The post BEPS world in the automotive industry

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The automotive industry has followed a global footprint strategy since many years and it represents now the industry with the highest cross border intercompany transaction volume. In 2015 the seven largest original equipment manufacturers (OEMs) had turnovers of more than 1,000 billion Euro. The OEMs have factories around the world and suppliers have expanded their global presence to be close to these factories. Thus it is not a surprise that tax and customs authorities spend their utmost attention on arm's length transfer prices of OEMs and their suppliers.

1. Current tax audit environment

Given the high volume of intercompany transactions, tax audits are mostly focused on classical transfer pricing topics, i.e. the arm's length profit for distributors and for manufacturing operations. The suppliers often struggle in tax audits with the economic qualification of their plants, i.e. plants which contractually operate as license manufacturers are requalified to be contract manufacturers as the core intellectual property (IP), application engineering and sales functions are not controlled by the plant. The major challenges in tax audits are presented in the table below.

TP audit challenges in the automotive industry

Distribution	*Contract manufacturing*	*License manufacturing*	*Research and development*	*Services*
• Benchmarking challenges (retail vs. wholesale) • Profit level indicator (RoS vs. C+) • Aggregation vs. separation of financial services • Marketing intangibles • Location specific advantages	• Profit level indicator (C+, Berry Ratio, RoA, RoNA) • Location savings • Start-up /extension costs • Benchmarking challenges • Attribution of risks	• Substance of license manufacturer (vs. contract manufacturer) • Arm's length royalties for trademark and/ or technology • Limitations in royalty rates in BRIC countries and joint ventures	• Arm's length mark-up for contract R&D • Attribution of intangible related return to contract R&D	• Documentation of benefit • Duplicative services

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Substance requirements

A major challenge is the compensation of the intangibles and the question of "who should bear the major risk in a transaction?" In most cases the producing entity compensates the entity generating the core IP (product core design) through a royalty and through a separate compensation for application engineering (which is sometimes included in the license for core IP). As the royalty is often a fixed percentage of net sales, factories often bear contractually the major risk of the projects. This raises concerns of the tax authorities in the involved countries. If the factory is loss making, the tax authority in that country highlights that economically the factory has only limited control of volume and price risks and should be treated as a contract manufacturer. Thus, the factory should receive a stable C+ return. Vice versa, if the factory is making high profits the tax authority in the country of the IP owner has challenged the license fees and requires a higher royalty. The issue of lack of control and substance is now emphasised in note 1.48 of the OECD guidelines. The OECD describes a situation which has a certain similarity to the set up in the automotive supplier industry. In the example the parent company negotiates contracts on behalf of its subsidiary and provides technical support services which enables the subsidiary to fulfil its customer contracts. The parent company grants a royalty to its subsidiary and, according to the example, takes central control in project execution. The OECD concludes that a license agreement is not in line with the actual transaction. In an earlier version of the final OECD guidelines it indicates that the factory does in fact provide a service to the parent company, which would have meant that the factory would have been required to invoice the parent company instead of the customer. The OECD is now silent on the consequences if the factory continues to invoice the customer.

Location specific advantages

The countries of the emerging markets strongly encourage the concept of location specific advantages. China is now the most important automotive market and puts a high emphasis that location specific advantages must be considered when the arm's length principle is applied. The OECD is very unclear on the treatment of location specific advantages and provides little practical guidance. If the treatment of such advantages cannot be derived from third party data, the OECD suggests to share such advantages. However, the OECD is silent on the question "how a split should be performed." The industry countries view the established brands and technology as a core value driver, whereas countries like China claim their share

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for the local consumer preferences, their cheap and qualified labour on top of the functional return of the local operations. The issue becomes even more challenging as competent authority cases with China are complex – if successful at all.

Service transaction

A global supplier operates a network of factories and often provides comprehensive technical and managerial assistance, while the plant is focused on operational execution. From the perspective of the country of the plant, the taxpayers are burdened with high and complex charges which might be separate for core IP (i.e. license transactions), project specific application engineering, technical services, global and regional services etc. Tax authorities are inclined to challenge the benefit and require a high documentation to evidence the local benefit.

Quick savings

Another complex issue relates to quick savings. If the supplier is awarded with a new project the OEM sometimes requires that one time or ongoing price reductions are realised on ongoing projects. As the business is global, the OEM might receive a discount by a factory in a country whereas the benefit of a new project is awarded to a factory in a different country. Obviously this might artificially move income across border whereas the entity which grants a discount – if it were a third party – would ask for a compensation from the benefiting entity. Some suppliers have introduced balancing payments to neutralise the effects of a quick saving, thus the benefiting entity compensates the effected entity. Such balancing payments can then be easily challenged as often there is only very poor evidence available to substantiate the effects of quick savings, i.e. the nexus between the current project and the new awarded contract is not agreed in writing with the OEM but informally agreed.

2. What to do in the post-BEPS world?

It is yet not fully clear how the new OECD rules will be applied, but already there are many challenges for automotive companies:

- **Review of the business model:** As explained above, factories often operate as license manufacturers and bear significant risk. Companies must review the substance and ensure that either the substance is sufficient or business models might need to be redesigned. Some companies have introduced profit oriented license systems to ensure that the profit is in line with the limited functional and risk profile of factories.
- **IP landscape and research and development (R&D) functions:** The OECD now requires in the Masterfile to draw a clear landscape of the group's IP. Many automotive multinationals have followed a centralised IP strategy, however at the same time OEMs and suppliers follow a global footprint strategy for their R&D functions and outsourced R&D functions are compensated based on a C+ method. To maintain a centralised IP strategy it is a must to document and ensure control over outsourced R&D functions. It is easy to predict that tax authorities in the countries of the service provider will carefully scrutinise whether the R&D is controlled by the foreign principal or alternatively they will require to receive part of the intangible related return.
- **Marketing intangibles:** The OEMs should carefully review their marketing strategy and review how far it is centrally controlled. The OECD has strengthened its concept of marketing intangibles and countries will carefully review how far local distribution companies or regional hubs take control in local marketing.
- **Service transactions:** These must be carefully considered and structured. It should become clear that there's no double charging and the compensation must observe local withholding taxes and VAT issues.
- **Permanent establishments:** OEMs and suppliers are faced with many potential permanent establishment (PE) risks. In many cases plants are supported by central engineering teams and provide on ground support. The OECD will lower the threshold for the duration to create a fixed place of business which will create more PE challenges. Moreover, agency PE issues are and will be a major issue for the suppliers as, by the nature of their business, customer contracts are negotiated by a legal entity in one country but executed by a legal entity in a different country.
- **Documentation:** In many cases OEMs and suppliers have very similar functional and risk profiles for certain activities such as distribution and manufacturing and should be able to leverage from a global documentation approach. It is now an imperative to review and fine-tune the existing documentation processes.

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3. Outlook

The room for discussion within the concept of the arm's length principle becomes wider for tax authorities and the legal uncertainty for multinationals further increases. Given the high volume of intercompany transactions and the history of tax audits in the industry legal certainty will become a high value asset. Thus, automotive companies are well advised to establish a well-defined risk management process. Even if risks are closely monitored, substantial risk will remain as the views of tax authorities are yet not aligned in practice. Thus, utmost attention must be spend on emerging markets and the expansion of the use of advance pricing agreements (APAs) must be considered.

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