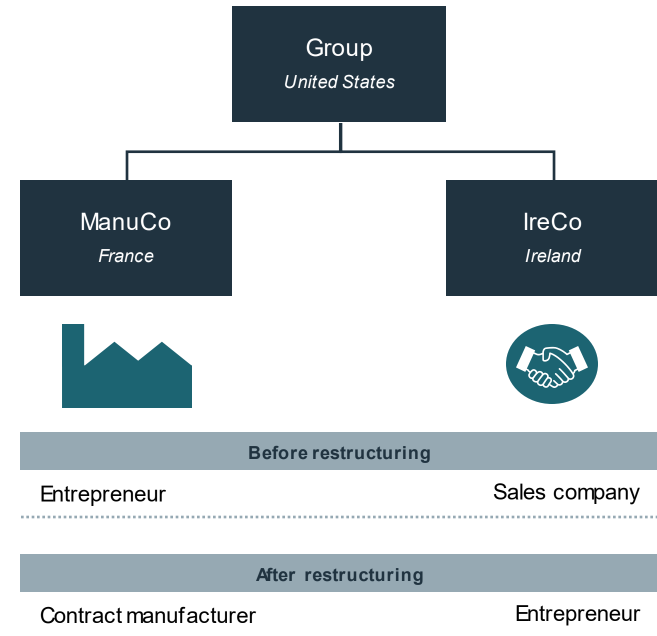
The Case

- A French manufacturing company ('ManuCo') deploys a production facility that forms part of a US multinational commodity group.
- The products are sold by an Irish company ('IreCo') that is remunerated based on the transactional net margin method with net profit indicator sales ('TNMM Sales').
- The group wishes to centralise production and sales planning in Ireland with ManuCo becoming a contract manufacturer, remunerated based on the TNMM with net profit indicator costs ('TNMM Cost'), and IreCo becoming the central entrepreneur, reporting the residual profit.
- For the business restructuring to be at arm's length, the post-restructuring situation should be among the best options realistically available to ManuCo.
- Under a traditional benchmark approach, ManuCo's post-restructuring profit would show a dramatic decline, resulting in a significant risk of exit taxation in the France.



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The Challenge

- The Group wishes to ensure that the restructuring does not result in French exit taxation but that the post-restructuring transfer prices also reflect ManuCo's changed risk profile in which ManuCo is no longer exposed to price volatility of raw material and end-products.

- Exit taxation?
- Arm's length TNMM margin?

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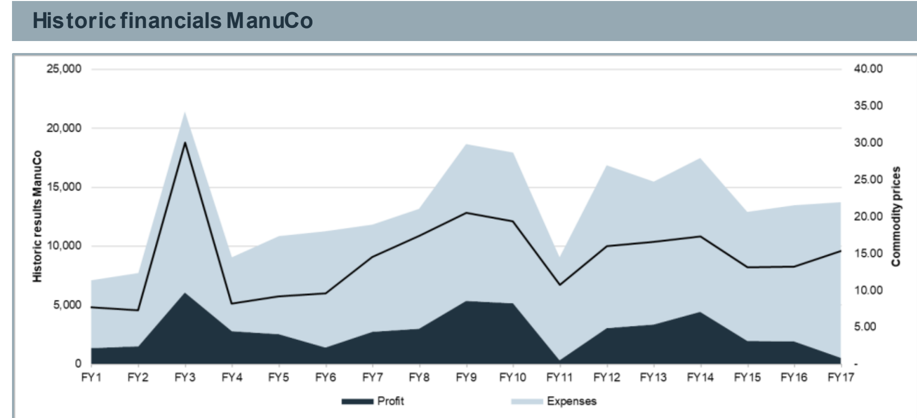
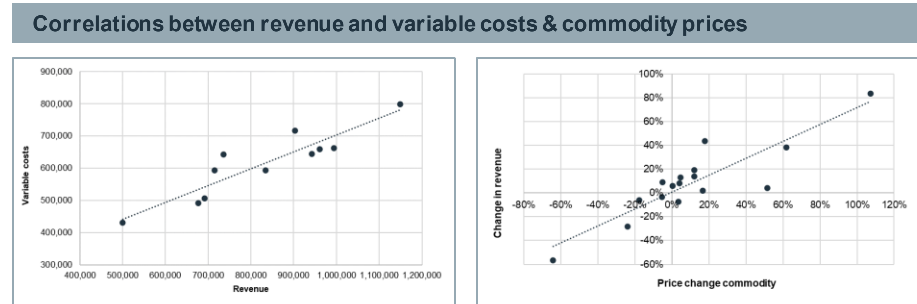
The Solution

- The solution started with an analysis of the historic correlation between price movements of raw materials, end-products and ManuCo's profits.
- The analysis revealed a high volatility in market prices for both raw materials and end-products.



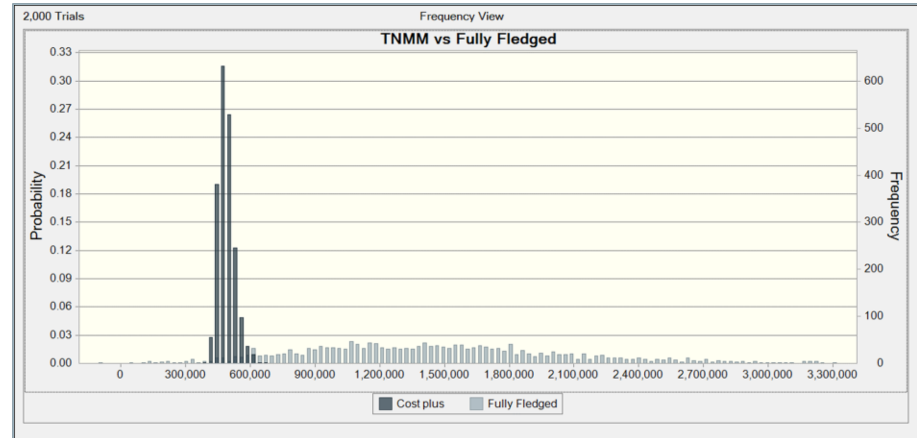
- The analysis also revealed a strong correlation between revenues, variable cost and commodity prices.



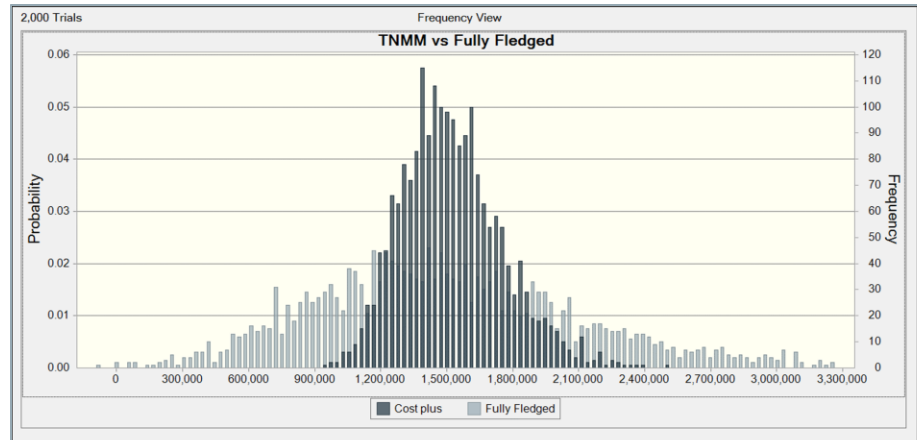
The Solution

- Subsequently the expected present value of ManuCo's forecast profits was simulated for the option in which ManuCo would remain a fully-fledged manufacturer and the option of it transforming into a contract manufacturer remunerated with the benchmarked TNMM Cost of 5%.
- The simulation revealed that with a 5% TNMM Cost margin, ManuCo would forgo upward profit potential compared to the fully fledged option (light columns right of dark columns), with an insignificant reduction of risk (see dark columns left of light columns). This confirmed a non-arm's length profit shift.
- To establish an arm's length mark-up level, the simulations were replicated, using different mark-up levels, generating a range of arm's length mark-up levels between 9% and 12%. The risk distribution graph indicates that the TNMM Cost with 9-12% mark-up appears an arm's length remuneration for ManuCo compared to the fully fledged option. At this level of margin, the forgone profit potential (light columns right of dark graph) outweighs the cut-off lower profit levels (left of dark graph).
- Based on the analysis, the Group decided to set the mark-up at 9%, thus avoiding the risk of transfer pricing disputes while at the same time stabilising ManuCo's profits.

Comparison TNMM Cost 5% and fully-fledged



TNMM Cost margin: 9%-12%



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