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MNEs Trumped by Tariffs: Aligning Tax and Trade Strategies Through Transfer Pricing

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President Donald J. Trump Declares National Emergency to Increase our Competitive Edge, Protect our Sovereignty, and Strengthen our National and Economic Security , the Fact Sheet[1] published on 2 April 2025, read as POTUS announced sweeping tariffs on 85 countries, including the EU, China, India, Japan, and South Korea, to address a national emergency arising out of America's massive trade deficit. On top of a baseline tariff of 10% throughout, the USA announced country-specific tariffs of 34% on China, 26% on India, 20% on the EU, 24% on Japan, and 25% on South Korea. Specifically, tariffs on Chinese imports surged to 145%, while China retaliated with tariffs of 125% on US goods. For countries other than China, the reciprocal tariffs are under a 90-day pause period.

With regards to India, the White House statement makes seven separate mentions of India as a high tariff country across sectors, observing "*.... India imposes their own uniquely burdensome and/or duplicative testing and certification requirements in sectors such as chemicals, telecom products, and medical devices that make it difficult or costly for American companies to sell their products in India. If these barriers were removed, it is estimated that US exports would increase by at least $5.3 billion annually.*"

These measures have disrupted supply chains, increased costs for consumers and businesses, and raised concerns across the Multinational Enterprises (MNEs), who are actively participating in Global Trade, mostly through corporate set-ups in most countries.

While the MNEs evaluate the alternative mechanism to deal with the tariffs in terms of rerouting the supply chains, restructuring the operations, identifying alternative markets, etc., another critical aspect that requires close consideration is the impact on the ever-evolving Transfer Pricing policies. Each of the international trade between related parties needs to be reassessed both legally and economically to determine which entity would bear the consequence of the increased tariffs as the global consumer would ultimately not bear the price hike, and the customer loyalty would shift to the MNEs who would offer the goods at a lower price by managing the pricing more effectively.

The resurgence of tariff wars, particularly those initiated by the United States, has far-reaching implications not only for global trade but also for transfer pricing. The recent geopolitical tensions fuelled by protectionist policies are making MNEs nervous, and they are facing the battle of increasing costs and disruption in supply chains. While a breather for 90 days has given some relief for MNEs, the future looks very uncertain for MNEs operating and importing from their related parties in an unfriendly jurisdiction. The MNEs need to reevaluate supply chains, pricing structures, and long-term transfer pricing (TP) strategies.

This article explores the potential implications of tariffs on transfer pricing, delving into the challenges MNEs face, the impact on Advance Pricing Agreements (APAs), and mitigation measures to manage these risks.

Key TP implications –

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Given the tariff war between the US and China, let's try to understand how the overall impact would pan out on an MNE that is based in the US and outsources manufacturing to its subsidiary in China. For the illustration, we have assumed that for the manufacturing activity, China doesn't source any raw materials from the US.

Particulars	**Original US Co P&L**	**Original China Co P&L**	**Original Consolidated P&L**	**Revised US Co P&L**	**Revised China Co P&L**	**Revised Consolidated P&L**
Sales	10,000	5,000	10,000	10,000	5,000	10,000
Less: COGS	5,000	4,000	4,000	5,000	4,000	4,000
Less: Reciprocal tariffs	Nil	Nil	Nil	7,250 (145% on the cost of manufactured goods)	Nil	7,250
Gross Profit	5,000	1,000	6,000	(-) 2,250	1,000	(-) 1,250
Gross Profit Margin %	**50%**	**20%**	**60%**	**(-) 22.5%**	**20%**	**(-) 12.5%**
Less: Operating Expenses	2,500	750	3,250	2,500	750	3,250
Operating Profit	2,500	250	2,750	(-) 4,750	250	(-) 4,500
Operating Profit Margin %	**25%**	**5%**	**27.5%**	**(-) 47.5%**	**5%**	**(-) 45%**

In an ideal scenario, contract manufacturers operate as limited-risk entities and earn a fixed margin over their costs. However, with the imposition of reciprocal tariffs by China on goods imported from the US, it remains to be seen whether the China Co. can recover these additional costs either with or without a markup from its US Principal. This will largely depend on how the intercompany agreement is structured. Having said that, Chinese tax authorities are likely to expect China Co. to recover such costs from the US entity.

Another important consideration is whether these reciprocal tariffs qualify as extraordinary expenses and can be treated as non-operating for the purposes of transfer pricing and arm's length analysis. One argument supporting this treatment can be that the tariffs are beyond the control of either party and could not have been anticipated or factored into the intercompany pricing policy at the time of agreement negotiation.

These issues will need to be assessed on a case-by-case basis and cannot be addressed through a one-size-fits-all approach.

Moreover, with reciprocal tariffs imposed by both the US and China, the overall feasibility of the current supply chain structure is likely to be challenged. This may compel the US entity to reevaluate its supply chain and consider relocating manufacturing operations to a more cost-effective jurisdiction.

Let us now evaluate the implications of shifting the manufacturing activity to India.

Particulars	**Original US Co P&L**	**Original India Co P&L**	**Original Consolidated P&L**	**Revised US Co P&L**	**Revised India Co P&L**	**Revised Consolidated P&L**
Sales	10,000	5,000	10,000	10,000	5,000	10,000
Less: COGS	5,000	4,000	4,000	5,000	4,000	4,000
Less: Reciprocal tariffs	Nil	Nil	Nil	1,300 (assuming 26% on the cost of manufactured goods)	Nil	1,300

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Particulars	Original US Co P&L	Original India Co P&L	Original Consolidated P&L	Revised US Co P&L	Revised India Co P&L	Revised Consolidated P&L
Gross Profit	5,000	1,000	6,000	3,700	1,000	4,700
Gross Profit Margin %	**50%**	**20%**	**60%**	**37%**	**20%**	**47%**
Less: Operating Expenses	2,500	500	3,000	2,500	500	3,000
Operating Profit	2,500	500	3,000	1,200	500	1,700
Operating Profit Margin %	**25%**	**10%**	**30%**	**12%**	**10%**	**17%**

Assumptions – The cost of goods sold (COGS) for manufacturing in India is assumed to remain unchanged, supported by government incentives under the Production Linked Incentive (PLI) scheme and the country's relatively low labor costs.

In this context, the ongoing tariff conflict between the US and China could present a significant opportunity for Indian trade, provided that the MNEs and the Government of India collaborate to foster an ecosystem that supports the development and sustainability of large-scale, state-of-the-art manufacturing facilities. This potential is reinforced by a recent news article[2], which talks about Apple's plans to expand iPhone manufacturing in India.

Let's now examine another scenario involving a simple distribution model, where a US-based distributor imports diamonds and jewellery from its Indian parent company and resells them in the local market.

Particulars	Original US Distributor P&L	Revised US Distributor P&L
Sales	10,000	10,000
Less: COGS	6,000	6,000
Less: Reciprocal tariffs @26%	Nil	1,560
Gross Profit	4,000	2,440
Gross Profit Margin %	40%	24%
Less: Operating Expenses	3,500	3,500
Operating Profit	500	(-) 1,060
Operating Profit Margin %	5%	(-) 10.6%

While the example might be too simple for today's complex operations, the math is not complex enough to understand the extent of impact. To continue its business operations, the MNE might have to re-examine its supply chain and product pricing to maintain relevance in the market and profitability. Another aspect from the Transfer Pricing perspective would be to retain the Distribution profitability (at a gross level in the case of a normal risk distributor and at a net level in the case of a limited risk distributor). In this case, the seller may have to reduce the cost of the products sold to the US, leading to an arm's length profit in the hands of the distributor.

In addition to the points discussed above, several other aspects are critical to transfer pricing analysis and are likely to be impacted by the introduction of reciprocal tariffs. Some key issues include:

Benchmarking analysis:

The following factors would require close consideration and adjustments to the extent feasible:

- **Use of Multiple-Year Data:** Typically, transfer pricing comparability analysis relies on data from the current financial year along with the two preceding years. In the present scenario, while current-year data may reflect the impact of reciprocal tariffs (particularly for companies with high imports), the prior two years' data will not capture this effect. Consequently, adjustments may be

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necessary to reflect the impact of tariffs. The approach and methodology for such adjustments are likely to be subjective, leaving room for interpretation and potential challenges.
- **Foreign Exchange Adjustments:** Given the volatility in global foreign exchange rates, a forex adjustment may also be warranted to ensure a more accurate and fair comparison.
- **Working Capital Adjustments:** The imposition of tariffs could significantly affect the working capital requirements of MNEs. As a result, working capital adjustments may become necessary as part of the benchmarking analysis.
- **Regional Comparables and Country-Specific Tariffs:** In cases where local comparable companies are unavailable, regional comparables are often used. However, with the introduction of country-specific reciprocal tariffs, regional comparables may also require careful adjustment. For example, in the case of a contract manufacturer based in China, regional comparables might not reflect the same level of tariff impact. The uneven nature of tariff impositions across countries means that each comparable company's profitability could be impacted differently, necessitating a case-by-case adjustment.

Overall, these required adjustments introduce vulnerabilities in the comparability analysis, which may be questioned by tax authorities. This, in turn, could result in double economic adjustments and increased controversy.

Business Restructuring

Depending on the functional profile of the US entity - whether it operates as a contract manufacturer under a cost-plus model, a limited-risk distributor with an assured margin, or a fully risk-bearing principal- the impact of tariffs on profitability may vary. From a US perspective, the effect would be dependent on which entity ultimately absorbs the tariff costs.

In response to these tariff implications, MNEs may consider restructuring their supply chains by altering intercompany procurement, distribution, or manufacturing arrangements. However, such changes may give rise to business restructuring considerations under transfer pricing regulations, necessitating careful alignment with the arm's length principle.

Impact on APAs

Advance Pricing Agreements (APAs) are typically based on critical assumptions, including the characterisation of entities and expected profitability. Most APAs include provisions for cancellation or revision in the event of significant changes in business conditions. In a high-tariff environment, such as one driven by reciprocal tariffs, these underlying assumptions may no longer hold true, particularly for limited-risk manufacturers or service providers with minimum profitability thresholds, potentially rendering existing APAs ineffective.

While current APAs may be impacted, MNEs may still view the APA route as a preferred option for achieving long-term tax certainty.

Harmonisation of transfer prices with Customs valuation

Customs considerations play a critical role in cross-border pricing strategies. While transfer pricing adjustments, such as reducing import prices to preserve target profitability, may be justified from an income tax perspective, such changes may raise concerns from a customs standpoint, as they could result in a lower customs duty base. Striking a balance between transfer pricing compliance and customs valuation requirements becomes particularly challenging in a high-tariff environment, making it essential for businesses to navigate both frameworks carefully to avoid regulatory scrutiny and potential disputes.

Conclusion

While transfer pricing adjustments may offer temporary relief, the escalating US-China tariff war makes supply chain restructuring increasingly inevitable. MNEs are now operating in a highly sensitive environment where tax authorities across jurisdictions scrutinize functional analyses, entity characterizations, and intercompany agreements more aggressively, seeking a larger share of profits. This evolving landscape underscores the deep interconnection between trade policies and transfer

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pricing rules.

In response, MNEs must revisit and realign their supply chains, intercompany contracts, FAR (Functions, Assets, and Risks) profiles, pricing models, benchmarking strategies, and potential restructuring options.

The global push toward protecting local tax bases may accelerate a shift from integrated global operations to more decentralized, regionally autonomous structures. In this complex and politically charged environment, agility, preparedness, and a proactive approach will be critical to navigating the intersecting pressures of trade, tax, and geopolitics.

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[1] https://www.whitehouse.gov/fact-sheets/2025/04/fact-sheet-president-donald-j-trump-declares-national-emergency-to-increase-our-competitive-edge-protect-our-sovereignty-and-strengthen-our-national-and-economic-security/

[2] https://timesofindia.indiatimes.com/business/india-business/apple-looks-to-manufacture-more-iphones-in-india-as-trumps-tariffs-hit-china-harder-report/articleshow/120120817.cms

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