Tariffs, Trade, and Transfer Pricing: A Guide to Navigating Economic Uncertainty

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In this article, the authors examine the rise of tariffs in international trade and explain their effect on typical manufacturing models across four sectors of the economy.

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Introduction

The recent imposition of tariffs by the United States on Canada, Mexico, and China has led to economic uncertainty and swift retaliatory measures from each of these countries.[1] The Trump administration's use of tariffs has affected many companies' supply chains, resulting in working capital needs and cost

inefficiencies as they seek alternative supply sources or new routes for their goods, or to renegotiate with suppliers and customers given their increased costs. This uncertainty complicates planning as businesses attempt to predict the future landscape of international trade and what it may mean for their supply chains and financial results.

Adding to the complexity, today's global economy has made the relationship between trade and transfer pricing increasingly important. As companies navigate the intricacies of international trade, they must understand the interdependencies and differences between customs (duties and tariffs) and transfer pricing and what they mean for businesses' supply chains. This article examines common manufacturing and supply chain models across several industry sectors, highlights where tariffs could affect operations, and offers potential guidance on addressing these challenges.

Table 1 summarizes the key industry characteristics and typical manufacturing models across four sectors of the economy.

Industry Sector	Industry Characteristics	Typical Manufacturing Model
Consumer Products	High-volume, fast-moving consumer goods with varying inventory levels, global sourcing and manufacturing footprint	Contract manufacturing or toll manufacturing
Life Sciences	Regulated supply chains, pharmaceutical and medical device manufacturing	Centralized production for API[a] at principal or contract manufacturing for API/formulation or medical device production
Industrials & Energy	Capital-intensive, large-scale industrial production and energy, commodity driven, highly vertically integrated	Fully fledged, contract manufacturing or toll manufacturing (includes maquiladora)
Automotive	Just-in-time manufacturing, global sourcing with regional supply chains	Contract manufacturing or toll manufacturing (includes maquiladora)

[a]API stands for "active pharmaceutical ingredient."

Within these sectors, we observe several common transactional profiles among legal entities in our clients' supply chains:

- toll (or maquiladora[2]) manufacturer for a U.S. principal;
- contract manufacturer for a U.S. principal;
- U.S. distributor for a fully fledged foreign manufacturer; and
- U.S. limited-risk distributor for a foreign principal.

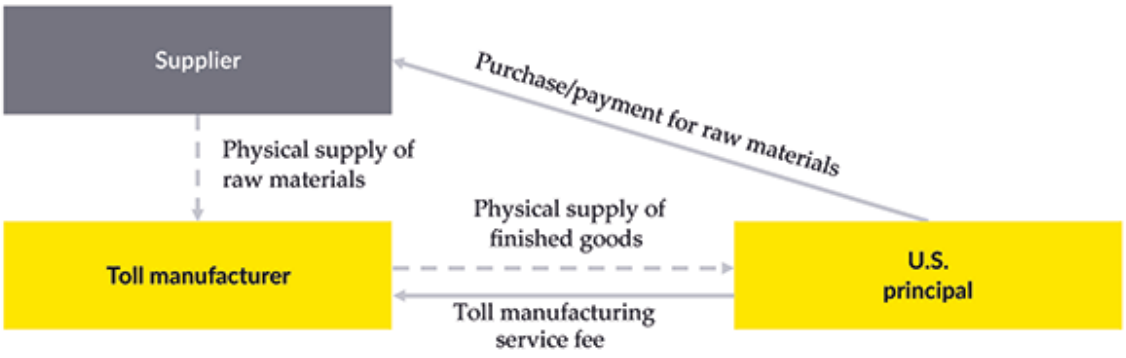
In the sections that follow, we analyze the effects of duties and tariffs on the transactions and the interdependencies between customs and transfer pricing within these manufacturing models. We also describe actions companies should consider taking to address cost inefficiencies in this uncertain environment.

Transactions and Supply Chain Models

Toll (or Maquiladora) Manufacturing for a U.S. Principal

In a toll (or Mexican maquiladora) manufacturing arrangement, the principal retains ownership of the work-in-progress and finished goods inventory throughout the production process. The diagram below depicts the flows within a toll manufacturing model for a U.S. principal. As outlined in table 1, toll manufacturing models can be found in a variety of industry sectors, including consumer products, life sciences, industrials, and automotive.

Figure 1. Typical Manufacturing Model Flows: Toll Manufacturer (including maquiladora)



The toll manufacturer operates as a manufacturing service provider for the U.S. principal; therefore, there is no sale of inventory between the entities for tax purposes. For customs purposes, however, there is a physical importation of the product into the United States necessitating the U.S. principal, as importer of record, to declare an import value.

Contract Manufacturer for U.S. Principal

Under a typical contract manufacturing model, the manufacturer purchases materials and parts from suppliers and owns the inventory throughout the production process until it subsequently sells the product to the U.S. principal. As outlined in table 1 above, contract manufacturing models can also be found in a variety of industry sectors, including consumer products, life sciences, industrials, energy, and

automotive. While contract manufacturers exist in several countries, with the most recent imposition of tariffs, those of focus are in Mexico, Canada, or China.

Figure 2. Typical Manufacturing Model Flows: Contract Manufacturer

The customs value is generally determined by the transaction value between the contract manufacturer and the U.S. principal (transfer price). Like under the toll manufacturing model, the U.S. principal, as the importer of record, is responsible for the payment of duties and tariffs upon import. Further, duties and tariffs reduce the U.S. principal's operating profit and increase its working capital needs unless pricing and payment terms can be renegotiated with the customer.

While customs valuation is critical, both toll and contract manufacturing models typically reduce the effect of customs duties and tariffs upon import because they can help achieve some of the lowest import prices.[3] The manufacturers often operate on cost-plus pricing, with the U.S. principal earning the majority of supply chain profit and benefiting from competitive manufacturing costs. To further enhance cost-efficiency in the current environment, the U.S. principal should consider inventory planning (accelerating imports), offloading volume to a controlled contract manufacturer that is not subject to tariffs, and reevaluating opportunities to produce or source goods domestically. This approach can help reduce the financial effect of tariffs, preserving profitability while maintaining operational efficiency in the global supply chain.

U.S. Distributor for Fully Fledged Foreign Manufacturer

Under this model, the U.S. distributor imports finished goods from a fully-fledged foreign manufacturer for sale to customers. The fully fledged manufacturer licenses or owns intellectual property relevant to the product it produces. Each party bears risks relevant to its functions in the supply chain and transaction. As outlined in table 1 above, fully fledged manufacturing models can also be found in a variety of industry sectors but are common in industrials.

Figure 3. Typical Manufacturing Model Flows: Fully Fledged Manufacturer

Under this model, the customs value would typically be determined by the transaction value between the manufacturer and distributor (the transfer price). Duties and tariffs are paid by the U.S. distributor upon importation, which would have a significant effect on its operating profits and working capital needs (in the current tariff environment, the U.S. distributor's cost of the product could increase by as much as 20-25 percent).

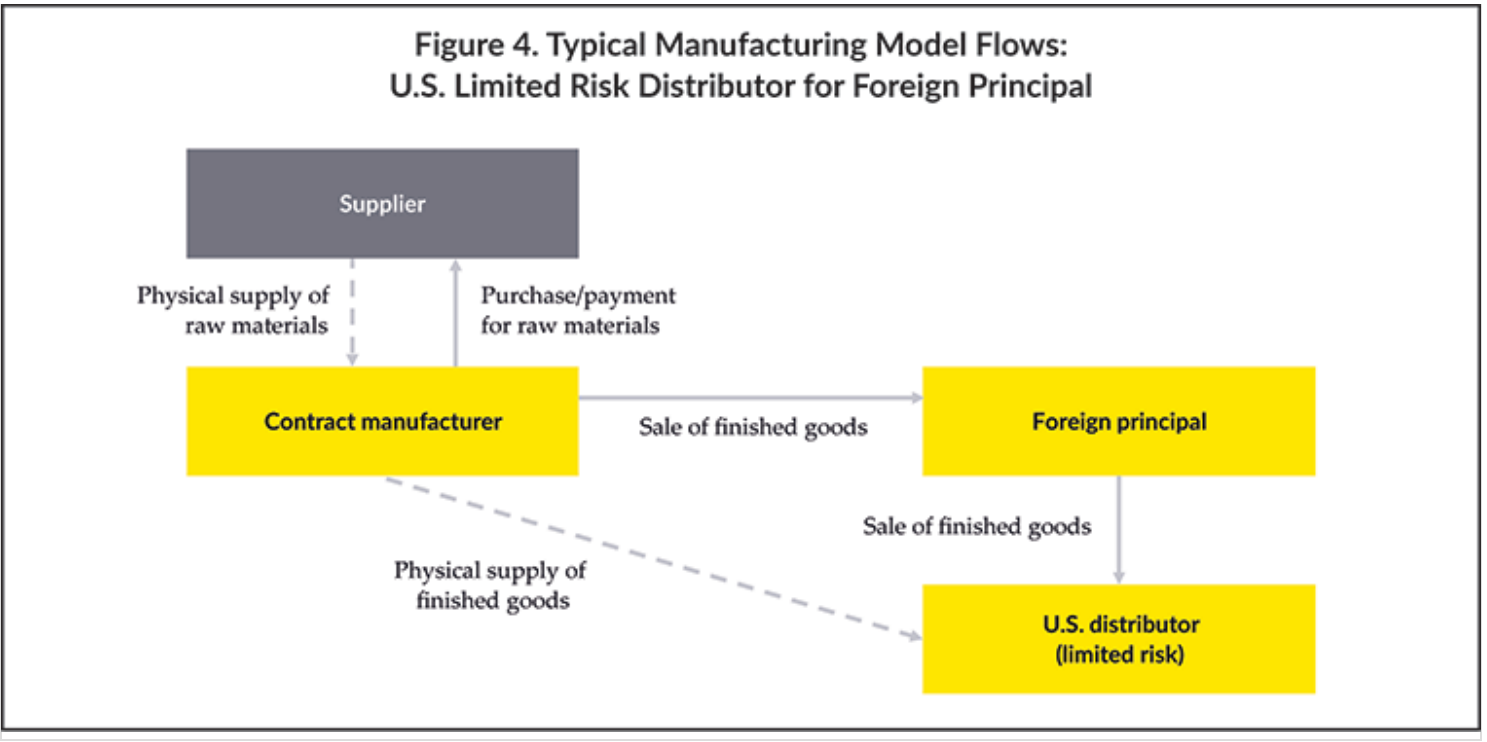
This reduction in profitability may require the parties to review and renegotiate their intercompany agreements to ensure that they support the new cost structure and reflect the relative risks and working capital borne by the parties. It may also have implications for any advance pricing agreements in place because the agreed-upon transfer prices may no longer reflect the economic reality of the transactions.

To reduce these effects, there are several approaches companies should consider, including:

- accelerating imports into the United States while tariffs are not in place;
- exploring alternative sources of supply, such as engaging contract manufacturers in other countries, to reduce or eliminate tariffs; and
- identifying opportunities to reduce the U.S. customs import value from existing manufacturers, which would necessitate evaluating local tax and transfer pricing risks associated with potential changes.

U.S. Limited-Risk Distributor for Foreign Principal

In this model, the U.S. limited-risk distributor is responsible for importing finished goods from a foreign principal for resale to customers. The foreign principal assumes the economically significant risks in the supply chain and transaction.



The import price and customs valuation are likely to be the highest of the manufacturing models to achieve an arm's-length margin for the U.S. distributor. The import price may also embed returns for services performed or intangible property owned, for example, by the foreign principal. The effect of customs duties and tariffs is again significant because the U.S. distributor is responsible for their payment upon import, which may reduce its operating profits below an arm's-length result. The transfer price between the foreign principal and the U.S. distributor would either need to be adjusted iteratively to account for the margin effect of the tariff, potentially increasing the tariff further, or exclude the effect of the tariff and have it separately reimbursed by the foreign principal. Under the former approach, a year-end transfer pricing adjustment may also be necessary to keep the U.S. distributor's margin at arm's length, again raising potential questions about the original customs valuation, duties, and tariffs paid.

To help address these effects, there are several approaches companies should consider, based on their business needs, including:

- accelerating certain imports into the United States, if appropriate, while tariffs are not in place;
- exploring first sale for export, which would trace the declared value back to the source of manufacturing (Thailand manufacturer for the foreign principal, for example), plus any assists, potentially reducing its value; and
- identifying potential reductions to U.S. customs import value from the foreign principal, which could involve separately charging for relevant transactions.

Conclusion

The evolving international trade landscape, marked by recent tariff developments, presents both challenges and opportunities for businesses navigating their supply chains. Understanding the intricate relationship between customs duties, tariffs, and transfer pricing is no longer optional; it is essential for maintaining operational efficiency and profitability. By understanding and actively analyzing transfer

pricing and trade policies, companies can scenario-plan and be prepared to respond to dynamic changes in the trade environment. While several actions take time to implement because of the operational, information technology, or cross-functional business requirements, they should be evaluated and prioritized on companies' planning scorecards, as appropriate.[4]

FOOTNOTES

[1] The Trump administration recently clarified that until April 2 tariffs do not apply to goods that satisfy the U.S.-Mexico-Canada Agreement rules of origin. While the Trump administration also implemented tariffs on U.S. imports of aluminum and steel, this article examines typical manufacturing models among the countries noted. The trade landscape remains fluid, and there may be additional countries in the scope of tariffs and/or changes to tariffs rates applied.

[2] A maquiladora is a manufacturing facility in Mexico that operates under a special government program enabling foreign companies to temporarily import raw materials duty free. These materials are assembled or processed before the finished products are exported, typically back to the country of origin. This allows companies to benefit from Mexico's lower labor costs while maintaining efficient supply chain operations. For purposes of this article, we describe toll and maquiladora manufacturing similarly, although there are distinct differences in these arrangements.

[3] We expect that in 2025 the safe harbor transfer pricing method under the maquiladora regime could result in relatively high markups on manufacturing services, particularly for asset-intensive maquiladoras, and relatively higher U.S. import values when compared with other manufacturing models.

[4] The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or any other member firm of the global EY organization. This information is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide accounting, tax, or other professional advice. Copyright 2025 Ernst & Young LLP. All rights reserved.

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