

Tariffs Impact on U.S. Distributors' Profitability and Transfer Pricing Strategies



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Introduction

The United States has entered a new era of trade policy characterized by increased tariffs, impacting global supply chains and creating significant challenges for transfer pricing compliance. This shift necessitates a careful re-evaluation of intercompany transactions and pricing strategies for multinational enterprises (MNEs) operating within and trading with the U.S.

Specifically, tariffs directly impact the cost of imported goods, thereby altering the profitability of cross-border transactions adding a layer of complexity. From a transfer pricing perspective, this new tariff landscape presents both opportunities, such as the potential to renegotiate intercompany pricing and restructure supply chains for greater tax efficiency, and challenges, including the increased difficulty in benchmarking, the need for robust documentation to justify tariff cost allocation, and the potential for disputes with tax authorities regarding compliance with the arm's-length standard in a distorted market.

This article provides an explanation of intersection of tariffs and transfer pricing through illustrative examples involving a Latin American exporter and its related U.S. distributor, and also presents key mitigation strategies applicable in both the short and long term.

Tariffs in a Nutshell

Tariffs are taxes imposed on imported goods, historically used for revenue generation and protecting domestic industries. They increase the cost of imported goods, potentially leading to higher prices for consumers.

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Tariffs can have cumulative effects. For instance, "Tariff Stacking", where multiple tariffs are applied to different stages of a product's journey or different components, can significantly inflate the final cost. Also, tariffs on intermediate goods (components used in manufacturing) can increase costs for domestic producers, who may then pass those costs onto consumers, leading to price increases across various sectors. Furthermore, tariffs imposed by one country can lead to retaliatory tariffs from others, harming export-oriented industries and potentially escalating into trade wars with broader economic consequences.

Tariffs are collected by the importing country's customs authorities (e.g., US Customs and Border Protection in the United States) from the domestic companies that import the goods. In modern developed economies like the US, while tariffs generally constitute a smaller percentage of overall government revenue compared to income taxes, they have historically been and continue to be strategically employed to protect specific domestic industries from foreign competition.

Current Tariff Landscape

The current tariff landscape in the United States is significantly shaped by the "American First Trade Policy Memorandum" issued last February, which emphasizes a protectionist stance aimed at prioritizing domestic industries and reducing trade deficits^[4]. Subsequently, on "Liberation Day" on April 2, 2025, a minimum 10% tariff on imports from nearly all countries was initially imposed. This was followed by a plan for individualized reciprocal higher tariffs on countries with substantial trade deficits with the US, with rates ranging from 11% to 50% for 86 countries. However, a significant development occurred on April 9, with President Trump announcing a 90-day pause on these reciprocal tariffs for almost all nations, with the notable exception of China. Instead of the initially planned reciprocal rate, tariffs on imports from China were drastically increased to a 125% reciprocal tariff, a 20% tariff to address the fentanyl crisis, and Section 301 tariffs on specific goods, between 7.5% and 100%^[5].

As an example, upon entrance in force of the above tariffs, assuming a complete pass-through, a product like a smartphone that previously cost US\$ 500 would now cost US\$ 1,125 due to the tariff alone ($\text{US\$ } 500 * (1 + 1.25)$). This dramatic price increase directly impacts U.S. consumers purchasing these goods and would contribute to the overall inflation rate for electronics.

The specific tariff rates and affected goods are subject to change based on ongoing trade negotiations and political considerations. For instance, President Trump recently suggested that the tariffs on Chinese goods will "come down substantially" during future negotiations. However, the specifics and timing of any potential reduction remain uncertain.



[4] Released on February 20, 2025, this memorandum advocates for the aggressive enforcement of existing trade laws, the renegotiation or withdrawal from multilateral trade agreements deemed unfavorable to the US, and the imposition of tariffs and other trade barriers to protect American jobs and manufacturing.

[5] As a result, China faces up to a 245% tariff on imports to the United States. Source: White House Facts Sheet – Section Strengthening American Industry published on April 15, 2025 on www.whitehouse.gov.

Overlap Between Customs and Transfer Pricing

The overlap between customs and transfer pricing arises because both disciplines deal with the valuation of cross-border transactions, particularly the pricing of goods. However, they serve different primary purposes and operate under distinct sets of rules, which can create complexities, especially with increasing tariffs. The following table summarizes the main purposes, rules and focus of both disciplines:

Table 1: Customs versus Transfer Pricing Valuation

Customs Valuation	Transfer Pricing
Purpose: To determine the dutiable value of imported goods, which forms the basis for calculating customs duties and taxes. Rules: Governed by customs laws and regulations, often based on the WTO Customs Valuation Agreement. The primary method is the transaction value – the price actually paid or payable for the goods. A hierarchical system of alternative valuation methods exists if the transaction value is not acceptable (e.g., value of identical/similar goods, deductive value, computed value). Focus: Primarily concerned with the price at the point of import and ensuring the correct duties are collected.	Purpose: To ensure that the pricing of intercompany transactions (between related entities) adheres to the arm's-length principle for income tax purposes. This prevents multinational enterprises from artificially shifting profits to low-tax jurisdictions. Rules: Governed by income tax laws and regulations (e.g., IRC Section 482 in the US) and guidelines like the OECD Transfer Pricing Guidelines. Various methods are used to determine arm's-length prices, including the Comparable Uncontrolled Price (CUP) method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method (TNMM), and Profit Split Method. Focus: Concerned with the allocation of profits across different tax jurisdictions based on the economic substance of the intercompany transactions over a period.

Moreover, the relationship between customs duties and transfer pricing presents an inverse optimization challenge for taxpayers. For customs purposes, the primary goal is typically to minimize the dutiable value of imported goods to reduce the amount of tariffs payable. Conversely, for transfer pricing purposes, the objective is to establish an adequate and arm's-length profit margin for each related entity involved in cross-border transactions to comply with tax regulations. This often requires setting transfer prices that reflect the value added by each entity. Therefore, a conflict arises because a lower import price for customs might not reflect an arm's-length price that provides a sufficient margin for the importing distributor from a transfer pricing perspective.

Profitability Squeeze for US Distributors:

US distributors, often acting as intermediaries between foreign manufacturers and domestic retailers or end-users, face immediate pressure from these tariffs. Their traditional business model, which relies on importing goods and adding a mark-up for distribution services, is directly impacted by the increased cost of goods.

From a transfer pricing perspective, the distribution model adopted by a company is crucial for determining the arm's length remuneration of the distributor. Key models include:

- **Full-Fledged Distributor:** This entity performs a wide range of functions (sales, marketing, inventory management, etc.) and assumes significant risks (market, credit, inventory). They are typically compensated with a return on sales or a profit margin reflecting their value-added activities and risk exposure.
- **Limited-Risk Distributor (LRD):** This distributor has a more limited functional profile, primarily focusing on logistics and sales execution, and assumes fewer risks (often contractually mitigated by the principal). LRDs typically earn a lower, more stable return, often benchmarked using a return on sales or a Berry Ratio.
- **Commission Agent:** This entity acts as an intermediary, soliciting sales on behalf of the principal without taking title to the goods or assuming significant risks. They are compensated with a commission based on sales.

While some distributors might attempt to pass these costs on to consumers, the price elasticity of demand and competitive pressures can limit their ability to do so fully, leading to a direct erosion of their profit margins.

Implications for Latin American Exporters to the U.S. Market



The US market is exceptionally relevant for Latin American exporters, consistently ranking as the largest or second-largest trading partner for most countries in the region^[6]. Those engaged in business with related parties in the U.S. are particularly vulnerable to the effects of the current baseline tariff. This increased cost can significantly erode their profit margins and consequently will require them to review their transfer pricing policy and tax compliance approach.

Consider as example a Peruvian manufacturer/exporter selling goods (e.g. coffee or produce) to its U.S. distributor with the following financials before the U.S. tariffs are into effect.

[6] As of 2022, the United States absorbed approximately 41.71% of the total goods exports from Latin America and the Caribbean. Notably, Latin America is a crucial supplier of fresh produce to the US market, with significant exports including fruits, vegetables and cut flowers.

Table 2: Example – Scenario Before Tariffs

	Latam Exporter Pre-Tariff	US Distributor Pre-Tariff
Sales	80	100
Cost of Goods Sold	68	80
Tariff		
Gross Profit	12	20
Gross Margin	15.0%	20.0%
Operating Expenses	8	15
Operating Profit	4	5
Operating Margin	5.0%	5.0%

Assuming that the tariff cannot be transferred to the final consumer and the selling price remains constant at \$ 100 and a 10% tariff is imposed to the import cost of US\$ 80, the U.S. distributor's cost increases by \$ 8. The following alternatives illustrate the potential effects on the transfer price and the resulting consequences for both parties' transfer pricing compliance. Proper transfer pricing documentation is crucial in both scenarios to justify the allocation of the tariff burden and demonstrate that the related-party transactions remain arm's length under these new economic realities.

Alternative 1: No Price Increase to Final Consumer – Shared Cost: If the US distributor cannot increase the price to the final consumer due to market conditions, the US\$ 8 tariff increase could be shared. The Peruvian exporter would increase its transfer price by \$ 4, and the US distributor would absorb the remaining \$ 4, both experiencing a reduction in their respective profit margins.

Alternative 2: Distributor Absorbs Total Tariff – Losses Incurred: If the Peruvian exporter maintains its original transfer price of US\$ 80, and the US distributor cannot pass on the tariff cost, the distributor's cost of goods sold effectively increases to US\$ 88. If the distributor's previous margin was less than US\$ 8 on a \$ 100 selling price, it would now incur losses. From a transfer pricing perspective, this situation would be unsustainable in the long run unless the distributor performs unique and valuable functions justifying a temporary period of lower profitability due to extraordinary market conditions like the imposition of new tariffs.



Table 3: Example – Scenario Post – Tariffs

	Latam Exporter Split 50%	US Distributor Split 50%	Latam Exporter	US Distributor Absorb 100%
Sales	80	100	80	100
Cost of Goods Sold	68	80	68	80
Tariff @ 10%	4	4		8
Gross Profit	8	16	12	12
Gross Margin	10.0%	16.0%	15.0%	12.0%
Operating Expenses	8	15	8	15
Operating Profit	0	1	4	-3
Operating Margin	0.0%	1.0%	5.0%	-3.0%

Even if the U.S. distributor can increase the consumer price, it might still face pressure on its margins if it cannot fully pass on the tariff cost or if the decreased sales volume reduces overall profitability. This is especially pronounced if the price elasticity of demand is high, meaning consumers are sensitive to price changes and readily switch to alternative products (either domestically produced or imported from countries without such high tariffs).

If the tariffs are expected to be long-lasting and significantly impact demand, the Latin American exporter might need to reconsider its supply chain strategy, potentially exploring alternative markets or even establishing production facilities within the US to avoid tariffs altogether. This would have significant transfer pricing implications related to the new functions and risks assumed in the altered supply chain.

Mitigation Strategies in a Tariff-Driven Environment

While short-term strategies focus on immediate cost management and documentation, long-term strategies involve more significant supply chain and business model adaptations, necessitating corresponding and well-documented transfer pricing adjustments to ensure continued arm's-length. In both situations, it is recommended to strengthen transfer pricing documentation to justify the pricing of transactions under the new tariff regime, explaining the economic impact and the rationale for any deviations from historical pricing.

Short-Term Mitigation Strategies:

- **Unbundling Transactions:** For Latin American exporters selling to related US distributors, consider separating the sale of goods from other services (e.g., marketing, technical support) that might not be subject to tariffs. The service fees could be priced at arm's length based on their specific value, potentially reducing the dutiable value. Example: A Colombian coffee exporter might separately charge its US affiliate for marketing activities, reducing the value of the coffee beans subject to tariffs.
- **Cost Absorption Analysis:** Analyze the capacity of both the Latam exporter and the U.S. distributor to absorb a portion of the increased tariff costs without jeopardizing their arm's-length profitability.

- **Tariff Pass-Through Assessment:** Evaluate the feasibility of passing the tariff costs onto the final U.S. consumer. High demand inelasticity might allow for price increases, but high elasticity (as seen with readily substitutable goods) could severely impact sales volumes.

Long-Term Mitigation Strategies:

- **Supply Chain Redesign:**
 - **Diversification of Sourcing:** Explore alternative sourcing locations outside of tariffed countries. A Chilean wine exporter heavily reliant on the US market might consider diversifying sales to Europe or Asia.
 - **Nearshoring/Reshoring:** For some Latam exporters, establishing or expanding operations in Mexico or even the US could circumvent tariffs under agreements like USMCA^[7] (if applicable) or by becoming a domestic producer.
 - **Modification of Goods:** Altering the product slightly to change its tariff classification could be a long-term strategy, though this needs careful customs and transfer pricing analysis.
- **Strategic Use of Legal Structures:** Re-evaluating the legal and operational structure of the supply chain might offer long-term benefits. For instance, a toll manufacturing arrangement where the US entity owns raw materials processed in Latam and then re-imported might have different tariff implications.
- **Looking for Certainty:** Seeking Advance Pricing Agreements (APAs) with the IRS remains a robust option for achieving long-term certainty regarding the transfer pricing treatment of transactions, particularly when significant business model changes are implemented in response to tariffs. Furthermore, the more recent International Compliance Assurance Programme (ICAP) offers a valuable avenue for multinational enterprises, including US taxpayers, to proactively engage with tax authorities in multiple jurisdictions, providing a multilateral risk assessment that can lead to greater comfort and a degree of certainty concerning their cross-border transactions in this evolving tariff landscape.

Implications for Tax Compliance

Tax authorities, both in the U.S. and Latin America, will likely scrutinize transfer pricing policies in light of significant tariff changes to ensure profits are not being artificially shifted to avoid tax or customs duties. It is crucial to ensure consistency between the valuation declared for customs purposes and the transfer prices used for income tax purposes. Significant discrepancies can trigger audits and penalties.

Moreover, without careful planning, the changes in their business models due to the interaction of tariffs and transfer pricing could lead to non-arm's length positions that can be ultimately challenged by the tax authorities.

For Latin American exporters, understanding the specific tariffs affecting their goods and proactively adapting their business models and transfer pricing policies is crucial for maintaining competitiveness and ensuring tax compliance in the uncertain global trade landscape.

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[7] The United States-Mexico-Canada Agreement (USMCA), which entered into force on July 1, 2020, is a free trade agreement between the United States, Mexico, and Canada. It replaced the North American Free Trade Agreement (NAFTA), which had been in effect since 1994. Often referred to as "NAFTA 2.0" or "New NAFTA," the USMCA largely modernizes and updates the provisions of its predecessor.