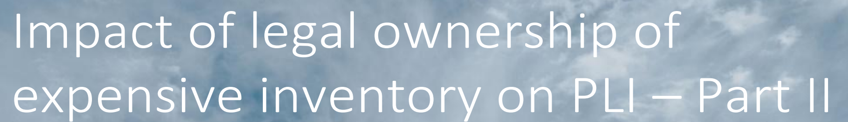

Impact of legal ownership of expensive inventory on PLI – Part II

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In this two-part blog, we analyze a recent case[1] 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 summary

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. These purchases represented about 91% of Inventec CZ's total costs. 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.

Inventec CZ maintained that it operated as a contract manufacturer, performing routine production tasks, and therefore, even though it took legal ownership of the high-value materials during production, it should be remunerated at a cost-plus on operating expenses, excluding material costs. Inventec CZ contended that all risks related to the materials were borne by Inventec TW, which retained control over material flows and key decisions. As evidence of its position, Inventec CZ provided proofs 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 of material ownership.

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 authorities 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. 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 decision, disputing, in particular, the use of the return on total costs (hereinafter "ROTC") as PLI, which incorporates material costs, instead of its preferred PLI - return on value-added costs (hereinafter "ROVAC"), defined as profit relative to total costs minus material costs.

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

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.

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".

The Supreme Administrative Court ("SAC") stated firstly that 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.

According to the SAC, the use of the selected criteria could not be regarded as arbitrary. The SAC therefore agreed with the Regional Court that the CTA had sufficiently justified its choice of method for adjusting the transfer pricing applied by Inventec CZ. 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. 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.

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. 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".

Allocation of burden of proof under Dutch law

In the Netherlands, under Article 8b of the Corporate Income Tax Act (*Wet op de vennootschapsbelasting 1969*: CITA) the Dutch Tax Authorities ("DTA") bears the initial burden of making it plausible (*aannemelijk maken*), on the basis of facts and circumstances, that the transfer price agreed between related parties deviates from what independent parties would have agreed under comparable conditions. So, the initial burden of proof is on the DTA. Any resulting advantage or disadvantage is presumed to be caused by the affiliation between the parties. This presumption, however, is rebuttable.

Observing the case, we question whether the facts presented by the CTA are sufficient to make it plausible (*aannemelijk maken*) that the transfer price agreed between Inventec CZ and Inventec TW deviates from the price that independent parties would have agreed upon under comparable circumstances. The CTA argued that independent entities which both hold title to inventories and perform production activities typically earn a return on their total costs (including materials), rather than solely on their operating expenses. However, to substantiate such a position, the CTA would be expected to provide supporting evidence from comparable independent third-party data, such as financial statements, contractual terms, or other relevant documentation.

The CTA could also refer to its quantified allocation of risks between Inventec CZ and Inventec TW and its adjustment of the ROTC base (to 24.62% of the initial level) as factual support for its position that the transfer price was not at arm's length. Moreover, Inventec CZ's own submissions indicating an acknowledgement of a measurable share of functions and risks at Inventec CZ (31.37% on the aggregate split presented) could similarly be used as evidence to reinforce the argument that the transfer price did not reflect arm's length conditions. This submission was, however, not present in the first assessment phase (meaning, initially, it could not have presented this to make it plausible that the transfer price was not at arm's length).

Making plausible vs demonstrating convincingly

If, and to the extent that, the CTA were able to substantiate the presumption that the transfer price was not at arm's length, Inventec CZ (if it were a Dutch taxpayer) could have rebutted this presumption by demonstrating that the alleged non-arm's-length nature of the transfer price was not attributable to its affiliation with Inventec TW. In other words, Inventec CZ would have had the opportunity to refute the presumption that the non-arm's-length transfer price was attributable to the affiliation with Inventec TW.

Inventec CZ wouldn't have to *prove* that the presumption is incorrect; it would suffice for Inventec CZ to *make plausible* (*aanvoert en aannemelijk maakt*) circumstances that give rise to *reasonable doubt* (*redelijkerwijs moet worden getwijfeld*) as to the correctness of the DTA's presumption.

For instance, Inventec CZ could have emphasized the procurement of raw materials by Inventec TW in coordination with HP, submitting supporting documentation showing that Inventec TW insured the

inventories and exercised control over the material flows. It could also have underlined that since 2021, the same manufacturing process has continued without Inventec CZ's formal purchase of materials, illustrating that the previous title transfer to Inventec CZ was an administrative formality without any substantive shift in risk or control. Furthermore, Inventec CZ could have demonstrated that it was not involved in any dealings between Inventec TW and HP, and that, in practice, it exercised no control over its turnover and/or material flows.

The nature and quality of the evidence required to give rise to such reasonable doubt/plausibility depends on the strength of the presumption to be rebutted. Where the presumption is strong, more persuasive evidence is needed to give rise to such doubt. In such circumstances, a taxpayer must present, and, if disputed, make plausible, the facts and circumstances sufficient to give rise to reasonable doubt regarding the causal link between the affiliation and non-arm's-length conduct.

Based on the foregoing, it is doubtful whether, under Dutch law, the burden of proof would have shifted to Inventec CZ. Even if the CTA had substantiated a presumption that the transfer price was not at arm's length, Inventec CZ could (at least) have tried to effectively rebut this presumption by presenting plausible facts and circumstances that give rise to reasonable doubt as to the correctness of the DTA's assumption.

However, pursuant to Article 27e of the General Tax Act (*Algemene wet inzake rijksbelastingen*: GTA), if a taxpayer significantly underreports its CIT-return and had reason to know, or should reasonably have known, that the reported CIT was materially understated, the burden of proof is shifted and increased. In such cases, the taxpayer must convincingly demonstrate (*overtuigend aantonen*) the facts and circumstances giving rise to reasonable doubt regarding the correctness of the presumption made by the tax authorities. This provision applies only if the arm's length principle, as set out in Article 8b CITA and clarified previously, is satisfied.

It is important to note that, in accordance with settled case law, the shift of the burden of proof under Article 27e GTA applies to the entirety of the CIT return. Consequently, if the burden of proof has already been shifted on other grounds, the taxpayer must still convincingly demonstrate *(overtuigend aantonen*) the facts and circumstances that substantiate reasonable doubt as to the correctness of the tax authorities' presumption. This item has not been examined in detail due to the limited facts available from the judgment of the SAC.

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