Search All Issues Contents

Tax Management
Transfer Pricing
REPORT

**Volume 14 Number 9** **Page 386**
**Wednesday, August 31, 2005**
ISSN 1521-7760

## Perspective

**CORPORATE STRUCTURE**

# Transfer Pricing and Foreign Direct Investment Decisions

**By Karl Wündisch***

**Karl Wündisch is head of portfolio management, prices, and trademarks for Schering AG in Berlin and co-author of International Transfer Pricing In the Ethical Pharmaceutical Industry.*

When multinational companies try to answer the question,[1] 'Where in the world to put the plant?' nation states competing for foreign direct investment are quick to offer significant subsidies if projections for new jobs and exports are at the core of the investment scenario.

However, the same countries--and often those with the greatest needs for jobs and economic growth--are slow to realise that their bureaucratic regulatory systems--particularly their transfer pricing regimes--may be the decisive obstacle for positive investment decisions of globally oriented companies. Their regulations still reflect the protective attitude of the last century when "local content" requirements appeared to be the solution: foreign direct investment as quid pro quo for access to their particular national market.

On the other hand, at least three nations--Ireland, Singapore, and Mexico--are positive examples of proactive regulatory policies and they are increasingly enjoying sustained results. Ireland's inward investment program accounts for 35% of gross domestic product, where [Euros]34 billion worth of intermediates and finished pharmaceuticals were exported in 2002. The continuous growth of Singapore's investment record is equally impressive, and Mexico's has been growing as well.[2]

While Ireland and Singapore predominantly used a mixture of subsidies, tax holidays, vocational training, infrastructure support, and particularly relief from administrative burden, Mexico mainly has allowed its northern neighbour, the United States, to participate in maquiladoras[3] to use its low-cost labour.

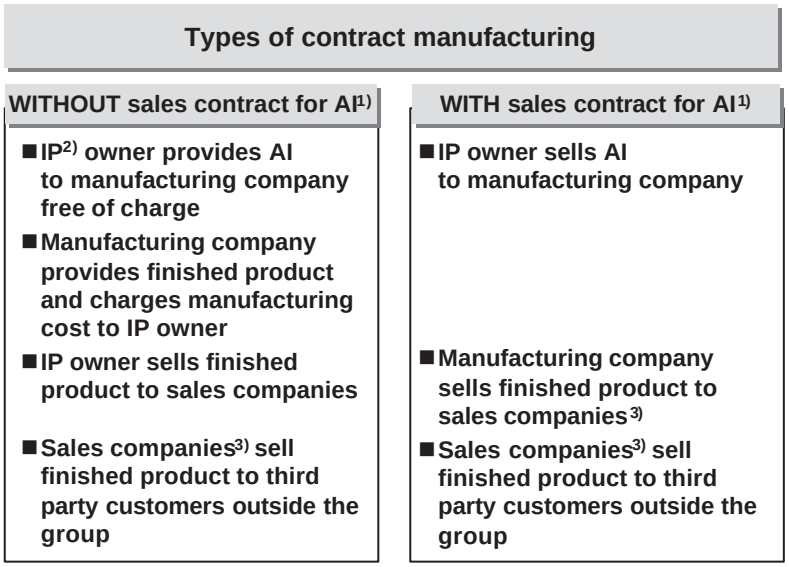
The increasingly global competition among manufacturers themselves requires them to continually analyze the comparative advantages of alternative locations to arrive at a long-term defendable strategic decision for the allocation of planned capacity. Mainly for reasons of a disparate recognition of the value added, resulting from foreign direct investment vs. national investment--which may also be from multinational subsidiaries' cash flow and therefore be from a foreign source--many Asian and Latin American countries have yet to realise what structural changes they will have to make in order to become competitive for strategically located state-of-the-art facilities serving the needs of world markets.

Nation states interested in attracting new or expanding already existing foreign direct investments would benefit by reviewing their regulatory policies if they wish to become a respected partner for privately financed investments. An important competitive advantage to positively tip the balance of investment decisions is a lack of red tape[4] (tariff and non-tariff barriers to trade and investment)[5] especially in the area of transfer pricing.[6]

This article describes a unique business model for contract manufacturing in the chemical, pharmaceutical, and biotechnology industry in combination with consignment stocks that is designed to provide an understanding of the options already available to multinational companies in most of the developed world.

## Objectives of the Model

Multinational group companies of the chemical, pharmaceutical, and biotech industry have a peculiar transfer pricing problem to solve: For most of them their major cost element is geared towards research and development (R&D) activities, which are to be accounted as sunk cost in the year of expenditure. This is because it is inherently impossible to safely predict the outcome of any research activity. Actually, more than 75% of research projects never lead to any marketable product.[7] Therefore, any valuation effort of the embedded intellectual property rights in marketable active ingredients and therewith any attempt of a R&D cost allocation to products sold must remain futile or lead to arbitrary conclusions.




1) AI: Active Ingredient 2) IP: Intellectual Property 3) IP owner or its subsidiaries

**Figure 1**

To limit the resulting significant transfer pricing risk exposure, multinational group companies operating in the chemical, pharmaceutical, and biotech industry need a low-risk solution.

The model's objectives are to:

1. limit transfer pricing exposure risk;

2. implement contract manufacturing;

3. make use of consignment stocks; and

4. generate free capital for investments.

# Limiting Transfer Pricing Exposure Risks

In this scenario, a corporate group of companies each specializes in certain functions and therefore accepts certain risks. Any transfer of tangible and intangible goods or services creates a valuation and pricing requirement as well as associated risks that require transparent corporate guidance to limit a potential risk exposure. For instance, only during post-merger integration exercises did management find that products have "changed hands" up to 18 times between corporate group companies, thereby creating the need to properly analyse, value, price, document, and defend each of the 18 transfer conditions in view of the respective functions and risks of the selling and the purchasing group company.

The model proposed in this article aims at limiting--where possible--product sales between group companies. Particularly, active ingredient sales are to be restrained because they have been and are becoming increasingly the focus and risk of transfer pricing audits. Lacking the expertise to discern the facts and circumstances of creating and ignoring the uniqueness of most chemical, pharmaceutical, and biotech active substances, auditors are often quick to present inadequate comparators. Since the basis for defense of active ingredients' prices is seen to be weak in principle, the alternative model proposed below should be considered. It avoids the inherent

arbitrariness in the valuation of intangible properties embedded in active ingredients. The model suggests not to sell active ingredients between companies of a corporate group and demonstrates an alternative mode to thereby limit the transfer pricing exposure risks.

# Implementing Contract Manufacturing

Various terms, such as toll manufacturing and loan manufacturing, are used for specialised, mostly secondary[8] manufacturers offering their production know-how and services. Here the all-encompassing term "contract manufacturing" is used with a clear definition of its role and responsibilities.

For the purposes and virtues of this model, distinction is being made between an intellectual property owner transferring active ingredients with or without a sales contract.

**With a sales contract.** If the intellectual property owner sells the active ingredient to the group manufacturer, the latter gains title and full ownership. The manufacturing company applies facilities and production know-how to make the finished product, and eventually sells the finished product in its own right to sales companies around the world. The group sales companies, having acquired title and ownership via a complex and therewith a potentially risk-prone transfer pricing concept, then sell the finished product to third-party customers outside the corporate group.

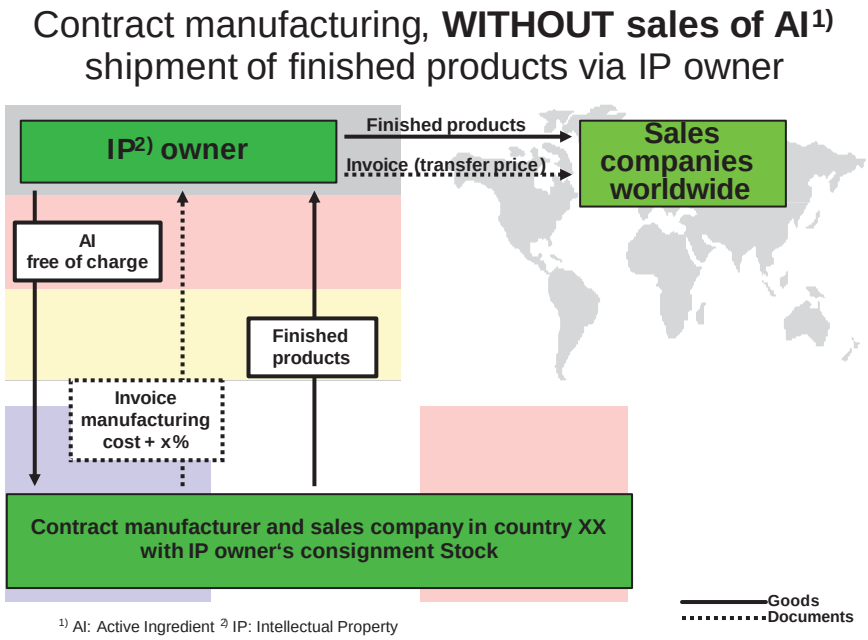



**Figure 2**

**Without a sales contract.** The other case is that of an intellectual property owner, having devoted long-term research and development efforts towards marketable active ingredients. It then provides the active ingredients free of charge to the corporate group's specialised manufacturing company. The latter takes on the role as a true contract manufacturer, i.e. no change of title or ownership of the active ingredients of the intellectual property takes place. The contract manufacturer's facility and production know-how is applied to make the finished product available to the intellectual property owner. The contract manufacturer invoices its manufacturing cost on a cost plus basis. The finished products then are sold by the intellectual property owner to the corporate group's sales companies. In turn, the sales companies sell the finished products to third-party customers outside the corporate group.

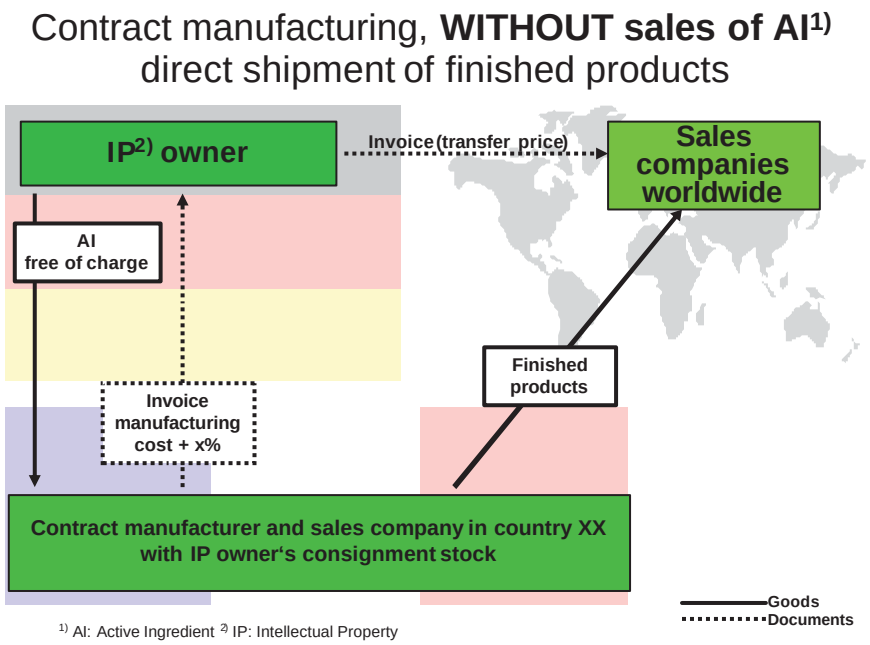



**Figure 3**

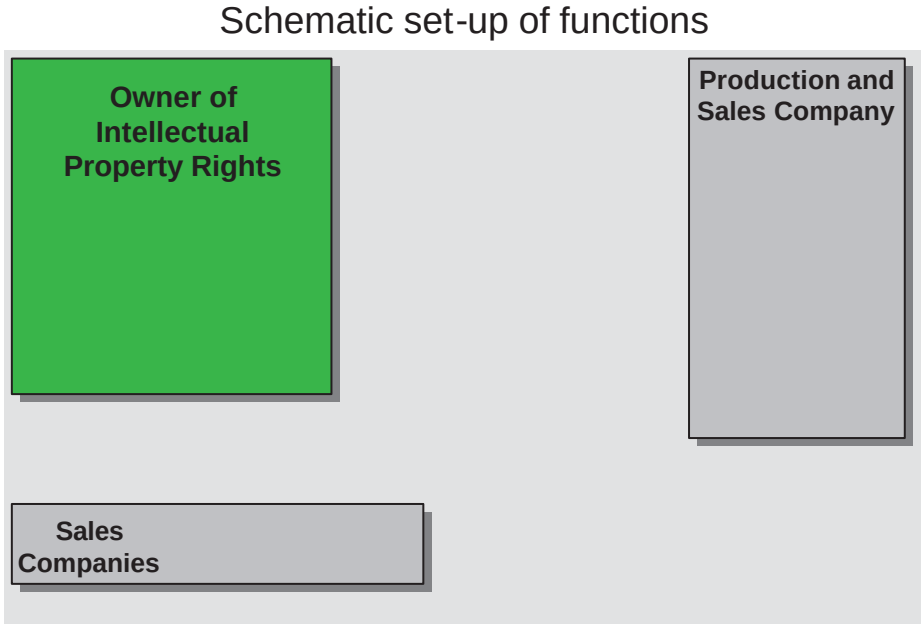



**Figure 4**

Transfer of Active Ingredients

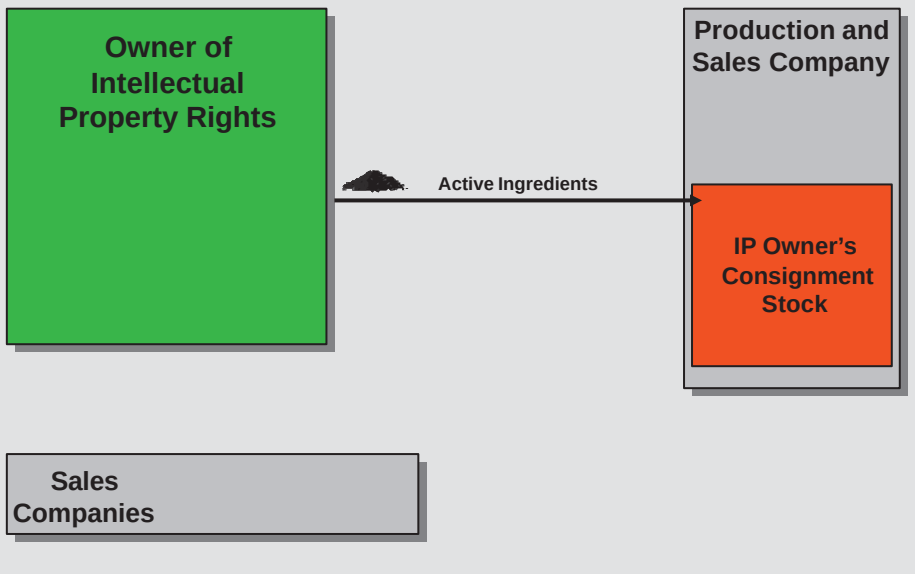



**Figure 5**

Contract Manufacturer retrieving Active Ingredients from Consignment Stock

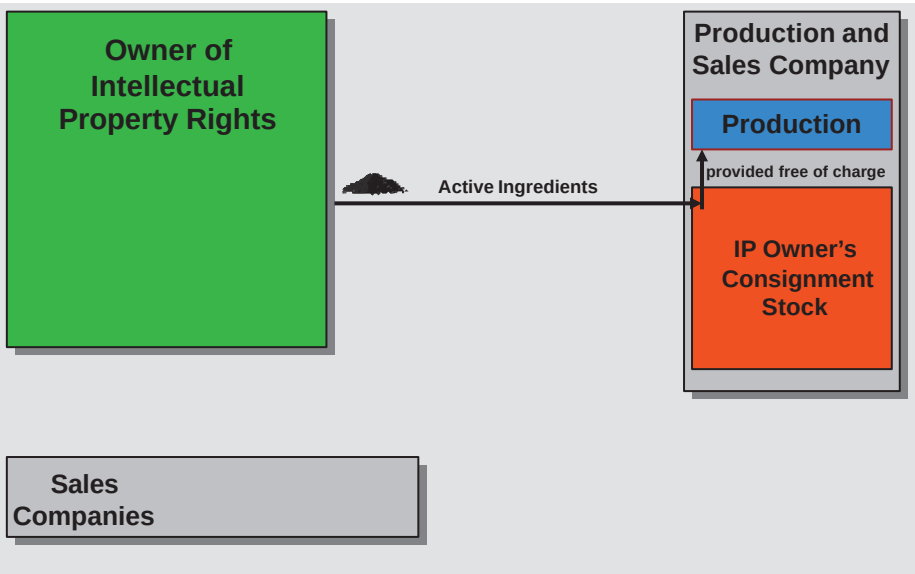



**Figure 6**

# Use of Consignment Stocks

Ideally, the intellectual property owner maintains a consignment stock at the sites of both the contract manufacturer as well as at those of the sales companies.[9]

The aim from a transfer pricing perspective is that title change occurs only when a non-arbitrary and transparent valuation of the products sold can be assured. In the case of the intellectual property owner transferring active ingredients into consignment stock and the contract manufacturer retrieving it free of charge, the applied know-how and production services can transparently be charged for on a cost plus basis.

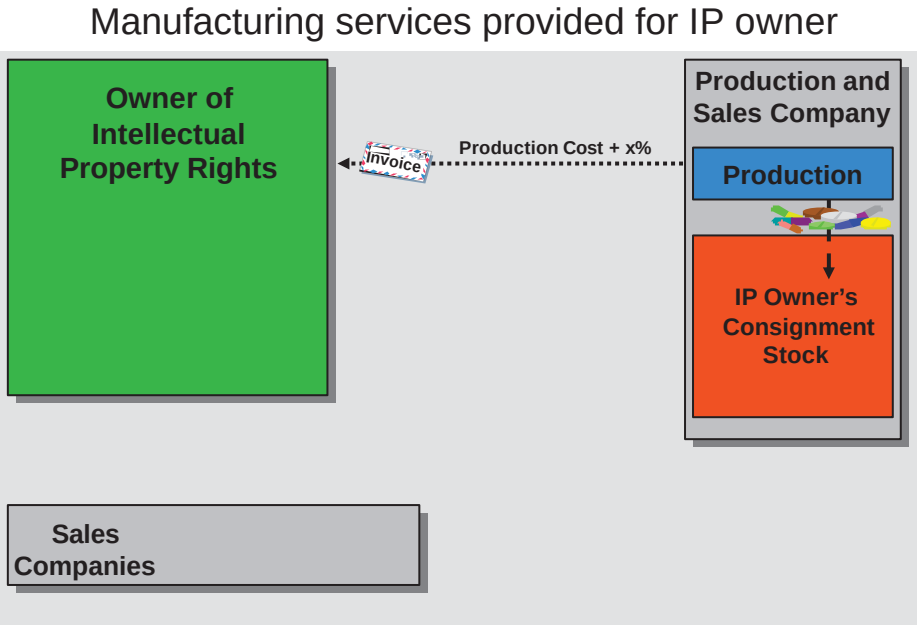



**Figure 7**

Upon having secured the finished product, the contract manufacturer places this into the intellectual property owner's consignment stock for finished products, which may then be dispatched upon request to the intellectual property owner (see Figure 2), which in turn exports the finished product to the sales companies of the group. Invoicing of finished products to the sales companies worldwide can be transparently effectuated by applying the resale price method.

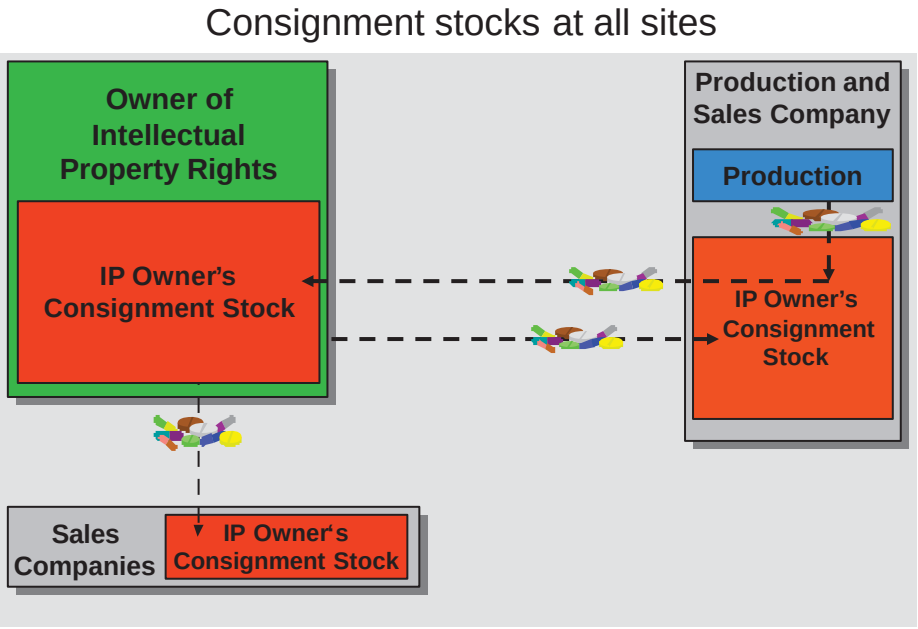



**Figure 8**

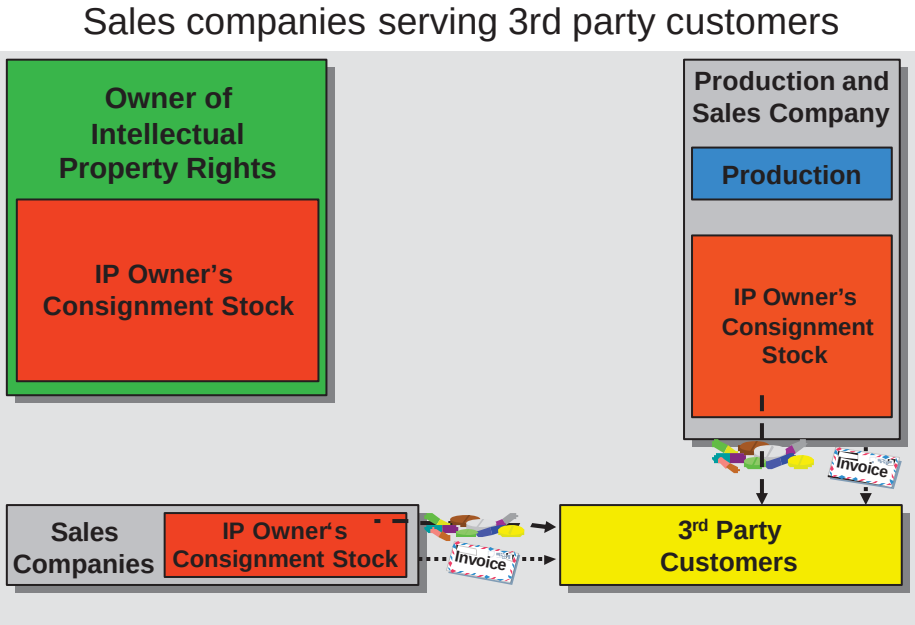



**Figure 9**

Alternatively (see Figure 3), the intellectual property owner may direct the contract manufacturer to dispatch the finished products directly to the sales companies of the group worldwide, with the intellectual property owner then invoicing the sales companies by again applying the resale price method.

Figures 4 though 12 show a step-by-step description of the value chain.

In Figure 4, the owner of the intellectual property rights has residence in Country 1, a Production and Sales company of the corporate group in Country 2, and various sales companies around the world in Countries 1 - 1xx.

In Figure 5, the owner of the intellectual property rights transfers active ingredients into its consignment stock at the site of the Production and Sales company in Country 2.

In Figure 6, the Production company, acting as a true contract manufacturer, retrieves from the intellectual property owner's consignment stock the active ingredients to perform the production services.

In Figure 7, the contract manufacturer then places the result of its services, the finished products, into the intellectual property owner's consignment stock and sends an invoice to the intellectual property owner for its production cost and a negotiated margin.

Figure 8 shows that the intellectual property owner maintaining consignment stocks ideally at all sites of the group companies, especially those with the function of selling the finished products to third parties in their respective markets. To assure the availability of finished products in all countries and to avoid any out-of-stock situation, the intellectual property owner maintains a logistic function to move stock from manufacturing sites to its consignment stock at the sites of the sales companies.

In Figure 9, the sales companies retrieve products from the consignment stock at their location and therewith take title to fulfill orders of third parties in their respective markets. They send accompanying invoices with certain terms of payment.

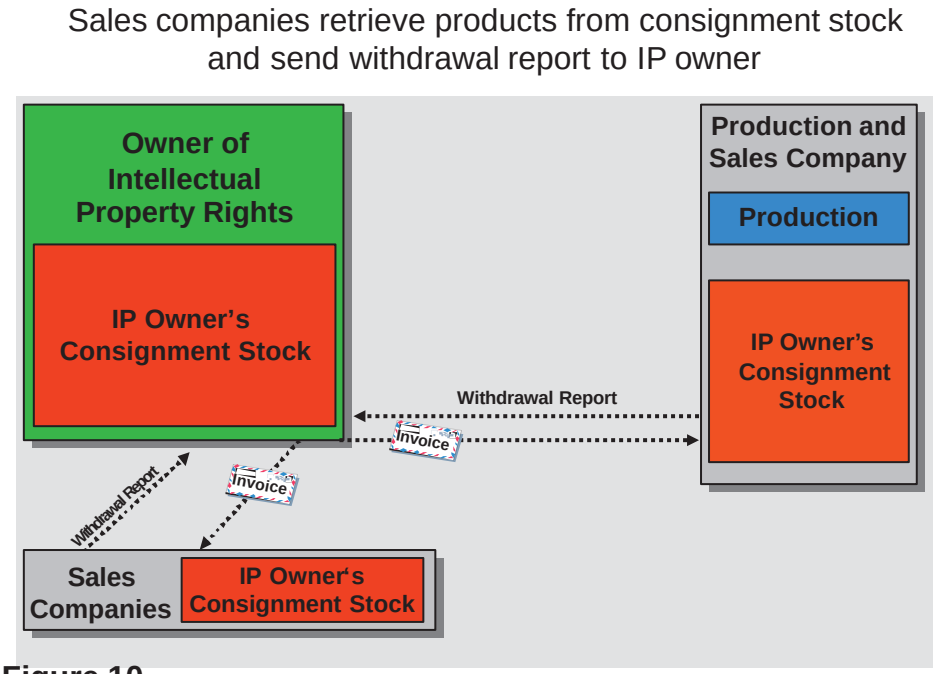



**Figure 10**

At Figure 10, sales companies are sending a withdrawal report at month-end to the intellectual property owner and receive a corresponding invoice with certain terms of payment.

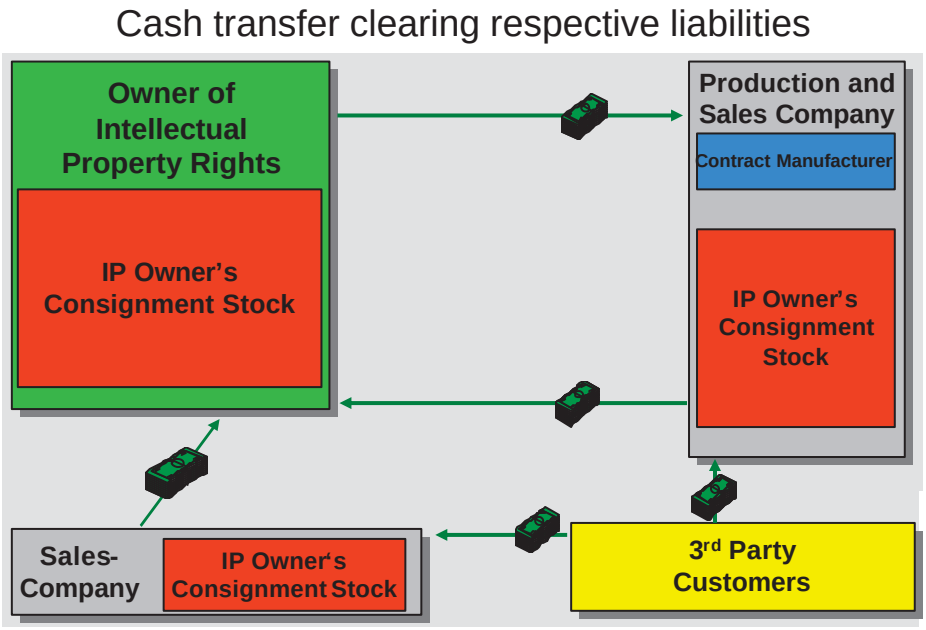



**Figure 11**

The final step, shown in Figure 11, is effectuated when cash changes hands, i.e. when:

- third-party customers have transmitted payment to the sales companies;
- group sales companies in turn having paid the intellectual property owner for the finished products withdrawn from the consignment stock; and
- the intellectual property owner has cleared the liability with the contract manufacturer for the production cost and the agreed-upon margin.

The business model with all steps

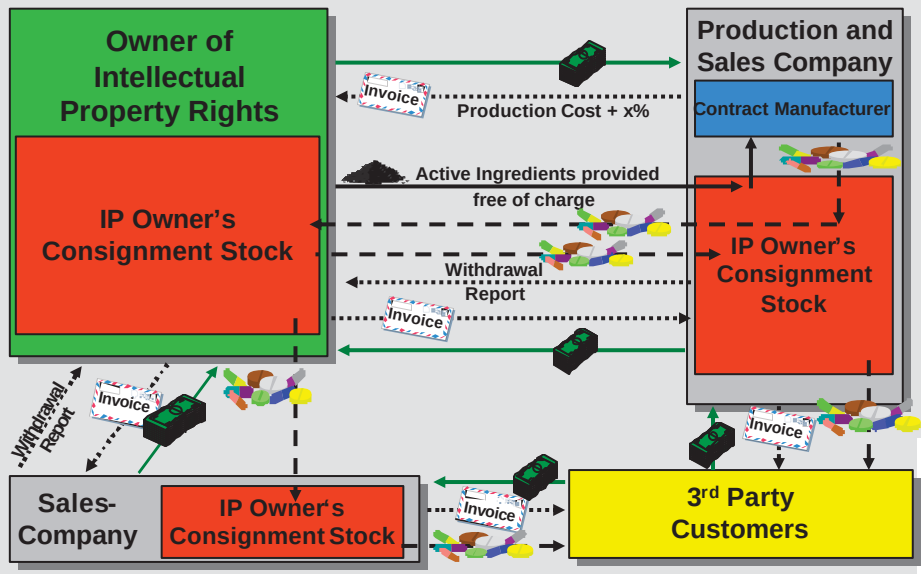



**Figure 12**

Figure 12 shows the complete business model with all steps.

The rather complex chart, "Freed-up capital for investments," at Figure 13 shows a cash flow comparison of the two alternatives:

**A.** selling the active ingredient (Sale of AI), or

**B.** not selling the active ingredient within the corporate group (NO sale of AI).

Clearly, chemical, pharmaceutical, and biotech companies are faced with time consuming processes of providing active ingredients to its secondary manufacturers and eventually finished products to the sites of the sales companies worldwide, which is indicated here with an average period of ten months.

***Alternative A--Sale of AI.*** pictures the situation when an intellectual property owner may be required to sell the active ingredient irrespective of the transfer pricing risk exposure. This incurs an income tax liability for the sale at the very beginning of the value chain. The corresponding profit via the sale of the finished products to the first third-party customer outside the corporate group may on average be realised only some ten months later.

***Alternative B--NO Sale of AI.*** pictures the situation where through the use of a group contract manufacturer title change of active ingredients does not occur and title and ownership transfer from the intellectual property owner to the sales companies of finished products takes place only at the time third-party customer orders are filled.

Experiences within a corporate group have shown that a calculation of imputed interest derived from matching the sale of finished products to the first customer outside the group and the corresponding tax liability occurring at that time amount to significant freed-up capital for alternative investments. Depending on the size and currency of intra-group transactions, this U.S. dollar, Euro, or Pound Sterling amount may be a three digit million figure annually. This freed-up capital--plus additional savings from reduced transaction costs--is continuously available and increasing under the proposed business model with the growth of sales.

# Advantages, Practical Issues

The advantages of the model are considerable.

From a transfer pricing point of view, transparent and defendable methods may be applied. The intellectual property owner is the high risk-taker who allows for cost coverage and appropriate profit margins of group companies, which provide for routine secondary manufacturing and sales functions. Appropriately, the cost plus and the resale price methods are respectively applied. The intellectual property owner then seeks compensation

for undertaking his non-routine, high-value added functions and the bearing of the associated risks with the residual profit from current sales to its sales subsidiaries.

Because active ingredients are not sold between group companies, additional layers of transfer pricing analyses are avoided. Therefore, attempts to arbitrarily value the embedded intellectual property rights in active ingredients and therewith a non-defendable allocation of R&D cost to products sold is prevented.

The advantages of the model from a financing point of view will be well recognised as profits will be accounted for only when actually realised, so that the income tax liability occurs when profit is really earned by sales of finished products to the first third-party customer outside the group.

By aligning sales to third parties with the occurrence of the related income tax liability significant free capital for alternative investments can be secured. Depending on the size of current and planned intercompany sales and the length of time of the respective intercompany value chain, the freed-up capital potential is large, available continuously, and growing with sales. Additionally, considerable savings resulting from reduced transaction costs in various currencies will be realised.

There are, however, some practical problems to be considered. Transfer prices for active ingredients are still needed in some countries for customs purposes and for export and import statistics and many countries do not yet fully understand the benefits of such a fully fledged contract manufacturing model.

In addition, inventory control of consignment stocks require additional IT support and import procedures from consignment stock for national markets require analysis and solutions of permanent establishment and value added tax issues.

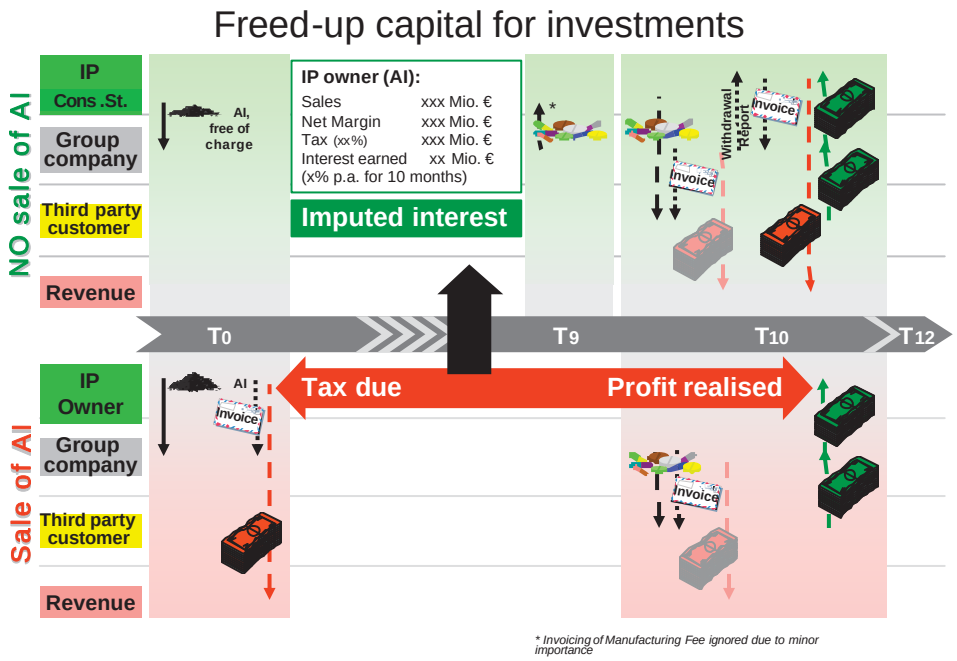



**Figure 13**

# Conclusion

The schematically described contract manufacturing model is an economically advantageous alternative for R&D performing chemical, pharmaceutical, and biotech multinational corporations and the nation states in which they are investing. The intellectual property owner--providing without a sales contract--active ingredients to its secondary manufacturing companies and establishing consignment stocks at the sites of manufacturing and sales companies may transparently apply the cost plus method for secondary manufacturing processes and the resale price method for sales of its finished products.

Multinational enterprises are prepared to invest in state-of-the-art secondary manufacturing facilities for not only national or regional but also for the global supply of products. Therewith, they would be providing for a strategically set competence center with the long-term creation of new jobs at high world standards together with inducing procurements from existing or new suppliers and service providers.[10] For globally oriented companies, such an

investment decision could provide economies of scale advantages[11] for the supply chain management and particularly a significantly reduced risk exposure resulting from a transparent and defendable transfer pricing system.

It is hoped that this schematic description of the business model produces an incentive also for nation states to clarify for themselves[12] the potentially significant advantages by becoming a more attractive partner for foreign direct investments.

---

[1] A question coined by Prof. C.K. Prahalad, then at INSEAD--the international business school at Fountainebleau, France, see for instance: Prahalad, C.K. and Doz, Y., *The Multinational Mission: Balancing Local Demands and Global Vision*, New York: The Free Press 1987.

[2] *See* Industrial Development Agency Ireland, http://idaireland.com/home/index.aspx; Economic Development Board Singapore, http://www.sedb.com/; and Made in Mexico, Inc. htttp://www.madeinmexicoinc.com.

[3] Maquiladoras are assembly operations that are entitled to special customs treatment and whose assets may be up to 100 percent foreign owned and managed.

[4] The Organization for Economic Cooperation and Development's Red Tape Score Board project: *Manual for measuring Administrative Burdens in the Road Freight Industry*, dated July 2005, has been released as a template for other sectors, and of course nation states, to follow.

[5] See OECD Working Paper No. 432, *The Benefits of Liberalising Product Markets and Reducing Barriers to International Trade and Investment: The Case of The United States and the European Union*, dated 5/26/05, http://www.oecd.org/eco.

[6] Mainly due to unresolved disagreements about Brazil's rigid enforcement of its transfer pricing regulations based on fixed margin requirements, the German government early in 2005 saw it necessary to terminate the double taxation agreement that was in place for 30 years. See 13 *Transfer Pricing Report* 1230, 04/27/05.

[7] Only about 21 percent of drugs that begin phase I human trials are eventually approved for marketing. *See* Tufts Center for the Study of Drug Development, News & Events. http://csdd.tufts.edu/NewsEvents/RecentNews.asp?newsid=29. Accessed June 9, 2005.

Banik, M. and Westgren, R.E. (2004), "A Wealth of Failures: Sensemaking in a Pharmaceutical R&D Pipeline," *Int. J. Technology Intelligence and Planning*, Vol. 1, No. 1, pp. 25-38, (at p. 30).

[8] A secondary manufacturer is distinct from and follows the primary manufacturer--who is producing the active ingredients--with all subsequent steps towards providing the finished product.

[9] This concept has first been suggested in Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, International Bureau of Fiscal Documentation, 2003, p. 162, Appendix W12.

[10] The so-called "multiplier effect" is often overlooked: Suppliers and service providers are drawn by original investors to follow wherever they go and are therewith induced to invest themselves in order to maintain or expand their respective market share. See, for instance, Bramley-Harker, Edward, and Maunder, Simon, "The Contribution of the Pharmaceutical Industry in the London and Thames Valley Region to the Local and UK Economy," NERA Economic Consulting, London, April 2004.

[11] The basic criterion for any investment decision carries greater weight for state-of-the-art plants costing more than $300 million and their use for global supplies of goods. See "Climbing the helical staircase--A survey of biotechnology," *The Economist*, March 27, 2003.

[12] Further guidance is provided by Attridge, C. James, and Preker, Alexander S., *Improving Access to Medicines in Developing Countries, Application of the New Institutional Economics to the Analysis of Manufacturing and Distribution Issues*, The International Bank for Reconstruction and Development at The World Bank, Washington,

D.C., March 2005.