



Impact of legal ownership of expensive inventory on PLI – Part I

November 2025

Reading time: 15 minutes

In this two-part blog, we analyze a recent case¹ from the Czech Republic dealing with the impact of legal ownership of high-value material used in the production process on the arm's length remuneration of a contract manufacturer. Part I of this blog comprises a detailed analysis of the case, along with our key observations, while Part II comprises a summary of the case, followed by a (theoretical) analysis of the allocation of burden-of-proof under Dutch law, i.e., as if the Czech case were a Dutch case.

Case overview

Inventec CZE s.r.o. ("Inventec CZ") is a wholly owned Czech subsidiary of Inventec Corp., Taiwan ("Inventec TW"). In 2013, Inventec CZ purchased materials worth EUR 680 million from Inventec TW. Inventec CZ used the materials to manufacture server cabinets for Hewlett-Packard ("HP"), an unrelated party. The terms and conditions of the sales contracts with HP were negotiated and agreed upon by Inventec TW.

A notable feature of this case is the high value of the materials purchased by Inventec CZ from Inventec TW, which amounted to CZK 16.7 billion (approximately EUR 680 million at the prevailing exchange rate in August 2025). These purchases represented about 91% of Inventec CZ's total costs. Consequently, the ratio of cost of goods sold ("COGS") to operating expenses ("OPEX") was significantly higher than that observed in comparable manufacturing companies.

Inventec CZ claimed that acquiring the high-value materials from Inventec TW was a formal requirement with no substantive impact on the economic characterization of its activities. It maintained that it operated as a contract manufacturer, performing narrowly defined production tasks, which ought to be considered routine. Despite being carried out on high-value materials, Inventec CZ claimed that its activities did not involve substantial value creation. Inventec CZ contended that all risks related to the materials were borne by Inventec TW, which retained control over material flows and key decisions.

Accordingly, Inventec CZ argued that it should be remunerated at a cost-plus on operating expenses, excluding material costs. In its transfer pricing, Inventec CZ applied the transactional net margin method ("TNMM"), using operating expenses (9% of total costs) as the profit level indicator ("PLI"). Under this approach, Inventec CZ excluded EUR 680 million of material costs from its value-adding base.

Following a tax audit, the Czech tax authorities ("CTA") challenged Inventec CZ's transfer pricing. The CTA concluded that the pricing arrangements between Inventec CZ and Inventec TW did not comply with the arm's length principle. The CTA agreed that Inventec CZ displayed some characteristics of a contract manufacturer but argued that, if independent, it would have included a markup on materials it took ownership of. Consequently, the CTA applied a markup on the total OPEX and COGS.

¹ Czech Republic vs Inventec s.r.o., Case No 29 Af 56/2022

This led to an additional corporate income tax (“CIT”) assessment of CZK 68,744,660 (approximately EUR 2.8 million at the August 2025 exchange rate) and a penalty of CZK 13,748,932 (approximately EUR 0.5–0.6 million). Inventec CZ appealed the assessment, disputing, in particular, the use of the return on total costs (“ROTC”) as PLI, which incorporates material costs, instead of its preferred PLI - return on value-added costs (“ROVAC”), defined as profit relative to total costs minus material costs.

Therefore, the central issue in dispute was about the appropriate PLI: the ROTC method (profit/total costs) used by the CTA versus the ROVAC method (profit/[total costs - material costs]) advanced by Inventec CZ. In the first instance, the Regional Court in Brno overturned the CTA’s decision and remanded the case for reconsideration. Upon review, the CTA revised its position by applying a reduced profit margin to material costs, reflecting a functional split between Inventec CZ and Inventec TW.

The CTA concluded that Inventec CZ contributed 24.62% and Inventec TW 75.38% to the functions, risks, and assets associated with material ownership during production. The profit mark-up was therefore adjusted to 24.62% of the market ROTC margin determined for comparable independent entities. As a result, the additional tax was reduced to CZK 13,969,940 (approximately EUR 0.5–0.6 million), with the penalty reduced to CZK 2,793,988 (approximately EUR 0.1 million). Inventec CZ subsequently appealed this revised assessment.

Taxpayer’s position

Inventec CZ explained that, although it formally acquired ownership of the materials and recorded the purchase, the procurement of these materials was managed by Inventec TW in close coordination with HP. The purchase of materials was described as a formal act with no substantive impact on the nature of Inventec CZ’s business. According to Inventec CZ, the same manufacturing process could have been undertaken even without the formal purchase of the materials (as has been the case since 2021). In its view, all risks associated with the materials were borne by Inventec TW, which exercised control over material flows. Inventec CZ argued that its remuneration should be limited to a surcharge on the operational costs incurred for production and related functions, excluding the cost of materials.

Inventec CZ further argued that the CTA’s transfer pricing analysis was incorrectly based on ROTC. Although the CTA moderated its original approach by reducing the profit mark-up to 24.62% of the market ROTC margin determined for comparable independent entities, Inventec CZ contended that this adjustment only reduced the numerical impact without addressing the methodology. The fundamental difference between the positions of the CTA and Inventec CZ derives from whether the formal ownership of materials implies the assumption of the associated risks. In support of its position, Inventec CZ stated that Inventec TW bore the risks related to the materials. It referred to evidence such as the re-invoicing of damages, insurance contracts for materials concluded by Inventec TW and a liquidity analysis of Inventec CZ. Inventec CZ emphasized that it did not possess the financial capacity to bear the risks related to the ownership of materials. It argued that, even though it had accounted for materials worth CZK 16.7 billion in 2013, it was unrealistic to expect that Inventec CZ had the liquidity to assume the related risks.

Interestingly, during the court proceedings, Inventec CZ submitted TP documentation that indicated a division of functions and risks between Inventec CZ and Inventec TW in ratios of 19:11 and 16:5, resulting in an overall split of 35:16, corresponding to 68.63% for Inventec TW and 31.37% for Inventec CZ. However, Inventec CZ consistently maintained that this outcome was distorted because it considered functions and

risks associated with the ownership of the materials, which were reflected in the TP-documentation/functional analysis as a separate item, “Assets - Production material”.

Position of the tax authorities

The CTA clarified that it had not assigned all risks to Inventec CZ. It had instead examined the distribution of risks between Inventec CZ and Inventec TW and subsequently quantified the allocation to adjust the PLI. Regarding Inventec CZ’s financial capacity to assume risks and its liquidity position, the CTA asserted that the apparent lack of liquidity resulted from imbalanced pricing between Inventec CZ and its parent company. This pricing, in the CTA’s view, reduced Inventec CZ’s income while increasing the profits of Inventec TW. Regarding the application of the full-cost indicator (ROTC), the CTA argued that this was the more appropriate approach. It maintained that the materials in question not only formed part of Inventec CZ’s assets but were also linked to processes and activities that entailed certain risks. According to the CTA, these risks should be reflected in the calculations to some extent rather than being excluded entirely.

The CTA contended that its approach was sufficiently substantiated and did not constitute an inadmissible practice under the OECD Transfer Pricing Guidelines (“OECD TPG”). It maintained that including the risk, function, and asset quantification results in the subsequent step to determine the final mark-up did not undermine the transfer pricing method’s reliability compared to applying an alternative PLI. According to the CTA, its approach accounted for a broader set of circumstances relevant to Inventec CZ’s operations, including the substantial volume of material purchases. By contrast, it argued that the approach proposed by Inventec CZ disregarded the material costs, which represented a significant factor in the overall analysis.

Decision of the Supreme Administrative Court

The Supreme Administrative Court (“SAC”) emphasized that its role was to review the decision of the Regional Court in light of the specific arguments made by Inventec CZ to contest the conclusions reached. A substantial part of Inventec CZ’s complaint, however, comprised challenges to the procedure followed by the CTA and raised objections to the Regional Court’s judgment in more general terms.

Acknowledging the lack of a uniform or general algorithm for determining arm’s length prices, the SAC stated that though multiple transfer pricing methods could be used to establish prices, these methods must not be applied arbitrarily. According to the SAC, the choice of method fell within the discretion of the CTA, provided that the transfer price was determined based on objective criteria and in a manner that allowed the reliability of the conclusion, the appropriateness of the method, and the final determination of the arm’s length price to be reviewed. The CTA was therefore required to justify the selection of its chosen method convincingly or explain why it did not consider the method proposed by Inventec CZ to be suitable.

The SAC agreed with the Regional Court that the CTA had sufficiently justified its choice of method for adjusting the transfer pricing applied by Inventec CZ. According to the SAC, the use of the selected criteria could not be regarded as arbitrary. The decision of the SAC was based on the observation that the CTA had acknowledged Inventec CZ’s limited responsibility for controlling and handling the materials as well as the fact that Inventec CZ did not add significant value by processing the materials. The CTA’s functional analysis attributed 24.62% of the functions, risks, and assets to Inventec CZ, with the remainder allocated to Inventec TW. This analysis/attribution, according to the SAC (as well as the Regional Court), not being so far from Inventec CZ’s own allocation of 31.37%, could not be found to be “overstated”.

The SAC did not consider Inventec CZ's lack of liquidity to be a valid argument for Inventec CZ not bearing any risks associated with the ownership of the materials in question. Instead, the SAC agreed with the CTA that Inventec CZ bore *only a very limited risk* and therefore did not need to have liquidity corresponding to the total value of the materials. The SAC accepted the CTA's argument that an independent entity in the position of Inventec CZ, motivated by the desire to generate profit, would have had higher profits, which would have increased its liquidity, enabling it to bear the potential risks associated with the ownership of the materials. The SAC accordingly concluded that, had Inventec CZ operated as an independent entity in an open market, it would have either applied a surcharge to the prices of its products to account for these risks or transferred them contractually to another party. Therefore, using the ROTC indicator, which incorporates material costs, was deemed more appropriate.

The SAC endorsed the CTA's view that, within the business model under review, Inventec CZ could not have owned the materials without bearing at least some associated risks. According to the SAC, the ownership of the materials entailed exposure to certain risks, which could not be characterized as a mere financial arrangement. The SAC therefore concluded that, if compensation for these risks were not reflected in the prices set by Inventec TW, such prices would not correspond to those that independent entities would have established in comparable circumstances.

Hence, although Inventec CZ exhibited characteristics of a contract manufacturer, the SAC found that an independent entity in its position would have applied a surcharge to account for the ownership of materials. Since Inventec CZ owned, stored, and processed the materials into finished products, which it sold while bearing some responsibility for them, the costs of material acquisition were to be included in the cost base. Accordingly, the ROTC market margin derived from comparable independent entities was reduced to 24.62%. The SAC found this approach to be reasonable and suited to the specific circumstances of the case.

Observations

Within our team, we have discussed the Inventec CZ case. Below we set out our key observations, focusing on (i) the allocation of the burden of proof, (ii) the implications of legal ownership of high-value materials, and (iii) the limits of comparability adjustments under the TNMM.

A. Allocation of the burden of proof

In the case discussed above, Inventec CZ appealed against the CTA's TP-adjustment. The Regional Court dismissed the appeal, declaring it unfounded. According to the Regional Court, the CTA had sufficiently explained why the ROTC was a more appropriate PLI than the PLI applied by Inventec CZ (ROVAC, not including material costs). When Inventec CZ appealed the decision of the Regional Court, the SAC agreed with the Regional Court that the CTA had sufficiently and convincingly explained in its decision the application of the method it chose to calculate profitability and that the use of the given criteria could not be considered arbitrary. In its judgment, the SAC stated that the choice of TP- method and the application of certain criteria fall within the administrative discretion of the CTA, which also has the necessary expertise in this regard.

From the proceedings in the case, it *appears* that the burden of proof lay with the taxpayer/Inventec CZ from the early stages of the proceedings. This is more obvious in the appeal phase, when Inventec CZ presented a more detailed transfer pricing analysis allocating functions, assets, and risks between Inventec

CZ and Inventec TW as 68.63% and 31.37%, respectively. This (more nuanced) functional analysis and risk allocation appeared only at the appeal stage, rather than in the initial proceedings, which probably weakened Inventec CZ's position. It *appears* that the courts were quick to conclude that since Inventec CZ took legal/formal ownership of the materials during production, at least some of the materials-related risks had to be borne by Inventec CZ. The invoices, insurance contracts and liquidity analysis submitted by Inventec CZ in support of its selected PLI (i.e., ROVAC, not including material costs) were considered inconclusive in demonstrating that Inventec TW bore the predominant share of risks associated with the materials.

B. Implications of legal ownership of high-value materials

The CTA allocated part of the return to Inventec CZ in recognition of two elements: (i) the risks associated with the high-value materials that Inventec CZ legally owned during the production process; and (ii) the ambiguity surrounding Inventec CZ's role as a middleman between the Taiwanese parent and the customer, HP.

In its decision, the SAC placed weight on the legal ownership of materials amounting to approximately EUR 680 million, representing 91% of Inventec CZ's total costs. It did not accept the invoices, insurance contracts and liquidity analysis submitted by Inventec CZ as evidence that the materials related risks were entirely borne by Inventec TW. The SAC reasoned that an independent third party in a comparable position would not have accepted such (i.e., significant legal ownership) a role without securing compensation.

We question whether this conclusion reflects an arm's length outcome as it does not take into account Inventec TW's position. With the HP agreement, Inventec TW could, in principle, have approached multiple Czech manufacturing companies. Whether any of those independent companies would have had the bargaining power to capture part of the group-level profits in their remuneration is far from certain. In this respect, the SAC's reasoning, in our opinion, risks overstating the extent to which an independent entity would necessarily succeed in negotiating a share of the group-level profits.

C. Limits of comparability adjustments under the TNMM

The comparability adjustment made by the CTA effectively introduced a split of functions, assets, and risks that resulted in dividing the results of the original comparability study conducted by the CTA by a factor of four. For us, this raises concerns about whether the outcome of the study reflected a valid comparability adjustment in the first place or whether it points to a comparability defect that cannot be resolved through (comparability) adjustments.

Comparability adjustments are intended to correct relatively minor differences between the tested party's circumstances and those of the comparables. By contrast, reducing the profitability indicator to a quarter of the original range suggests a fundamental mismatch between the selected comparables and the tested party. In an arm's length situation, it is doubtful whether independent manufacturers would be willing to absorb 25% or any other meaningful proportion of the risks associated with material purchases valued at approximately EUR 680 million.

We question whether the CTA's outcome tests the limits of what a one-sided method, such as the TNMM, can achieve. The heavily adjusted TNMM seems problematic as the risk adjustment applied, and, in our

opinion, the comparability defect that it signals, would itself be an additional argument supporting the use of a different TP method.² Rather than stretching the TNMM beyond its practical limits, the case could have been more coherently addressed by revisiting the delineation of the controlled transaction and the selection of the TP method.

**

Patrick T.F. Schrievers

Partner

Phone: +31 (0) 243 529 690

Email: patrick.schrievers@noviotax.com

Neha Mohan

Senior Associate

Phone: +31 (0) 644 961 086

Email: neha.mohan@noviotax.com

***This article is intended for general information only and does not constitute professional advice. Although every effort has been made to ensure accuracy, no guarantees are made as to completeness or correctness. Readers are advised to seek appropriate professional advice, specific to their situation and circumstances. No liability is accepted for any reliance placed on this content.*

² E.g., both the EU Joint Transfer Pricing Forum and the OECD TPGL clarify that where reliable comparables cannot be found and/or where reliable adjustments cannot be made to increase the robustness of one-sided methods, the PSM may be the more appropriate approach.