

Transfer Pricing Forum

Transfer Pricing for the
International Practitioner

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THE TRANSFER PRICING FORUM is designed to present a comparative study of typical transfer pricing issues by Country Panelists who are distinguished transfer pricing practitioners in major and emerging industrial countries. Their discussions focus on practical questions posed by guidance, case law and practice in their respective jurisdiction, with practical recommendations whenever appropriate.

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2024 TRANSFER PRICING FORUM

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.

Japan

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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

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

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

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.

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

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