China's Shenzhen Tax Bureau Closes Major Transfer Pricing Case

The Shenzhen State Tax Bureau has recently closed one of the largest transfer pricing audit cases in China concerning the toll manufacturing operations of a World Fortune 500 company. According to the official website of the Shenzhen Municipal Office of the State Administration of Taxation (SAT), the taxpayer made an additional tax payment of USD 17 million for the three fiscal years covered under the audit.
URL: http://www.szgs.gov.cn

The taxpayer's subsidiary in China started operations in 2005 as a contract manufacturer (that is, purchasing components per specification and from vendors designated by its customers, and then selling the assembled product to its related-party company that holds the ultimate contract with the customer). Its operations quickly ramped up to approximately USD 1.5 billion. In 2008, the taxpayer decided to change its business model and converted the Chinese assembly subsidiary to a toll manufacturer. After the conversion, all the components belonged to a non-Chinese company within the group, and the China company provided toll manufacturing services. Thus, the Chinese assembly subsidiary was relieved from the carrying cost of the inventory, as well as the risks related to loss of inventory.

While it is customary in China to use a net cost plus margin for contract manufacturers, the taxpayer relied on the Return on Invested Capital profit level indicator to allow the manufacturing company to earn a return on its operating assets commensurate with returns earned by independent contract manufacturers. Because it is difficult to find independent companies that operate solely as toll manufacturers in the electronics industry, the taxpayer's approach is a reasonable way to compensate toll manufacturers. Apparently, the Shenzhen Tax Bureau rejected the taxpayer's use of the Return on Invested Capital as the profit level indicator, and relied on the net cost plus margin and tested the toll manufacturer after adding back the component and material costs to its cost base.

Electronics contract manufacturers do not normally alter, modify, or transform the purchased components, they just assemble them. Accordingly, the value added by an electronics contract manufacturer is limited for the most part to the labor, overhead, and use of equipment at their site. For example, for personal computers, the labor costs at the assembly plant would normally be approximately 5 percent of the total cost or less. Depending on the value of components and the amount of assembly effort, this ratio could vary. This would clearly put the material-to-labor ratio at center stage for comparability – put differently, a correct profitability analysis should take into account how much of a contract manufacturer's cost base relates to passthrough materials. As an example, think of the assembly of two computers, one with higher quality components (a faster processor, larger memory, and high-definition screen) and the other with standard components. While they would require the same amount of assembly effort and may well roll off the same assembly line, if we use the net cost plus margin, the contract manufacturer would earn more on the former than the latter.

The natural question to ask would be whether taxpayers make the net cost plus ratio work in these cases? The authors do not think there will be an easy answer. The net cost plus ratio should either be adjusted for the material-to-labor ratio, or only those comparables that have a similar material-to-labor ratio should be used. Neither is possible because the financial data for comparable companies rarely includes the material costs.

When a contract manufacturer converts to a toll manufacturer, as in this case, the problem becomes more acute. The simple reason is that there are not many electronics toll manufacturers. Net cost plus margin without any adjustments now becomes more problematic, but there is an easy solution, which the Chinese tax authorities used in this case: add back the material costs of the tested party, effectively treating it no different than the contract manufacturers. We have seen a similar approach by other tax administrations, which also prefer to add the material costs before determining the tested party's financial results, unless the taxpayer can come up with toll manufacturing comparables. Is there a way to address tax authorities' resistance to the use of the ROIC?

One particular difficulty for the taxpayer in this case might have been the conversion from a contract manufacturer to a toll manufacturer, the fact that it had a history of relying on the net cost plus ratio. It is possible that the Shenzhen Tax Bureau was reacting to that conversion more than rejecting ROIC as a profit level indicator. In general, tax authorities do not like changes in methodology without a major change in operations. It will of course be more difficult for a contract manufacturer to change its method of analysis and start reporting lower levels of profits.

In terms of lessons learned from this episode and others, the authors offer a few suggestions:

- Set up transfer pricing for contract or toll manufacturers with the "correct" analysis from the start.
- Because the net cost plus ratio is the tax administrations' favorite, the priority should be to try to make it work. A more detailed screening, if not an adjustment, for the material-to-labor ratio may be the key in this respect.
- If possible, try to leverage transactional comparables. For the analysis of contract or toll manufacturers, the transactional comparables are rarely used because the fees are specified on a per unit basis, instead of a cost-plus percentage. It may well be worth the effort to convert such per-unit fees into cost plus margins through an analysis or estimation of costs.
- Bring ROIC into play not just as a profit level indicator, but within the context of capital put at risk by the contract or toll manufacturer and its expected and actual returns.

The authors believe that similar contract and toll manufacturer margin controversies will continue to occupy the center stage not only in China, but other lower-cost manufacturing hubs.

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