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Argentina

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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?

To provide the relevant background for our response, we identify two transfer pricing models used by manufacturing MNEs with centralized headquarters operating as original equipment manufacturers (“OEMs”) and contract manufacturing subsidiaries in multiple countries.

The first one is the so called “centralized” operating model, in which the local subsidiaries are deemed to be low-risk manufacturing affiliates, entitled to routine income (little but somewhat guaranteed profit), while the foreign headquarters pick up the full bulk of the residual profit, including full compensation for centrally developed intangibles. Under such a paradigm, only the foreign headquarters is exposed to the key entrepreneurial risk-taking functions.

The second model is the “decentralized” operating model, with results which may appear contradictory to the previous one. Under this model, regional subsidiaries are considered entrepreneurial entities that, despite sourcing their centralized supporting services and know-how from the MNE`s headquarters, are exposed to material risks and functions, such as inventory, foreign exchange, manufacturing, and procurement. Further, such subsidiaries may even license some technology to other affiliates and may also perform material functions in developing centralized MNE intangibles in a synergetic interaction with the foreign headquarters.

The Argentine tax authorities are certainly biased against the so called “centralized model,” which is deemed to disregard the material risks and functions that the local MNE subsidiaries are usually exposed to. For this reason, such model is a regular source of conflict with the Argentine Revenue Service (“ARS”). This was the case during the Covid-19 pandemic, during which the tax authorities scrutinized whether there was actual consistency between tax losses attributed to low-risk or limited-risk domestic subsidiaries that could evidence a material incoherence with the original functional analysis (i.e., the one of “low but guaranteed profits”). For example, such a bias underlies the ARS document on recommendations for the transfer pricing analysis for the fiscal years impacted by the COVID-19 pandemic.

Conversely, the so called “decentralized” model that better preserves the materiality of the roles and functions performed by the domestic subs of the MNEs is the clear preference of the ARS. Nonetheless, in either case, proper implementation of the relevant transfer pricing model is the key to avoiding tax controversies. For example, while full-fledged contract manufacturing written agreements are usually

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avoided, such transfer pricing models are better implemented by means of a careful selection of target comparables, with a consistent elaboration as to their assets, risks, and functions vis a vis the tested party.

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 mentioned above, proper selection of the set of comparables is key to a successful implementation of the contract manufacturing approach. In Argentine tax practice, toll manufacturing is certainly not common in the cross-border context, as compared to the purely domestic one. However, there is a common practical denominator for both manufacturing models: even in such a local scenario, the tax authorities and the courts do preserve the materiality of the roles and functions performed by the toll manufacturer, as it is illustrated in state tax controversies.

The fact that the contract manufacturer provides the plant, machinery, equipment, and labor force and procures its own raw materials for the production process, requires pondering such roles and functions in the appropriate selection of comparables.

b. Adjustment for a contract manufacturer with capital intensive operations;

While the contract manufacturing approach is the choice of the car manufacturing industry in Argentina, and it is well tested in the courts after more than 20 years of tax controversies, the use of capital-intensive comparability adjustments has not been tested in the court. This is certainly not the case with capacity utilization, as will be explained below.

c. Capacity utilization for the contract manufacturer and implications for transfer pricing;

The successful implementation of capacity utilization adjustments evidences how resident contract manufacturers are exposed to material risks, as mentioned above concerning the "decentralized" approach.

However, local courts have been somewhat erratic in accepting idle capacity adjustments, making robust documentation and proper implementation critical. For example, in the *Dart Sudamericana S.A.*[1] case ("*Dart*"), the Tax Court upheld the ARS assessment since the taxpayer argued that recurring losses were the result of an economic downturn cycle but did not provide proper evidence. In addition, while Argentine MNEs may be allowed to segregate extraordinary losses on their financial statements in special circumstances to ensure a better comparability with the market set, the Court ruled that the taxpayer had failed to substantiate it properly. In the Court's opinion, a grounded capacity adjustment requires evidencing the theoretical maximum production capacity, the regular production amount, and the actual production figure during the economic downturn, which should be properly compared with the set of comparables.

[1] *Federal Tax Court, Chamber "A", March 30, 2023.*

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Conversely, grounded documentation supporting such loss-segregation adjustments was upheld for the car industry in a number of cases, like in the one involving *Scania Argentina S.A.*[2] ("*Scania*"), in which the Court fully sided with the company. The taxpayer properly elaborated its idle capacity adjustment in its transfer pricing study, which was subsequently defended in the Court through economic, accounting, and engineering witness experts' analysis. Such experts consistently concluded that the extraordinary losses were the consequence of material fixed costs that could not be set off against the reduced sales volume resulting from an unprofitable business cycle. For the Court, such a negative business cycle was properly evidenced, as well as the governmental policies that adversely affected the car manufacturing industry, in the context of a regional economic downturn.

The Tax Court also places a heavier burden of proof on the party that provides less substantiated transfer pricing reports. For example, in *Dart*, the Tax Court maintained that a taxpayer may not make unilateral loss-segregation adjustments unless it proves that the comparables did not experience similar extraordinary losses. The outcome is contrary to the one reached for the car industry, which has been historically more diligent at the time of substantiating idle capacity or similar loss-segregation adjustments.

d. Any other considerations.

The OECD Base Erosion and Profit Shifting (BEPS) Action Plans, as well as Pillars One and Two create new challenges that shift the perspective on how transfer pricing will be viewed going forward. The OECD's Pillar Two initiative, which aims to establish a global minimum effective tax rate of 15%, is a new deterrent for profit shifting. In fact, such initiatives are transforming transfer pricing from being a straightforward documentation compliance exercise to a strategic design that demands planning in anticipation of potential pitfalls for any MNE.

3. What are the transfer pricing implications of government subsidies or grants in contract manufacturing?

In your response, consider 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.**

As mentioned above, the car manufacturing industry has historically adopted the contract manufacturing approach but with a degree of business risks accruing on the local manufacturing entities that, under a decentralized model, are supposedly in control of such risks. In this case, in the presence of governmental subsidies there has been no discussion as to passing the subsidies on to the foreign consignor. Conversely, the local contract manufacturer has retained the upside and, consequently, the associated downside, as illustrated by Argentine case law.

In this regard, in the leading case Toyota Argentina SA vs. AFIP, Federal Supreme Court 9.2.14, the car manufacturing industry succeeded in excluding from the operating results tax subsidies promised by

[2] *Federal Tax Court, Chamber "A", April 17, 2023.*

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the government, who failed to comply with them, thus triggering extraordinary losses on the domestic manufacturing industry. In this regard, Toyota was allowed to segregate extraordinary losses in their financial statements to make them comparable with the market set. Toyota's first comparability adjustment was focused on idle capacity, i.e., losses resulting from fixed costs that could not be set off against the reduced sales volume resulting from an unprofitable business cycle. The ARS challenged the adjustment, arguing that the tested party may not make unilateral loss-segregation adjustments, unless it proves that its comparables did not experience similar extraordinary losses. However, like in the Scania case, the Court sided with Toyota, since the company`s expert witness was able to demonstrate the negative cycle that the company experienced and measure the magnitude of the resulting extraordinary loss by comparing actual production with the regular one, which was not achieved because of the economic downturn. As relevant to this question, the second adjustment made by the taxpayer consisted of segregating extraordinary losses resulting from a governmental subsidy that was not finally honored, thus burdening the manufacturing company with abnormal expenses. The Court sided with the taxpayer on this matter too, since it found that the company had demonstrated that the government had never paid the subsidies to the company, thus triggering extraordinary losses that would have rendered the tested party not comparable with the market set unless such losses were segregated in the tested party´s financial statements. Such extraordinary losses would be segregated to the extent that the comparables would either not have them or experience them in less material figures.

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.

Foreign exchange risks resulting from financial expenses are typically borne by the domestic contract manufacturer, who must account for them mandatorily, in view of the Corporate Income Tax provisions. Foreign exchange expenses must be accounted on a cash basis when they result from related party financing or under the accrual principle, when they result from unrelated party financing. This ITL mandatory outcome is another example of the kind of risks accruing on the local manufacturing entities.

Being clear that such risk remains on the local manufacturing entity, recent case law illustrates that one car manufacturer, Volkswagen Argentina, went even further to improve its operating income by summing up discharge of indebtedness income from related-party financing. The Tax Court agreed with the taxpayer, on the basis that the loan proceeds were used to improve the local manufacturing plant. However, the Supreme Court recently took the side of the ARS, maintaining that such income has a financial nature, thus being improperly computed as operating income.

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