

Transfer pricing in the automotive industry*

Production capacity
management and transfer
pricing economics

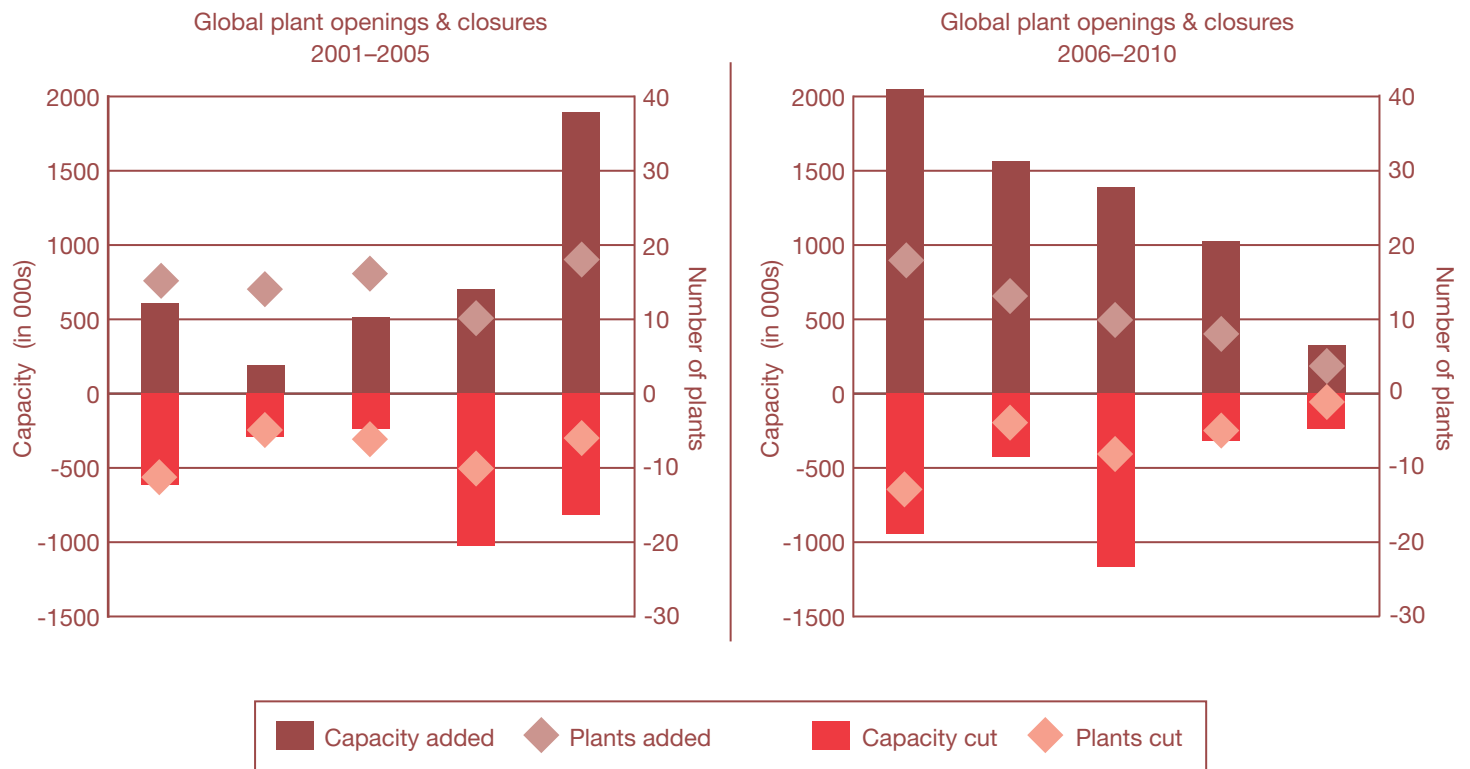
For years the mantra of automotive production has been to supply customers with “high quality, low-cost, innovative products.” As emerging markets have developed into high quality producers in addition to low-cost centers, automotive OEMs have moved production into these areas in search of more customers and greater cost savings; suppliers have naturally followed.

While OEMs have regularly increased sales volumes for vehicles worldwide, global production capacity growth has continued to outpace customer demand. In recent years the utilization of that global capacity has become the focus of attention. In 2005 there were 6 major plant closings around the world, but 18 new plants came on line during the same period. This trend is expected to continue over the coming years¹ [see chart]. Production Capacity Management (PCM) is clearly required to ensure that the costs of production enhance the affordability of products.

PCM occurs whenever a new plant opens, or an existing plant expands, contracts or closes. And while PCM begins in operations or strategy departments, finance organizations probably have the most to offer when evaluating the benefits of PCM. Applying the principles of *transfer pricing economics*, finance organizations can enhance the success of production capacity management movements in the following ways:

- Evaluating and establishing operational infrastructure;
- Developing “new plant” metrics; and
- Tax considerations and other costs.

Transfer pricing economics is a practical combination of micro- and macroeconomics. Properly applied, it lays out the entire value chain of activities of a corporation on a location by location basis, in order to assess the most equitable possible arrangements between disparate entities within a corporation. Then it compares the circumstances of each entity and assigns target profits to each location based on its particular activities, assets, and risks.



¹ Source—PwC Automotive Institute, AUTOFACTS 2006 Q3 forecast release

Using transfer
pricing economics
reveals hidden
opportunities.

Operational Infrastructure

How to maximize transfer pricing economics in operational infrastructure:

- Map out locations of activities
- Determine profits associated with the activities, assets, and risks of locations
- Determine where cash is required
- Move activities, assets, and risks before operations begin

Knowing levels and locations of profits, cash, and taxes is of paramount importance to any PCM strategy. Using transfer pricing economics to map all the transactions in which the new plant will participate, with suppliers and customers as well as with related parties, reveals hidden opportunities. Most likely, the source material and finished product transactions have been identified and estimated, but what about services and intangibles the new location will rely upon?

For instance, will the new location perform its own vendor identification, qualification, development and purchasing activities? Does it have the appropriate resources to complete these activities? Will established procedures be transferred to the new plant by an existing location? Will established suppliers be shifted to the new location? If this activity will be performed by someone else, how much are these services worth to the new plant? **Proper placement of these types of activities, so critical to successful operations at the new plant, can generate significant savings for the plant or provide significant income to the party that actually performs the activities.**

Some companies have estimated that by better managing their sourcing operations, hundreds of millions of dollars can be saved. At the extreme, one major global automaker has recently targeted \$1 billion in net material costs savings. Whether these savings will inure to a single location or to several is a strategic consideration under PCM that transfer pricing economics can help answer.

Other critical activities must also be similarly considered such as: production planning; research and development; quality control processes and procedures; in-plant customer representation, and logistics.

Transfer pricing economics not only establishes an arm's length amount of profits available to the new operation, but it also uncovers options within existing global operational and tax parameters that maximizes the value of the manufacturing as well as the sourcing activities.

The arm's length principle refers to the prices on transactions between related companies. These must be set in accordance with the economic conditions between independent competitive firms in the same or similar industries, without being influenced by the relationships between the related companies.

Case study:

When Tier 1 suppliers began to operate in Mexico, they sold to their new customers at a price that was significantly less than the pre-Mexico price. Fortunately for suppliers, the labor cost differential was greater than the price differential. The end result was that many Mexican operations began to accrue profits above what their manufacturing activities actually deserved. Cash became trapped in Mexico, forcing companies to become unnecessarily creative if they wanted use of the funds. Knowing who the customers are and what the operations of the Mexican plant are to be, allowed some Tier 1 suppliers to set the appropriate profits for Mexico and ensured that the value for services and marketing intangibles were properly captured in the U.S.

New Plant Metrics

How to maximize transfer pricing economics in new plant metrics:

- Map out levels and locations of profits, cash, and taxes
- Establish arm's length transfer prices at the beginning of the year
- Educate business unit managers at the beginning of the year
- Review, revise, and amend policies annually—your business changes every year, and so should your transfer prices.

In transfer pricing economics, plants are rewarded based on their activities, assets, and risks. As new plants come on line, their role in the supply chain determines their contribution to the value of the corporation—as a supplier of components or other intermediates, final assembly and sale, or sales to the marketing/distribution segments of the operations. How well plants execute on that mission is in part a function of whether the personnel of the new plant are properly measured and motivated. Often left only to Human Resources departments, transfer pricing economics can assist in the crucial alignment of the reward metrics of the plant (and its managers!) and its assigned activities, assets, and risks.

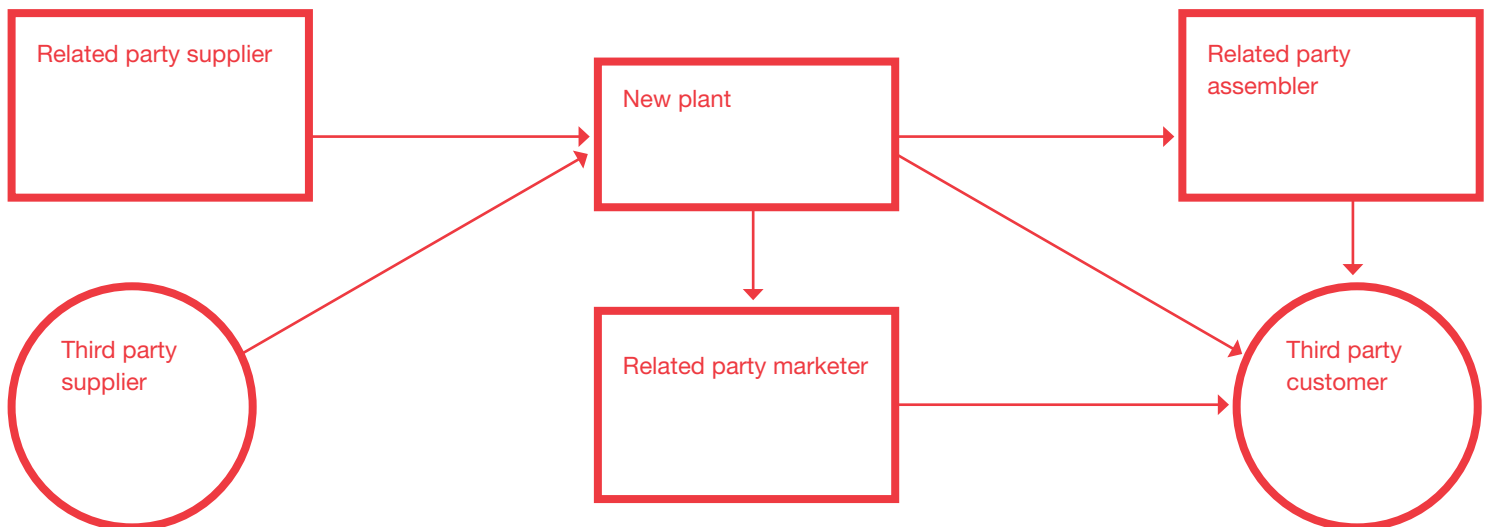
Initially, the new plant uses suppliers known to the company before developing their own local suppliers to ensure consistency of pricing and quality of inputs. This often means that most of the new plant's purchases and sales are to related parties.

Because these new “captive” plants often have a large portion of their purchases and sales coming from related parties, they have only limited control over their own profits and losses. Transfer pricing economics then becomes a critical component, if not a primary determinant, of the financial success of the new operation.

Corporate-wide measurement systems are often based on some level of earnings, like EBIT or Operating Profit. For companies

with a counterproductive transfer pricing system, intercompany pricing creates disincentives for the management of captive plants to work effectively within the organization. Without intervention, captive plant managers will only be extracting value or creating additional costs (not adding value) to the overall supply chain. Using a well-thought-out transfer pricing process to determine appropriate captive plant metrics will enhance the success of both the plant and the overall company.

For instance, consider a new plant, with sales to related and unrelated parties, as noted in the graphic below. The new plant ought to be maximizing its sales price to the unrelated customers, but must adhere to the arm's length principle for its related party customers. The price from the new plant to related party customers ought to enable them to maximize their price to their third party customers, while ensuring that the new plant receives an arm's length return on its activities. Too often, manufacturing facilities are focused on maximizing sales prices to related parties, causing purchasing companies to look elsewhere for their supplies—losing the benefits of the new plant in the first place. Furthermore, establishing appropriate pricing in advance—before the plant opens and completes its first year—enables managers to focus their attention on company-wide profit maximizing opportunities, and avoid potential income tax pitfalls.



Case study:

In perhaps one of the more well-publicized cases of changing management metrics, Caterpillar Corporation reorganized its entire business to motivate managers on the basis of business unit earnings rather than corporate earnings. (See, for instance “The Cat that Came Back”, Resilience Report, Booz Allen Hamilton Inc., August 17, 2005, p. 11) Recognizing that a significant portion of a business unit’s activities were inter-company, corporate headquarters mandated that the business units utilize market benchmarks to determine their transfer prices. This corporate-wide focus on internal activities allowed the business units to refocus on their entrepreneurial activities—whether those related to driving sales or driving costs out of the manufacturing process. Because of the set transfer pricing practices, all of the managers understood that their focus was external.

Tax Considerations

How to maximize transfer pricing economics in tax considerations:

- Map out levels and locations of profits, cash, and taxes
- Ensure that the activities, risks, and assets of the new plant are well-documented
- Match income levels to activities, risks, and assets
- Produce statutorily defined transfer pricing documentation

Many companies treat income taxes as an unavoidable expense. While income taxes may certainly be unavoidable, paying only the correct amount of tax is both legal and wise. How well aligned is your company's tax income with its business operations and objectives? In a poorly aligned new plant, the tax department may be forced to match income that is incongruent with the operation's activities, risks, and assets. By contrast, in a well-aligned PCM strategy, the tax department presents tax-effective and cash flow optimized options for business decision makers to assure that arm's length income is naturally earned in the new plant. In doing so, the company faces far less exposure to anti-shelter legislation and business purpose requirements. Tax departments in such companies may also avoid the annual search for "the one big idea" to control the company's tax cost. By doing so, the company may avoid the need for purely financial transactions, reduce its exposure, and limit the use of never ending, one-off tax planning ideas.

Determining intercompany transfer prices and documenting that they are arm's length are mandatory, annual exercises in many countries. In an age of highly suspicious fiscal authorities with respect to intercompany transactions, establishing up-front that the new plant is paying the appropriate amounts in its intercompany transactions helps avoid transfer pricing penalties. Likewise, there may be unforeseen adverse tax consequences of having a plant shut down with production moving to another country. In this instance, fiscal authorities and taxpayers will be diligent in examining possible transfers of intangibles, the need to compensate the old plant for losing the production to the new one, etc.

To do this properly, that is to say, to perform transfer pricing for tax purposes with arm's length results, transfer pricing economics are best incorporated early in the PCM process.

Case study:

A well-known automotive OEM recently opened a new contract assembly operation in a low cost manufacturing country. The OEM properly accounted for certain intercompany transactions such as component pricing and start-up services. They even provided for a small mark-up for the new plant's assembly services right from the outset. However, they grossly underestimated the production process value, capacity utilization and the labor rate savings that would occur in the new plant. As a result, taxable income, both in absolute terms and as a percentage of revenue are far in excess of a contract assembly operation. The company is now struggling with how to balance the true nature of its operations with the excessive profit amounts.

Conclusion

When the average greenfield plant investment ranges from \$400 million to \$1 billion, new tools must be brought to bear to ensure the success of the efforts. Utilizing transfer pricing tools when in the planning stages of PCM not only minimizes the costs incurred but indeed, enhances the company's profits:

- Maximizes overall company profits by properly measuring the performance of a new plant and its management;
- Maximizes plant performance by motivating new plant management according to parameters local management can control; and
- Minimizes the costs of tax and tax compliance by determining the operating characteristics of the new plant, before operations begin.

Lower production costs, lower material costs, better production processes, better technologies, shared platforms and the like are all compelling reasons for production capacity management in the automotive industry. A successful new operation requires the use of finance, tax, and transfer pricing from the very start.

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