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

Igor Wotke, TP Manager



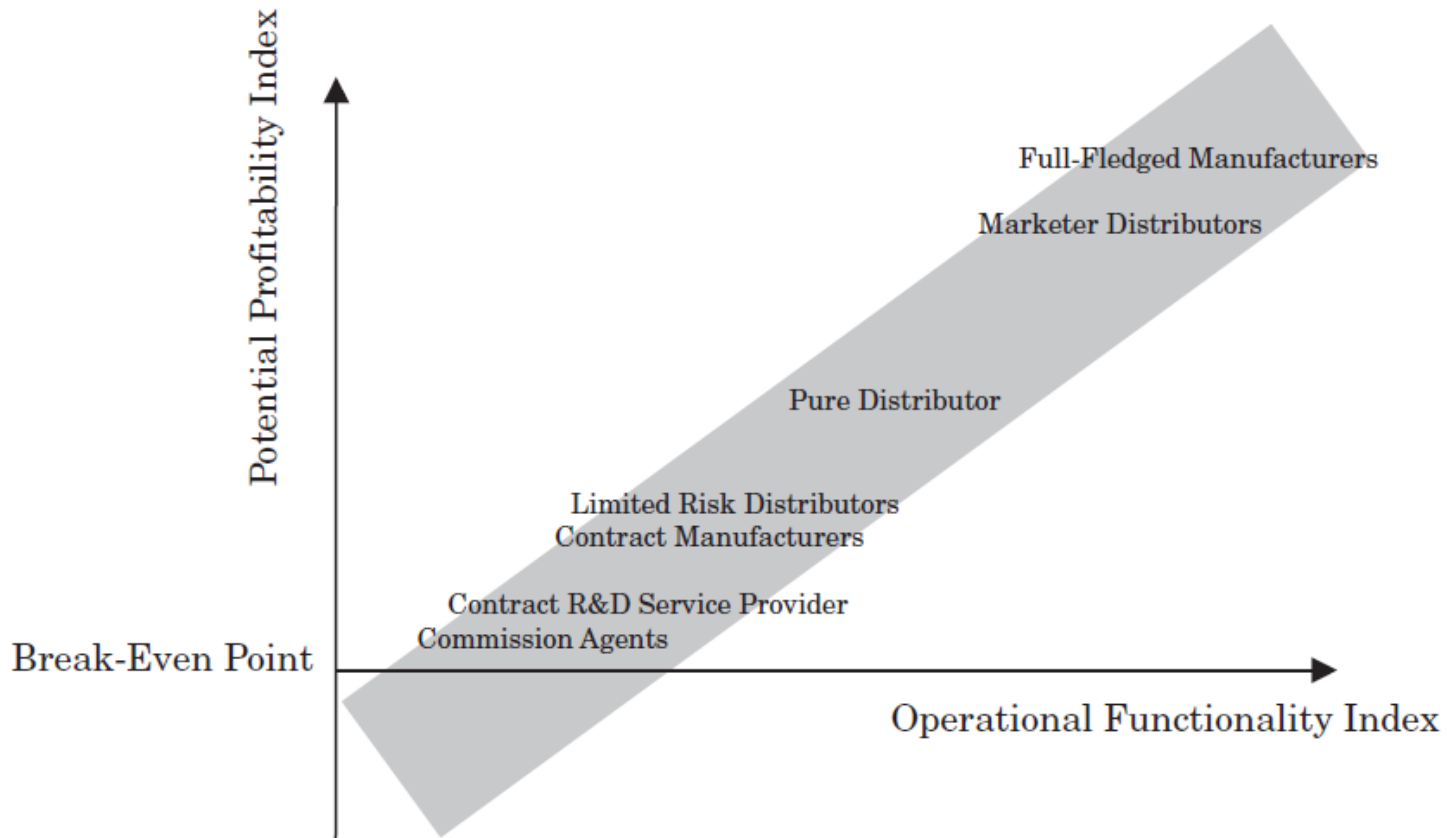
# Introduction & objectives

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)

# Igor Wotke – contact details

[igor.wotke@gmail.com](mailto:igor.wotke@gmail.com)

<https://www.linkedin.com/in/wotke/>