

Virtual Contract Manufacturing: The Last Frontier?

by William W. Chip

Reprinted from *Tax Notes Int'l*, July 9, 2012, p. 169

Virtual Contract Manufacturing: The Last Frontier?

by William W. Chip

William W. Chip is an international tax partner in the Washington office of Covington & Burling LLP.

When enterprises began to globalize in the middle of the 20th century, inefficiencies in international communications and transportation forced the operating subsidiaries in each country to perform for themselves most of the functions related to purchasing, manufacturing, and sales. They also had to assume and manage most of the risks arising from their performance of those functions and their ownership of input and output inventories. Modern risk managers classify those business risks as market risk (also called price risk), credit risk (also called default risk), and operational risk.

By the end of the 20th century, improvements in telecommunications and transportation made it possible for global businesses to achieve important efficiencies by centralizing both the performance of some business functions and the assumption and management of some business risks. Companies attentive to their global effective tax rates have taken advantage of those developments and adopted tax-efficient transfer pricing strategies tied to the movement of materials and products up the supply chain.

Those supply chain strategies are now well known, not just to tax professionals and their clients, but also to tax authorities nearly everywhere. At a Big Four firm's tax conference two years ago, one panelist bemoaned the challenge of a client's local commissionaire arrangement by a Latvian tax inspector! Although commissionaire-like arrangements have survived strict scrutiny in France¹ and Norway,² they did not fare as well in a more recent Spanish case.³

While the exposure of conventional supply chain strategies to tax authority challenges has increased since they first became popular, the "price of admission" has not diminished, because they involve extensive contractual documentation, transfer pricing studies, due diligence regarding exit taxes and other tax exposures, and management of the insurance, VAT, and documentation issues that result from changes in the ownership of raw materials and product inventory. Also, the strategies are as unpopular as ever with local managers who are (fairly enough) concerned about the impact on their bonuses of reducing locally reported profits and the distraction of their staffs during the investigation and implementation of the strategy.

For international tax managers and advisers, conventional supply chain strategies are not just expensive and risky; after the nth implementation, they are boring. One may ask in fairness whether the conventional versions of supply chain tax planning have reached the end of a road. Are there any new frontiers to explore and conquer?

This report explores the viability of entrepreneur strategies that simulate the risk-shifting and income-mobilizing features of traditional supply chain planning unburdened by cross-border shifts of functions and other production factors. The use of an "entrepreneur swap" to fashion a "virtual contract manufacturing" arrangement is explained.

²See *Dell Products v. the State (Tax East)*, HR-2011-02245-A (No. 2011/755) (Dec. 2, 2011).

³See *DSM Nutritional Products Europe Ltd. v. Administración General del Estado*, Second Section of the Third Chamber of the Supreme Court, No. STA/202/2012 (Jan. 12, 2012).

¹See *Société Zimmer Ltd., Conseil D'Etat*, Nos. 304715, 308525 (Mar. 31, 2010).

Conventional Entrepreneur Strategies

The conventional supply chain transfer pricing strategy repositions inventory ownership and some operating functions from high-taxed operating companies to a lower-taxed management company (the entrepreneur) that assumes responsibility for the repositioned functions and risks. In locations where the enterprise engages in manufacturing, the entrepreneur purchases and owns raw materials and contracts with the local subsidiary (the contract manufacturer) to transform them into products on a cost-plus basis. In locations where the enterprise engages in marketing, sales, and distribution, the entrepreneur contracts with the local subsidiary to sell products as a commissionaire (a civil law sales agent of an undisclosed principal) or stripped-risk distributor (a buy-sell distributor that is protected against price risk).

The fees that the entrepreneur pays to the operating affiliates are formulated to generate the routine operating margin that would be realized by an independent contract manufacturer or sales agent. In effect, the operating affiliates surrender to the entrepreneur a potentially volatile stream of profits and losses for a more stable stream of profits. The average expected profits of the volatile stream will exceed the average expected profits of the stable stream by an amount that represents compensation to the entrepreneur for any functions it performs plus a "risk premium" to compensate the entrepreneur for insuring the operating affiliate against losses.

Because supply chain transfer pricing strategies involve transactions between affiliated companies in high- and low-tax jurisdictions, their success depends on the availability of transfer pricing methods that allocate only routine profits to the high-tax locations and at the same time satisfy the arm's-length standard as understood and applied by the local tax authorities. Because there are a plethora of independent commission agents, distributors, and contract manufacturers that may serve as comparables, the methods for determining arm's-length compensation to a contract manufacturer, commissionaire, or stripped-risk distributor are fairly straightforward and defensible.

The desired outcome of the strategy is that profits of the global enterprise in excess of the routine profits allocated to the manufacturing and distribution subsidiaries should be taxable only in the entrepreneur's low-tax jurisdiction. For the strategy to succeed, the entrepreneur must arrange its affairs so that it has no taxable presence in the manufacturing and distribution locations and must have a means of transferring profits to the ultimate parent without having to pay substantial dividend withholding taxes. For that reason, it is not sufficient that the country in which the entrepreneur is incorporated have a low rate of tax; it must also have a good tax treaty network.

Switzerland is one of a few countries that meet all the criteria for locating an entrepreneur, and a Swiss subsidiary is often the entrepreneur in the supply chain

strategies of U.S. and European multinationals. However, more than a few U.S. Rust Belt giants make lots of money abroad but have Himalayan net operating loss carryovers negated by valuation allowances. In those cases, the U.S. parent can be a tax-efficient entrepreneur, with the benefit that foreign tax inspectors are generally less suspicious of dealings with a U.S. parent than with a Swiss affiliate.

The Risky and the Clunky

The conventional entrepreneur strategy is not without risk. The subpart F rules provide for U.S. taxation of the profits of a controlled foreign corporation that engages in specified transactions with foreign affiliates.⁴ Because entrepreneurs must engage in exactly those transactions, U.S. parents and parents in countries with similar CFC regimes must structure their supply chain transfer pricing strategies with special care.

U.S. parents of entrepreneur structures typically escape subpart F taxation by causing the CFCs that participate in the entrepreneur structure to elect to be classified as disregarded subsidiaries of a common foreign holding company. (Although the IRS in 1998 tried to close this escape hatch,⁵ it quickly retreated in the face of a threat by Congress to reopen it.⁶)

Because the intercompany transfer pricing in conventional supply chain strategies has not been easy for local tax authorities to challenge, they have found alternative grounds for attacking entrepreneur structures. Some tax authorities have argued that the entrepreneur has a taxable presence in the manufacturing or distributing location by virtue of its contracts with the local contract manufacturer or commissionaire. That is one reason why it is beneficial to incorporate the entrepreneur in a country with an extensive network of tax treaties that generally provides that a foreign company has no local taxable presence unless the local affiliate executes contracts that bind the entrepreneur.

Although the OECD is reviewing those tax treaty rules⁷ and is under some pressure to make it easier to find a permanent establishment for entrepreneurs, the rules will likely not change in the near future.

Some tax authorities have argued that the conversion of a local manufacturer or distributor to a contract manufacturer, commissionaire, or stripped-risk distributor involves a constructive distribution of operating intangibles to the shareholders. If so, the excess of the value of the intangibles over their local tax basis may

⁴Sections 951(a)(1)(A), 952(a)(2), and 954(a)(2).

⁵See Notice 98-11, 1998-1 C.B. 433, *Doc 98-2983*, 98 *TNT* 12-8.

⁶See Notice 98-35, 1998-2 C.B. 34, *Doc 98-20115*, 98 *TNT* 119-6.

⁷See OECD Centre for Tax Policy and Administration, "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention" (Oct. 12, 2011).

be subject to capital gains tax (an exit tax or severance payment) or dividend withholding tax. That argument may have some merit if the local operating company has invested heavily in the development of manufacturing or distribution intangibles; any such history, including preexisting third-party contracts, must be accounted for in the original transfer pricing analysis.

The profits retained by the local contract manufacturers, commissionaires, and stripped-risk distributors are low mainly because they are guaranteed. Thus, while the entrepreneur earns all the manufacturing and distribution profits in excess of those margins, it must in return absorb any net losses from manufacturing and distribution activities. What seemed like a good idea at the time can take on a different color if losses begin to accumulate in the low-taxed entrepreneur — which has occurred from time to time.

Tipping the Mobility Scale

Cross-border tax strategies based on transfer pricing mobilize income by repositioning the factors that drive profitability, which are typically categorized as assets, functions, and risks.⁸ On a scale of mobility, tangible property and functions are the least mobile because the ownership of tangible property and the location of employees have many nontax implications. Intangible property and risk are more mobile because they usually can be moved simply by signing a contract.

In industries where high-value intangibles are a factor, income mobilization is typically premised on cost-sharing strategies that may be parallel to, but are distinct from, supply chain management strategies. Consequently, the profit mobilization from supply chain entrepreneur strategies is more often attributable to repositioning risk than to repositioning intangibles. Although repositioning of risk may be the main supply chain profit driver, the classic techniques for repositioning supply chain risk have entailed the repositioning of some functions and ownership of raw materials and products. In effect, people and tangible property get stuck to the risk and are dragged along for the ride.

The stickiness of classical supply chain strategies accounts for their clunkiness; that is to say, the business headaches of the conventional entrepreneur strategies arise mainly from the transfer of business functions and supply/product ownership, not from the transfer of business risk. A mere transfer of risk, such as through an intercompany insurance contract or currency swap, is usually unproblematic, provided that the transfer pricing is defensible.

The riskiness and clunkiness of the conventional entrepreneur strategy raises this question: Is there a

version of the strategy that moves risk and almost nothing else, thereby achieving a significant part of the conventional tax benefit without the conventional pain and suffering? Twenty years ago, the answer was no. Today, I think the answer is yes.

Risk-Only Entrepreneur Strategies

Consider the oil and gas industry. Although oil majors were among the first companies to globalize, they seem not to have engaged in conventional supply chain transfer pricing strategies to the same extent as other industrial companies. I have observed the same pattern among agribusiness clients. Several factors account for that phenomenon,⁹ but I attribute it in part to the availability in commodity-based industries of techniques and tools for transferring risk and associated profits among affiliates that are more user-friendly and tax efficient than conventional supply chain structuring. In that regard, commodity-based industries are like the financial services industry, where price and credit risk are intensively and centrally managed, and where those risks are routinely transferred among business units and legal entities through the use of derivative financial instruments and other risk transfer agreements. Indeed, the most sophisticated risk management tools, including many adopted in the commodity-based industries, originated in the financial services sector.

Energy, agribusiness, and other commodity-based industries have from their inception been forced to cope with the business risks arising from extraordinarily volatile prices for their raw materials and products and long lead times between the extraction of raw materials and the sale of processed products. Because multinationals in the commodity-based industries are accustomed to transferring risk (and therefore profits) through sophisticated risk management instruments, the use of those instruments (and of the associated transfer pricing methods) to shift taxable income from high-tax to low-tax jurisdictions probably comes more naturally than do conventional contract manufacturing and commissionaire arrangements.

Of equal importance, intercompany risk management transactions (futures, forwards, options, and so forth) can be structured as treasury transactions that are less costly to implement, less likely to influence bonus-driving operating margins, and less intrusive in day-to-day operations than the intercompany contracts and transactions needed to initiate and operate a conventional supply chain structure.

Whatever may have been the case when entrepreneur structures first saw the light of day, it may be the

⁸See reg. section 1.482-1(d)(1), -5(c)(2)(ii); OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chap. I, para. 1.36.

⁹In the oil industry, for example, offshore subsidiaries were set up long ago as *per se* corporations, which were often difficult or impossible to convert into the disregarded companies needed to avoid subpart F.

case now that for many companies the more attractive supply chain strategy is to reposition risk alone, leaving where they naturally fall the ownership of supplies and products and the location of functions.

Because risk-only arrangements can be implemented entirely by contract, they are less intrusive to management and less expensive to implement than arrangements that modify — even slightly — the holding of legal title and the performance of business functions. While a conventional supply chain entrepreneur is buying manufacturing and distribution services from high-taxed affiliates and interrupting the passage of title in the supply chain, the entrepreneur in a risk-only structure is selling risk assumption services to the manufacturing and distributing affiliates, requiring no alteration in the chain of title passage and little or no change in the daily conduct of business by its affiliates.

Narrowing our entrepreneur strategy focus to its risk transfer component actually widens our perspective on the circumstances to which the strategy may apply. For example, many products are sold with a warranty, and it is no secret that for some products much of the profit derives from the sale of extended warranty and service contracts. A multinational group that has forsworn full-blown supply chain planning may be willing at least to vest responsibility for issuing and fulfilling warranty and service contracts in a low-taxed entrepreneur, which in turn may subcontract replacement and maintenance services to cost-plus affiliates in the customers' countries. Risk, and little else, is thereby repositioned in a tax-efficient way.

Hedge Funds as Comparables

As with conventional supply chain strategies, comparables for risk management strategies are readily available and provide a sound, defensible basis for transfer pricing. To pick a single (if unconventional) example, hedge funds make a pure split of their profits between experienced managers that perform all the fund's business functions and investors that supply all the fund's risk capital and assume all the fund's risk of loss. With few exceptions, a hedge fund manager receives a share of the fund's profits; his share of any losses may offset what would otherwise be his share of future profits, but he has not invested any capital that is directly impaired by the loss, nor is he required to contribute any capital to cover losses.

The hedge fund model is attractive because it provides a clean, arm's-length split of profits between the party that performs functions and the party that supplies risk capital. Whatever may be the risks of a taxpayer's business, there are hedge funds that speculate in that risk. Almost all of them will split their profits in the same ratios, and those profit-split outcomes are available on databases that can be rented. Indeed,

hedge funds afford a rare opportunity for taxpayers to apply the comparable profit-split method.¹⁰

The hedge fund model has been under something of a cloud since it was disparaged in the OECD's 2010 report on attribution of profit to PEs.¹¹ In its discussion of global banking, the OECD concluded that the model was not appropriate for allocating profits between a bank's home office and its PEs, because the model "rests on the premise that capital can be assigned to a particular part of the enterprise."¹² However, that argument has no bearing on arrangements that shift risk between two or more corporations. In fact, in its subsequent discussion of so-called global trading transactions, the report states that when the capital to support the risks created by risk management functions resides in a separate legal enterprise, "the reward for capital belongs with the enterprise in which the capital resides."¹³

The 2010 report's discussion of global trading strays from the topic of PE attribution to consider the most appropriate transfer pricing method for allocating profits among separate enterprises. It concludes that the hedge fund model may be appropriate for proprietary trading, which bears risks and infrastructure costs comparable to those borne by a typical hedge fund. However, when the enterprise is acting as a dealer rather than a trader, "taking spreads from facilitating customer wishes rather than in taking gains from trade," the report questions the reliability of the hedge fund model because the dealer's steady service fee income makes for a less risky business and the business demands a substantial selling infrastructure not needed by a hedge fund.¹⁴

I do not share the OECD's skepticism about using the hedge fund model for securities dealers, since there is a considerable amount of risk-taking in many global dealing books and a good economist can adjust for differences in infrastructure costs. Still, the model is only useful when the conduct of a business exposes the owner's capital to a substantial risk of loss based on a variable on which a reasonable number of hedge fund managers are inclined to speculate. Fortunately for the handful of economists who understand the hedge fund model, examples of that exposure abound in most supply chains, including the situation in which input and output prices are volatile and do not move in tandem.

The Risks of Moving Risk

The conventional entrepreneur strategy entails special tax risks that may be absent in a pure risk transfer

¹⁰Reg. section 1.482-6(c)(2).

¹¹OECD, "Report on the Attribution of Profits to Permanent Establishments" (July 22, 2010).

¹²*Id.* at para. 80.

¹³*Id.* at para. 123.

¹⁴*Id.* at para. 162.

arrangement. There are not yet any widely acceptable theories for imposing exit taxes or finding a PE on the basis of risk transfer agreements, and there likely never will be. The tax treatment of insurance is a good example.

An insurance company may assume some business risks of a manufacturer or distributor for a fixed period and an agreed premium. At the end of the term, the customer may enter into an identical or different arrangement with a different insurer. Apart from the payment of premiums, the tax law does not recognize any taxable transfer between the business and the insurance company or between the new and successor insurance company, either when the contract commences or terminates.

On the other hand, entrepreneur strategies that are constructed around risk transfer agreements do pose some unique tax issues, two of which are described here.

The OECD transfer pricing guidelines specify that a tax authority may disregard a purported intercompany risk transfer if the transferee is not financially capable of assuming or managing the risk,¹⁵ although they allow that at least some of the risk management may be outsourced.¹⁶ Accordingly, the entrepreneur must be well capitalized, and someone at the entrepreneur or under contract with the entrepreneur (not excluding employees of the U.S. parent) must monitor the assumed risks and have the training and authority to decide whether they should be hedged.

Importantly for a U.S. company, subpart F corrals profits attributable to financial and commodity transactions into the foreign personal holding company income basket.¹⁷ Fortunately, the election of disregarded status by the CFCs involved in the structure should be an effective safeguard against that classification, as it is for conventional strategies.

Virtual Contract Manufacturing

Although focusing on the risk-shifting component of the entrepreneur strategy may open our eyes to applications outside the traditional supply chain model, the risk-only approach can be, and has been, applied to ordinary industrial supply chains to establish what amounts to a virtual contract manufacturing arrangement.

Price risk is a key business risk of most manufacturing operations — the prices of inputs and outputs may be volatile and may not move in tandem. Indeed, price risk is often the most important risk assumed by a conventional entrepreneur. A standard contract manufac-

turing arrangement typically protects the manufacturer against price risks that it cannot control, such as adverse movements in the relative prices of its manufactured products and the raw materials or energy used to produce those products (the manufacturer continues to bear operational risks over which it has some control, such as the costs of equipment failure and labor disruptions). Likewise, the standard stripped-risk distribution arrangement protects the distributor from the input/output price risk that results from purchasing inventory before it is sold.

Manufacturers and distributors have sometimes been able to protect themselves against uncontrollable price risks by hedging. Until recently, hedges almost always took the form of a forward purchase of inputs, a forward sale of outputs, or both. Those hedges were executed on a futures exchange if one existed, and otherwise through a forward contract with a dealer. The ability to enter into a fully effective hedge was limited, because there might be no futures or forward market for a given input or output, or a market might exist for the inputs but not for the outputs, or vice versa.

In the last 20 years, dealers have developed ever more sophisticated risk-shifting contracts, ordinarily in the form of swap agreements. Most swap agreements are based on master agreements that have been published by the International Swap Dealers Association (ISDA).

The latest version is the 2002 ISDA Master Agreement, although many counterparties continue to use the 1992 version. An ISDA swap agreement consists of two documents, a schedule that contains party-specific information such as addresses, and a general description of the swaps that the parties intend to execute and one or more confirmations that confirm the application of the swap terms to specific transactions.

Under an ISDA swap agreement, a given volume of an input or output at a fixed price is swapped for the same volume at a floating price, or a given volume at a floating price according to one index is swapped for the same volume at a floating price under another index. A party that is concerned less about the absolute price of a given input or output than about the spread between those prices may enter into two swap contracts — one that hedges the input price and one that hedges the output price. If a single counterparty is assuming both price risks, the two hedges can be embodied in a single contract that swaps a fixed margin against a margin measured by designated floating prices for the inputs and outputs (an entrepreneur swap, if you will).

Although ISDA swaps are typically tied to prices of publicly traded goods or commodities, or else to the margins between those prices, under a total return swap a fixed margin can be swapped with the actual margin earned by the customer, defined as precisely as the parties may agree.

In principle, a manufacturing subsidiary can become a virtual contract manufacturer by entering into an

¹⁵OECD transfer pricing guidelines, *supra* note 8, at Chap. I, para. 1.49.

¹⁶*Id.* at Chap. IX, para. 9.23.

¹⁷Section 954(c)(1)(C) and (F).

entrepreneur swap that guarantees a low but fixed margin similar to what might have been earned had it become a contract manufacturer for the entrepreneur. Because the margin in the conventional arrangement must account for the performance of some supply-chain functions by the entrepreneur, the virtual contract manufacturing arrangement may mobilize somewhat less profit. Also, to avoid the deeming of a partnership for tax purposes, I recommend that an entrepreneur swap be based on gross margins rather than on margins net of operating costs.

Entrepreneur Swaps

The IRS, at least, has come to terms with the use of entrepreneur swaps. In LTR 200829011,¹⁸ the subsidiary of a U.S. multinational engaged in research and owned product technology. Its income consisted of product royalties from affiliates and third parties. The subsidiary wanted to stabilize its fluctuating stream of royalty income to prepare more realistic development budgets. The U.S. parent caused another subsidiary to enter into an ISDA swap with the research subsidiary that swapped the fluctuating royalty stream for an economically equivalent fixed stream of payments. The swap effectively converted the research subsidiary from an entrepreneur whose income might not cover its budget into a contract researcher that earned a smaller but steadier profit.

ISDA swap agreements are almost always cash settled — that is, there is no delivery of the volumes being swapped. Because they are purely financial transactions, care must be taken to ensure they are exempt from withholding tax. Payments under an entrepreneur swap should be exempt from U.S. withholding tax if the swap qualifies as a notional principal contract.¹⁹

¹⁸*Doc 2008-15816, 2008 TNT 140-15.*

¹⁹Reg. section 1.863-7(b)(1).

Generally, the tax treatment of a European counterparty will follow the international financial reporting standards treatment of the swap as reported on the counterparty's financial statement. If the agreement is classified as a derivative under IFRS, it should be treated as a derivative for tax purposes, which ordinarily means that payments to a foreign counterparty are not subject to withholding tax.

Periodic payments under an entrepreneur swap can be structured to take account of timing differences between the dates when inputs are purchased and outputs are sold. When the swap is cash settled, the mismatch in payments is resolved. The swap in that case has served as a de facto financing arrangement and possibly an attractive alternative to lending into countries that impose withholding tax on interest.

One impediment to the introduction of ISDA swaps into entrepreneur planning is that the ISDA-enforced format and terminology make them incomprehensible, not only to laypersons but also to lawyers who are not specialized in drafting them. Consequently, the devising of a schedule and confirmations that actually and transparently achieve the desired tax results is an arduous process that tests the IQ and patience of all who are involved, but one that more than repays the effort.

Conclusion

By taking advantage of modern risk management technology, today's multinational enterprise can achieve many of the tax benefits of traditional supply chain planning with less tax risk and perhaps less resistance from business managers. Of course, once the classic entrepreneur strategy has been stripped down to its risk transfer essentials, we may have reached the end of that particular tax planning road and will have nowhere else to go. In that respect, virtual contract manufacturing may be the last frontier. ◆