

Auto Tax Insights

January 2011

Advancing the Automotive Value Chain *Re-examine and revise transfer pricing policies*

The years of 2008 and 2009 were certainly memorable for the automotive industry, marking the dramatic trough of a long industry cycle. In an industry noted for its global value chain and substantial global footprint, this downturn caused havoc with transfer pricing policies that were logically designed with profitable value chains in mind.

TRANSFER PRICING VALUE CHAIN

Lessons learned

Whether you believe that 2010 signaled the beginning of the industry recovery or was the year of a paradigm shift into a new automotive industry, the challenge will be to remember the lessons learned and incorporate those lessons into new transfer pricing policies.

Because the non-Entrepreneurial elements are typically viewed as limited risk, for transfer pricing purposes, their arm's length prices or returns are computed first, while the Entrepreneur claims all remaining profits. The returns for the limited risk entities are fixed, in the sense that they are calculated first.

Automotive Transfer Pricing Value Chain



Figure 1

A TYPICAL AUTOMOTIVE VALUE CHAIN

The automotive value chain, described in transfer pricing terms has become the standard for many manufacturing companies. In its simplest form it comprises an Entrepreneur, a series of limited risk manufacturers, a number of limited risk distributors and service providers. Figure 1 provides an illustration of a simplified value chain and the entities involved.

The non-Entrepreneurial elements of the value chain receive a fixed return while the Entrepreneur receives all residual profits.

The actual profits of these entities (and prices) may vary as the profits and prices of the comparable companies vary, though with a long-standing view that limited risk entities are not fully exposed to market volatility and do not have the financial or management capacity to lose money, these entities are nearly universally expected to earn profits. And as long as the total value chain is sufficiently profitable, the system works well.

However, when the Entrepreneur consistently earns losses, as has occurred recently, a tremendous amount of pressure is placed on the transfer pricing model.

Recent automotive industry history

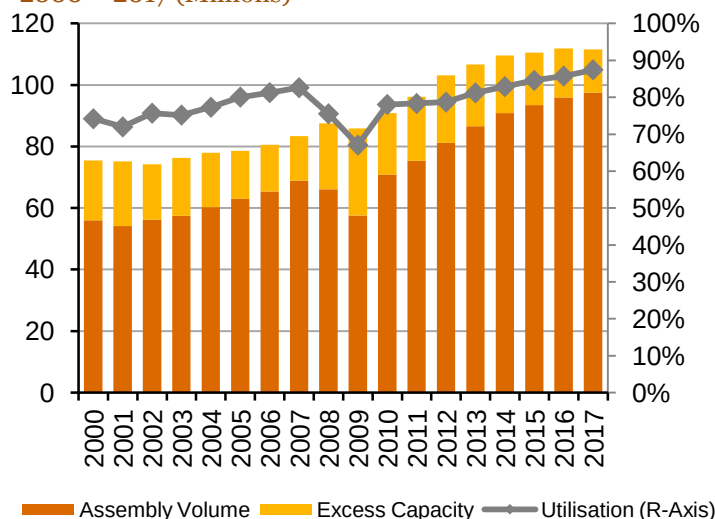
In 2000 and 2001 the industry saw global production drop, and at that time, those in the industry felt the resulting pains. However, the ensuing years showed all the promise of a usual recovery and most in the industry were happy for the relatively soft landing and subsequent strong recovery. Figure 2 below, from PwC Autofacts shows the production trends from 2000-2009. During the years 2001-2007 production was increasing, capacity utilizations were increasing and excess capacity was decreasing. All of these were excellent circumstances for automotive transfer pricing models. However, beginning in 2007 and dramatically illustrated in 2008 and 2009, profits disappeared from nearly all global automotive industry value chains.

When OEM production levels plummeted, so did their profits. Given the typical industry analyst view that if the factories can keep running, profits will come, a number of industry and government programs around the world were implemented to buoy production, with at least short term success.

Given the capital intensive nature of the industry, there is at least some intuitive appeal to the link between asset utilization and profits. Among the more notable programs were factory incentives designed to draw customers to the market more quickly and government scrappage programs designed for the same purpose but funded by taxpayers. Both types of programs ultimately created throughput for OEM plants. Unfortunately, none of the implemented programs could address harsh industry fundamentals, such as an inflexible cost structure, rapidly changing customer preferences (some environmentally driven) and real price deflation for automobiles.

From 1998-2008, the consumer price index for new cars and trucks decreased 6.2 percent according to the U.S. Bureau of Labor Statistics July 2008. To be fair, consumers were faced with a weak economy, a sharply lower stock market, a housing squeeze, high credit costs and limited credit availability, elevated gas prices, and "upside-down" loans, where the outstanding balance on the loan was more than the car's trade-in value.

Global: Light Vehicle Assembly Outlook
2000 – 2017 (Millions)



Source: Autofacts 2011 Q 1 Forecast Data Release

Further, while it may seem obvious, when OEM production and profits fall, the entire value chain suffers in the same way. Consider Figure 3 below, which shows the total North American OEM production from 1996-2009 and the average operating income for the top 20 largest Tier 1 suppliers in North America.

Both GM and Chrysler LLC ("Old Chrysler") filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy code and the businesses emerged with dramatic differences. Long-time vehicle brands, including GM's Pontiac, Saturn, and Hummer, and Ford's Volvo, were discontinued or sold. The Old Chrysler business that was purchased by CGLLC in 2009 and is now managed by Fiat, a new owner of CGLLC.

In Europe many companies reduced or eliminated flexible workforces and some (like Opel) faced the threat of going out of business which initiated intensive political involvement. Many suppliers did not survive and a successful integration of Continental and Schaeffler (initiated under different future expectations) became less certain under dark economic skies.



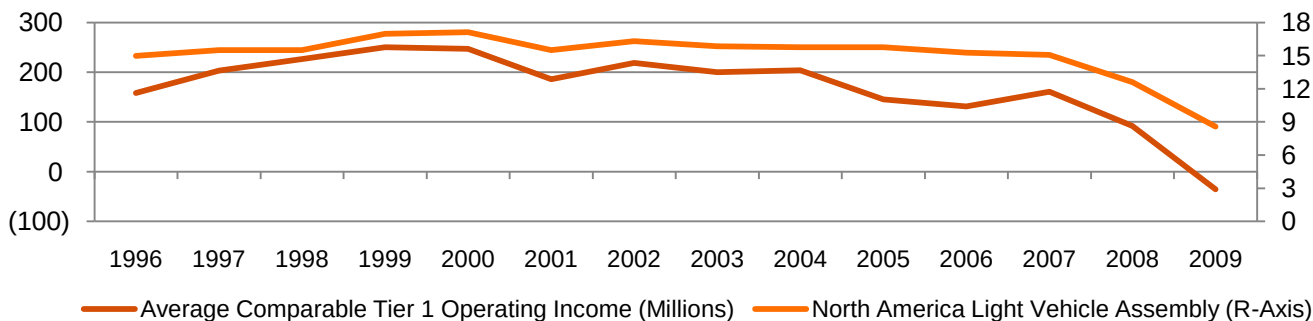
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Lessons learned

Regional Light Vehicle Assembly and Tier 1 Supplier Operating Income

Total North America Light Vehicle Assembly vs. Average Comparable Company Operating Income



Source: S&P Compustat, Autofacts

Through all of this, many limited risk entities continued to earn profits even though the total value chain was not profitable, and in fact, more than one Entrepreneur went bankrupt or virtually disappeared. This caused many companies to question whether the term "limited risk" meant "no risk" as then current transfer pricing models implied.

LESSONS LEARNED

Reactions in the automotive industry to the static nature of the traditional transfer pricing models were as varied as the companies themselves. Some companies rightfully reacted to the overall economic circumstances and forced limited risk entities to accept break even terms or even losses. Other companies correctly maintained their static models and sought to decrease the fixed returns as much as possible, though still earning profits.

Likewise, tax authorities around the world also adopted a variety of reactions ranging from pragmatic to seemingly incomprehensible. The at arm's length principle does however, by no means justify to impose additional tax on enterprises that are less successful than average.

Many companies are recognizing that the limited/no risk entity model does not sufficiently reflect how the real world operates nor the variety of circumstances a global manufacturing company faces.

First, consider that some markets such as Europe will likely have little growth in the coming years, North America will have low growth and China and other Asian markets will likely have very high growth in the coming years.

Then consider the end-consumer prices associated with those markets-- European and North American markets with lower volume growth rates, tend to have vehicles with very high content and higher prices especially relative to the high volume growth market of Asia. Further consider that for a variety of reasons from public perception to the high cost of freight, automotive companies tend to assemble vehicles in the same market in which they sell vehicles.

Given the variety of the cost of labor and structural costs across the three major markets of the world, the economics of each market can vary wildly based on costs alone. Finally, with the significantly different economic circumstances of each market, it is highly likely that the performance of each market may vary independently from another.

In the end, the reaction of industry players to their circumstances and the resulting reactions of tax authorities should cause industry players to re-examine whether the traditional, limited risk static transfer pricing models are appropriate for the coming decade.



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The future of automotive transfer pricing

In general transfer prices need to change when the relationship of the related parties change, when the industry itself changes, or when the comparable companies change. For some in the industry, the static model will remain in place. Whether it be due to a willingness to pay income tax in some jurisdictions while losing money overall, inertia related to the extreme efforts necessary to implement a new policy in a global organization or some other reason some companies will forgo the opportunity change. Many companies, however, are using the reorganizations and restructurings- legal and operational- that resulted from this trough to re-examine and revise their transfer pricing policies.

There are some common themes to how transfer pricing policies are being viewed. The underlying principles of the automotive business were overlooked in the static models and companies are analyzing how to ensure that transfer pricing policies reflect the commercial realities of the business. Tying the transfer pricing policy of each element of the value chain to the appropriate key performance indicators can provide a more accurate economic picture for the value chain. For instance, consider a manufacturing element of the value chain that was previously compensated on a cost plus basis and therefore virtually guaranteed a profit. Going forward, these entities may also incorporate volume through put into their transfer pricing to modify the cost plus in both good and poor economic times. In another example, a formerly limited risk distributor that was guaranteed a return on sales may be modified to reflect its ability to manage and adjust selling expenses. These are two simple examples show how automotive companies are tying transfer pricing to key performance indicators and exposure to market volatility.

Other companies are analyzing a complete overhaul of their transfer pricing systems, including the idea of a global or regional profit split.

“Those who cannot remember the past are condemned to repeat it.”

George Santayana

Clearly, the mechanics, administration, and predictability of such a transfer pricing policy have to be weighed against the benefits of high flexibility in reflecting the economic contributions (and taxable income) of the entities. Even so, automotive players are at least considering whether this is a viable option on a regional or global basis and whether such principles can be incorporated into more traditional policies.

The recent extreme volatility in the Automotive Industry landscape has put pressure on the choice of traditional transactional TP models and it remains to be seen whether they are still the most appropriate methods for the particular case. Furthermore, the assumption that limited risk entities cannot suffer losses is breaking down. Profit levels are frequently benchmarked against those of comparable independent entities, which can only be useful if the economically relevant characteristics are sufficiently comparable (OECD Transfer Pricing Guidelines). Clearly, when obtaining (financial) data on comparables, such data will always be historical and thus the challenge is how to set the prices for the future and whether or not an ex post review and adjustment would be required. Relative contribution to the value chain may need to be explored in more detail to determine the appropriate pricing structure independent of a comparability analysis, as such faces limitations in unstable economic periods.

Finally, automotive companies would be wise to also consider the approaches taxing authorities will pursue when examining transfer pricing policies. For example, in a number of taxing jurisdictions and even Courts, location savings - a competitive advantage relative to other players in the industry based on location - has been confused with location rents, extra profits (if any) deriving from location savings.



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Positioning your business value chain

The result has been that even when many automotive companies are operating in the same lower cost country, fiscal authorities are laying claim to the cost savings relative to their prior locations rather than relative to the competition, and seek to attribute a larger share of profits to the lower cost entities even if there is no location rent. In a similar fashion, especially if automotive industry performance is expected to vary greatly between geographies, we expect that taxing authorities will seek to assert that country premia may exist in a particular geography and levy additional tax, exacerbating the debate and potential controversies on the relative values of market/marketing versus technology intangibles in transfer pricing.

Whatever the final conclusion of this recent automotive economic trough, the automotive companies that revise their transfer pricing policies to reflect old and new economic relationships will be best positioned with a model that assigns profits- and losses- in their value chain that are consistent with the operational view of the consolidated business.

Upcoming Automotive and Tax Events

April 20-21

Automotive News China Congress
Shanghai, China

May 1-3

Automotive and Industrial Products Senior
Executive Tax Roundtable
Fort Lauderdale, Florida

June 29-30

PwC Automotive News European Rising Stars
Automotive News Europe Congress
PwC European Shareholder Value Awards
Cologne, Germany

Automotive Tax Contacts

*Tax Policy in a deficit-driven world:
2011 Tax Legislative Outlook*



Additional reading materials of interest
available on www.pwc.com

Tax Partner Spotlight

Neil Bristol
U.S. Automotive Tax Leader



Neil is PwC's U.S. Automotive Tax Leader based in Detroit. He has spent more than 25 years consulting with clients in the automotive industry. Neil serves as a business advisor to his clients as well as a tax specialist who focuses on multinational tax planning and compliance services. His role includes consultation on income tax accounting matters, cross-border expansion and planning, partnership special allocation issues, analyzing and planning around unique debt instruments, U.S. inbound investment issues, research and development projects, cost segregation projects, and strategic tax planning.

Neil has also served in several roles within the firm as a National Quality and Risk Management Leader as well as a leadership role with the firm's implementation of its global strategic sourcing platform in India. He is also active on several community boards in the Detroit area.

In his role, he has made U.S. Tax Policy and industry presentations in the U.S., Asia and Europe. His current clients include some of the world's largest automotive companies.

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