the result of an effective association of both firms since April 2002) and was promoted to Associate Partner in 2008.

Patrícia has extensive experience in tax planning, due diligence, and tax compliance for Portuguese and multinational companies. She advises clients in several aspects of transfer pricing, ranging from tax audits to comprehensive transfer pricing planning, structuring of intercompany transactions, and defensive documentation.

Her experience spans a wide range of industries, including communications, technology, media, financial services, automotive, consumer goods, tourism, and pharmaceuticals.

Patrícia has been a speaker at several seminars and conferences on tax, economic, and transfer pricing issues.

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Marta Fidalgo
Senior Consultant, Deloitte Tax, Lisbon

Marta Fidalgo is a Senior Tax Consultant in Deloitte's Lisbon office in the Transfer Pricing Department. Marta has experience analyzing transfer pricing issues and holds both bachelor's and master's degrees in law from the Catholic University of Portugal.

SPAIN

Marcos Perez Rodriguez
Partner, Ernst & Young Abogados, Spain

Marcos Perez Rodriguez has a degree in Law and Business Administration, Universidad Carlos III (Madrid) and an Executive Master at Corporate Finance, Centro de Estudios Europeos of Garrigues. Marcos joined EY in 2011, where he is a partner of the International Transaction Tax Services team. Marcos is specialized in assisting clients in tax and transfer pricing design, including complex supply chain solutions, business aligned conversions, and controversy procedures. Over the past years, Marcos's work has included numerous international planning and documentation work under the framework of the OECD Transfer Pricing Guidelines and EU Joint Transfer Pricing Forum regarding IP structuring, funding management, tax audits, tax court assistance and APA procedures, and tax due diligence services.

Gabriel Suarez
Senior Manager, Ernst & Young Abogados, Spain

Gabriel Suarez has a master's equivalent degree in Business Administration and in Law from CUNEF (Madrid) and a master's degree in Business Taxation from ICADE Business School. Gabriel joined EY in 2010, and he is a senior manager on the International Tax and Transaction Services team. His professional activity focuses on continued tax advice to multinational companies, including valuation analyses of intangible assets, financial assets and business entities, forecasting scenarios and modeling of efficiencies and impacts for risks assessment, and optimization solutions.

Begoña Rodríguez González
Junior, Ernst & Young Abogados, Spain

Begoña Rodríguez González has a degree in Law and Business Administration from IE University and double master's degrees in Law and Tax Law from IE University. Begoña joined EY in 2021, where she is a junior on the International Transaction Tax Services team. She has specialized in company consulting services regarding market and industry analysis, as well as valuation of financial transactions, and tangible and intangible assets.

TURKEY

Akif Tunç
Partner, Ernst & Young, Istanbul, Turkey

Akif Tunç has been working for EY since 2004 and is a partner at EY's Istanbul office in the Tax Department. He specializes in transfer pricing planning and documentation, international taxation, and cross-border tax advisory. Akif has a background in tax, and he has spent one year at EY's New York office – International Tax desks.

Akif is a Sworn-in Fiscal Advisor in Turkey, and he also has CPA, CMA, and CIA certifications.

UNITED STATES

Steven Wrappe
Managing Director, Grant Thorton LLP, Washington, D.C.

Steven Wrappe is the Managing Director and National Technical Leader of Transfer Pricing in Grant Thornton's Washington National Tax Office.

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