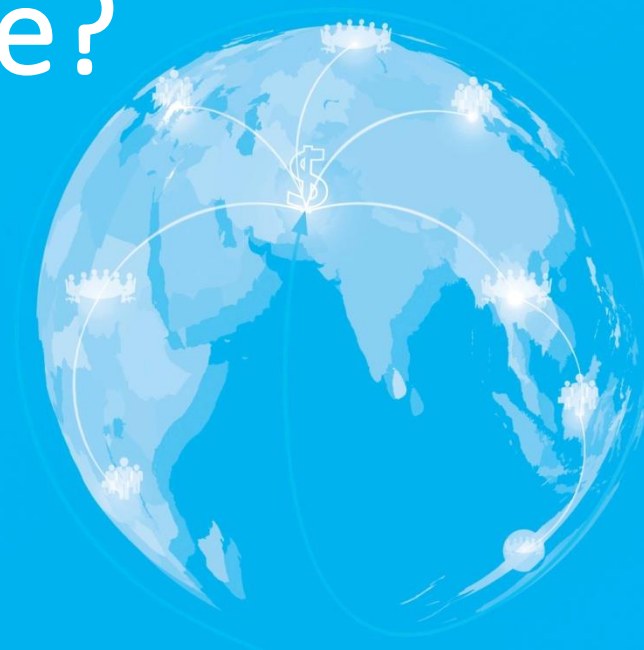


1st International IFA Czech Branch
Transfer Pricing Conference
16 October 2018



Shades of grey in the manufacturing continuum: Is there a cutting edge?

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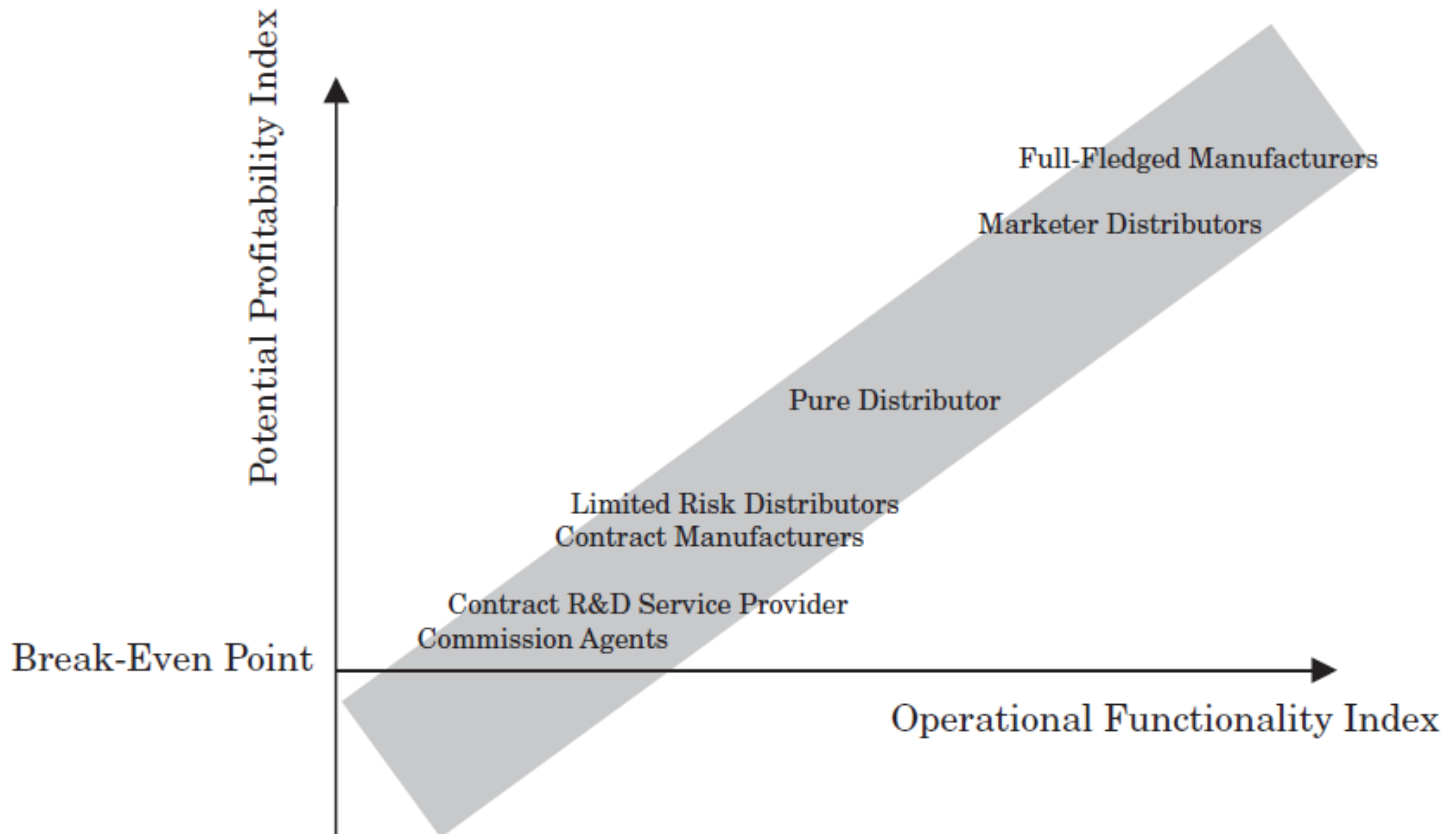
Introduction & objectives

1. Outline the issues of entity characterization (particularly on an example of “two neighbors” on the manufacturing continuum)
2. Discuss the pitfalls of the cost-base determination (when applying the C+ i.e. the cost plus method) from various perspectives and illustrate via example(s)
3. Wrap-up takeaways and proceed with Q&A

Manufacturing “Continuum”

- Classic spectrum of manufacturing entities (non-exhaustive list of categories on the continuum):
 - Full-fledged manufacturer (FFM)
 - License / limited scope manufacturer (LSM)
 - Contract manufacturers (CM)
 - Consignment / toll manufacturer (TM)

Manufacturing “Continuum” (cont’d)



Source: *Transfer Pricing and Characterization Of Multinational Enterprise Operations With a Focus on Canada and the U.S.*
by Hendrik Swaneveld, Charles Osoro, Martin Przysuski, Srinil Lalapet, and Pallavi Paul (Tax Notes International 17 May 2004)

Fuzzy logic on the continuum

- Shades of grey i.e. very thin line (if any) between the CM and the TM concept
 - Both undertake operational functions to manufacture
 - Both bearing limited risk
 - CM usually takes legal title to the materials, WIP, and finished products / inventory; whereas a TM **does not**
- Similarities in remuneration, typically Cost+ method
 - TP set as a “mark-up” on the appropriate cost base
 - Quite often a tug of war on the actual lev. of mark-up between the taxpayer[s] and the Tax Authorities
 - The definition of the cost base being the actual cornerstone!

Pitfalls

- Prima facie, the difference between a CM and a TM is the non-ownership of the WIP
 - Inventory / WIP on the BS indicates a CM profile
 - Quantitative aspect used (and potentially mis-used) by a Tax Authority
- What is “at arm’s length?” (CM vs. TM)
 - CM: Remuneration (implied / presumed) including the cost of material into the (cost) base?
 - TM: Given the fact no material / WIP / inventory is on the BS, is the cost base different?

Example 1

- Dummy example – processing of metal
 - Ferrum (FE) is a 100% subsidiary of Hephaistos
 - Aurum (AU) is a 100% subsidiary of Helios
 - FE is processing the iron ore into raw iron for its parent
 - AU is processing the gold ore into raw gold for its parent
 - Assuming the machinery for processing and other items “ceteris paribus” for both AU and FE entities
- What remuneration is “at arm’s length”?
 - Cost+ method selected as the most appropriate
 - If both AU and FE formally take legal title to the ore, should the cost base include also the material/WIP?

Example 2

- Somehow more realistic example – HW assembly
 - Gamer SarL (GS) is a 100% sub of Computer Ltd. (CL)
 - GS assembles gaming computers from components sourced from CL; besides, GS takes formally legal title to the inventory
 - GS has explicit guarantees (from CL) and also insurance in place (insurance fee recharged to CL) to get sheltered from any inventory shrinkage / loss from inventory & warehousing default
 - Tax Authorities (in the GS state) consider GS as a CM whereas both CL and GS argue that the actual profile of the latter is TM

Example 2 (cont'd)

- How to determine the “arm’s length” TP policy?
 - What should be included in the cost base?
 - What is the actual profile of GS? (substance over form)
 - What PLI should the Tax Authorities use to test (via TNMM) the actually applied C+ method?
- What other issues to consider in practice?
 - Apparent discrepancy between purely quantitative items (WIP / HW on the BS) and the documented (and contractually stipulated) terms & conditions
 - Lack of comparables (transactions and/or comparable unrelated companies)

Takeaways

- Relying solely on **quantitative indicators** might be mis-leading
- Shades of grey in the **manufacturing** continuum (**spectrum**) require more light to be shed on each case individually to:
 - Characterize an entity and
 - Apply the most appropriate TP method accordingly
- It is critical to examine the **actual functional profiles** based on
 - The actual behaviors of the related parties and
 - The actually applied terms & conditions
- The importance of **value-chain / industry** analysis hand-in-hand with the **functional & risk analysis** (resulting in the entity characterization) is crucial to consider the relevant circumstances and/or industry-specific factors

Closing sentence



"But this long run is a misleading guide to current affairs. In the long run we are all dead."
John Maynard Keynes (Economist, 1883-1946)

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