



IBFD Journal Articles

IBFD's high-quality journal articles support your research and daily practice by helping you keep abreast with the latest developments in international tax. Selected and thoroughly reviewed by our team of editors, our journal articles form an integrated set with our worldwide news coverage and our in-depth analyses of tax systems and treaty networks across the globe.

IBFD's journal articles originate from the following well-respected journal titles: *Asia-Pacific Tax Bulletin*, *Bulletin for International Taxation*, *European Taxation*, *Finance and Capital Markets (formerly Derivatives & Financial Instruments)*, *International Tax Studies*, *International Transfer Pricing Journal*, *International VAT Monitor* and *World Tax Journal*.

International

**Marco Adda,
Sven-Eric Bärsch,
Sven Kluge and
Francesco Giuliano Parlatore^[1]**

Transfer Pricing in the Automotive Supplier Industry

Automotive suppliers are characterized by a centralized IP ownership, centralized provision of services, and a global presence of local plants that sell and invoice manufactured components directly to their customers' local production facilities. All this makes cross-border intercompany transactions and the respective transfer pricing of automotive suppliers with respect to intangibles, manufacturing and services very challenging.

1. Introduction

The automotive industry in general and the automotive supplier industry in particular have followed a centralized strategy with a global presence but centralized technology and trademark IP ownership in few locations since many years. It is one of the industries with the highest volume of cross-border intercompany transactions and several types of those transactions, such as the sale of goods, the licensing of IP and the provision of intra-group services. The Original Equipment Manufacturer's (OEM) local production facilities are situated around the globe and automotive suppliers have established nearby these facilities. The increased intensity of tax audits focussing on transfer pricing comes as no surprise. The article is organized as follows: section 2. gives an overview of past developments and business trends in the automotive supplier industry. Next, section 3. presents typical operating structures in the automotive supplier industry. Section 4. then focuses on selected key themes in transfer pricing in that industry.

2. Past Developments and Business Trends

The period after the global financial crisis of 2008/09 was characterized by substantial growth for the automotive industry. In the last decade, sales levels in China grew above global average and made China the most important market for the automotive industry, measured in the number of vehicles sold. The automotive market in Europe also experienced an above average expansion until 2017. Globally, sales volumes of the automotive industry peaked in 2017, when 94.3 million vehicles were sold. Sales levels started to decline slowly in the subsequent years and took a markable hit during the COVID-19 pandemic. The level of sales volume is predicted to surpass its past peak in 2026.^[1]

The revenue of the automotive supplier industry peaked in 2018 but was impacted negatively by the pandemic. The pandemic resulted in an estimated loss of around 15% to 20% of global revenues for the automotive supplier industry; the United States and Europe have been hit hardest. The average margin performance of automotive suppliers declined in the course of the pandemic, causing debt levels of automotive suppliers to climb to unforeseen levels.^[2] The pandemic also caused extensive disruptions in supply chains and continued lockdowns in China are a dominant topic which especially affects automotive suppliers with production facilities in China.

Another dominant issue is the global shortage of chips. This shortage caused production volumes in the automotive industry to fall by 7.7 million units,^[3] which in turn affected the revenues of the automotive supplier industry. The war in Ukraine also impacts the automotive industry itself and the automotive supplier industry. Crucial components such as wire harnesses cannot be delivered anymore because a substantial proportion of them was produced in Ukraine. This adds to the chip crisis and COVID-19-related supply chain disruptions. The omission of the sales markets in Ukraine and Russia will, according to Deloitte, result in a decrease in production volume of around 2.6 million vehicles in 2022 and 2023 globally.^[4]

The challenges which emerged after 2020 due to the pandemic and the war in Ukraine stand behind the more fundamental and long-term challenge of the shift of the automotive industry towards electrification. Several countries set binding targets to phase out cars powered by

* **Marco Adda is partner at BonelliErede, Milan. Dr Sven-Eric Bärsch is partner at Flick Gocke Schaumburg, Frankfurt. Dr Sven Kluge is partner at Flick Gocke Schaumburg, Stuttgart. Francesco Giuliano Parlatore is managing associate at BonelliErede, Milan.**

1. Lazard & R. Berger, *Global Automotive Supplier Study 2020: COVID-19 crisis as a window of opportunity?* (Nov. 2020), available at <https://www.lazard.com/media/451494/global-automotive-supplier-study-2020.pdf> (accessed 30 Nov. 2022).

2. Id.

3. Deloitte, *Global Automotive Supplier Update: Local insights from the Triad Markets on trends and developments* (2022), available at <https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/consumer-business/deloitte-cn-cb-automotive-suppliers-preparing-for-transformation-en-220526.pdf> (accessed 30 Nov. 2022).

4. Id.

internal combustion engines. By 2035, the European Union set the target of registering only zero-emission cars. Canada, China, Japan, Türkiye and the United States set targets as well.^[5] In the coming years, there will thus be a substantial shift towards electric or biofuel-powered vehicles. Electric vehicles require different components than cars powered by internal combustion engines and thus, numerous core products of automotive suppliers will face falling demand. A radical shift in strategy is required.^[6] It is likely that many automotive OEMs will invest in the area of research and development to develop more fuel-efficient vehicles. Technologies relevant in this regard include fuel cell technology for hydrogen-powered vehicles, ethanol vehicles and plug-in hybrid electric vehicles.

Furthermore, trends such as vehicle connectivity and digitalization as well as autonomous driving and car sharing are of growing importance. In the near future, high-tech equipment such as in-vehicle telematics, which provides drivers with instant safety, communication, and infotainment services, is likely to become part of the standard equipment in vehicles. Also among the practical applications are vehicle fault detection, voice-assisted driving instructions, and vehicle-to-vehicle communications, which serve to avoid collisions by ensuring that vehicles maintain a safe distance from each other. These changes are expected to have an encouraging impact on multinational companies in the automotive industry. In addition, there is increasing pressure on automotive OEMs to develop global platforms upon which vehicles are designed, engineered and produced, to use the most capital-intensive facilities and resources first and localize them later reflecting regional preferences. In order to remain successful, automotive OEMs must recognize the developing nature of consumer perceptions and preferences.

The automotive industry is changing from a traditional vertical structure to a more horizontal structure with these new trends and developments. Under this horizontal structure, automotive OEMs are sourcing electronic components from semiconductor companies or may use network services from telecommunications companies to respond to evolving consumer demands for greater fuel efficiency and connectivity in vehicles. In addition, companies that have not supplied products to automotive OEMs in the past may now become important suppliers to the automotive industry. This is due to the fact that the automotive sector is investing significantly in the development of hybrid and electric vehicles, as well as in telematics. Due to these recent developments, the landscape of the automotive industry has changed, making it important for automotive manufacturers to anticipate cross-industry and cross-regional opportunities while remaining mindful of the business and tax requirements in different industries and markets.

3. Typical Operating Structures in the Automotive Supplier Industry

3.1. Overview

Automotive suppliers and OEMs form a narrow market. Generally, OEMs require automotive suppliers to establish their plants nearby the OEM's production facilities in order to secure just-in-time delivery. Often, automotive suppliers' local plants invoice directly to the OEM's local production facilities. In contrast to OEMs, the accounting of automotive suppliers' delivery of manufactured components generally does not include intra-group sales of manufactured components from its local plants to its principal or full-fledged manufacturer followed by their sales to the OEM's production facility. However, automotive suppliers' local plants often use technology and trademarks developed and owned by their principal. Moreover, local plants make use of intra-group services provided by the principal or other centralized service provider, such as procurement and sales. For instance, sales contracts are often negotiated between the OEMs' headquarters and automotive suppliers' entities, which are in close proximity to the OEMs' headquarters. Separate sales entities of automotive suppliers have been increasing in practical relevance but are still an exception. All this makes the intra-group transactions with local plants very important for the transfer pricing of automotive suppliers. Against this background, automotive suppliers' operating structures are often described by the following types of "units" according to their function and risk profiles: (i) principal or full-fledged manufacturer; (ii) licenced manufacturer; (iii) contract manufacturer; (iv) toll manufacturer; and (v) limited-risk distributor. Although the boundaries between these terms are sometimes unclear and they may oversimplify complex manufacturing profiles, this description is often useful in describing typical transfer pricing issues associated with the automotive supplier sector.

3.2. Principal or full-fledged manufacturer

Activities such as production planning, input procurement, supply chain management, quality control, long-term capacity utilization planning and perhaps sales to third-party customers may be the responsibility of a principal entity or a full-fledged manufacturer. The full-fledged manufacturer may bear a number of risks associated with these activities, such as warranty, capacity utilization, product liability, pricing risks and market demand. In addition, the principal or full-fledged manufacturer may also be significantly engaged in R&D activities, wherein it bears the risks inherent in the development, enhancement, maintenance and protection of valuable intangible assets that may result from the R&D activities.

A full-fledged manufacturer generates profits from both routine functions (including routine manufacturing activities) and from its contribution to valuable intangible assets. Considering a simplified model with only one principal or full-fledged manufacturer and many other manufacturers and eventually distributors in the value chain of a multinational automotive supplier, several units may generate profits from the performance of routine functions based, for instance, on the benchmarked profitability of functionally comparable companies, whereas the principal or full-fledged manufacturer receives all residual profits or losses from the value chain. In an ideal world, the

5. Id.

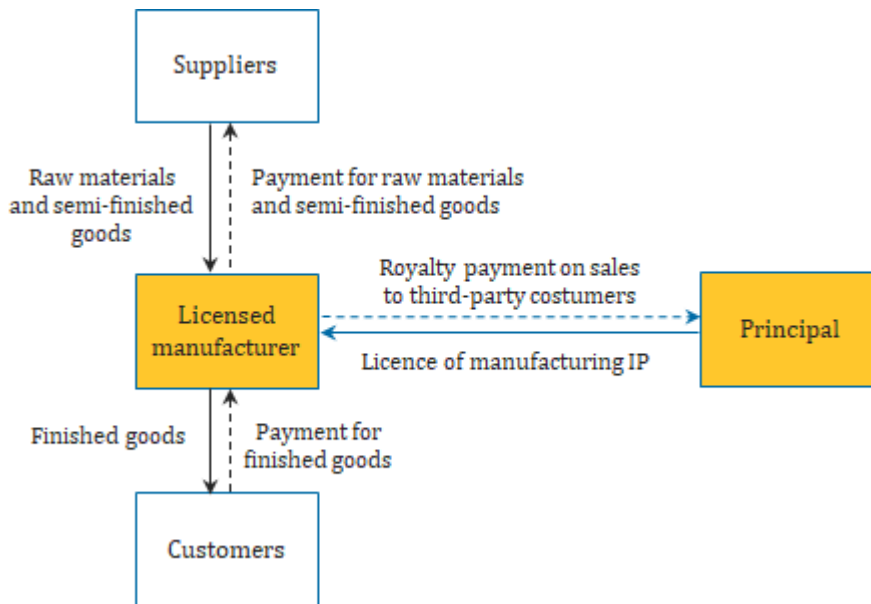
6. Deloitte, *Automotive suppliers: preparing for transformation* (2022), available at <https://www2.deloitte.com/cn/en/pages/consumer-business/articles/automotive-suppliers-preparing-for-transformation.html> (accessed 30 Nov. 2022).

profitability of the routine units is generally low but relatively stable, as it is subject to a benchmarked fixed profitability margin. In contrast, significant fluctuations are possible with regard to the profitability of the principal or full-fledged manufacturer compromising the aggregate profit level of the entire group. This is reflected in their higher risk profile.

3.3. Licensed manufacturer versus routine manufacturer

Under a licensed manufacturer framework, the manufacturer (licensee) produces goods under a licence agreement, according to which it uses intangible assets, such as product designs, patents, know-how, and manufacturing processes, which the principal (licensor) owns. In return for the use of the licensed intangible assets, the licensed manufacturer pays royalties to the principal. In addition, the licensed manufacturer usually purchases raw materials and semi-finished products for its own account and holds inventories of raw materials and finished products. The risks associated with holding inventories and selling products, including demand and pricing risk, are thus allocated to the licensed manufacturer. Normally, the licensed manufacturer owns the plant and equipment necessary for the production. This is illustrated in Figure 1.

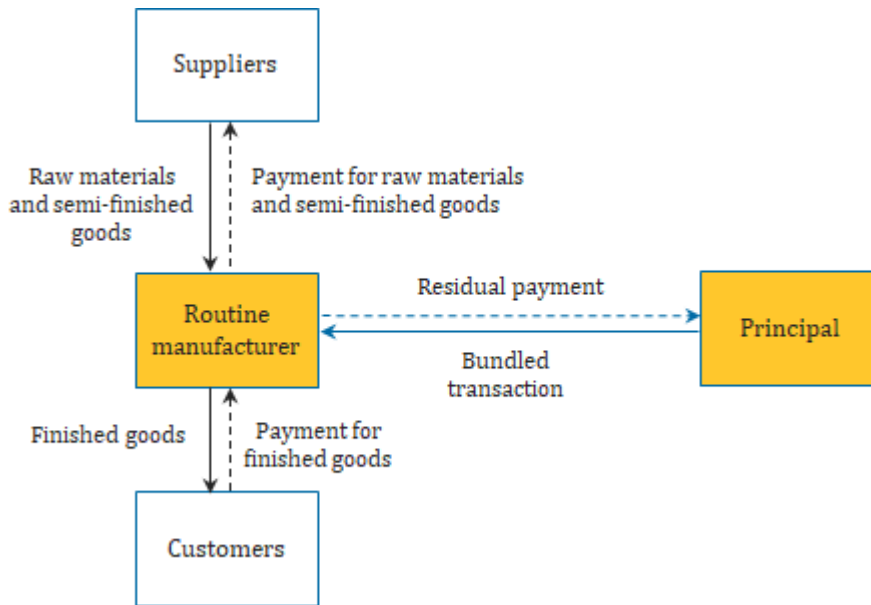
Figure 1 – Licensed manufacturer structure



A routine manufacturer is considered to bear less risk than a licensed/full-fledged manufacturer. The routine manufacturer is responsible for the production of the goods while the principal or licensed/full-fledged manufacturer directly bears the risk of demand and final customer prices. The principal or licensed/full-fledged manufacturer may guarantee acceptance of goods. Like the licensed manufacturer, the routine manufacturer typically sells directly to third-party customers at market prices. The routine manufacturer generally owns plant, equipment and the raw materials, and it has customer receivables. Thus, it bears the risks associated with owning fixed assets, raw material inventories and receivables. In order to ensure the generation of low but relatively stable profits from the performance of routine functions, the routine manufacturer may generate profits based on the benchmarked profitability of functionally comparable companies,

whereas the routine manufacturer pays all residual profits (or losses) from the value chain to the principal or full-fledged manufacturer. See Figure 2.

Figure 2 – Routine manufacturer structure



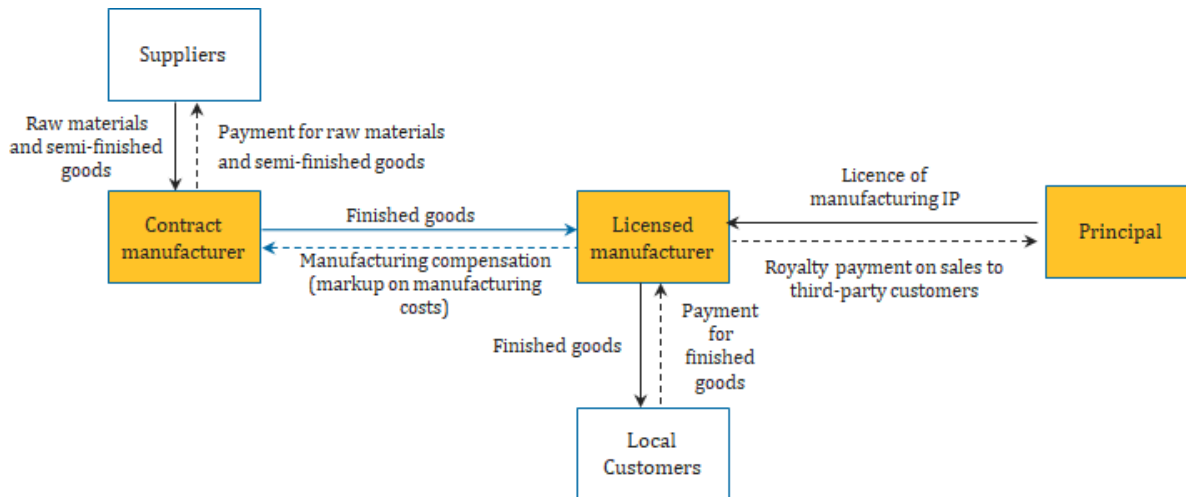
3.4. Contract manufacturer and toll manufacturer

Like the routine manufacturer, a contract manufacturer is also considered to bear less risk than a licensed/full-fledged manufacturer. The contract manufacturer is responsible for the production of the goods while the principal or licensed/fully-fledged manufacturer directly bears the risk of demand and final customer prices. The principal or licensed/full-fledged manufacturer may guarantee acceptance of goods if the products manufactured by the contract manufacturer meet the principal's product and quality specifications. Therefore, only relatively low risks are inherent in the warehousing and sale of finished goods at a contract manufacturer, as compared to a licensed/full-fledged manufacturer. The contract manufacturer generally owns plant, equipment and the raw materials. Thus, it continues to bear the risks associated with owning fixed assets and raw material inventories. A licensed/full-fledged manufacturer can often perform some contract manufacturing activities that are an adjunct to its other manufacturing activities.

A common intercompany transaction between a contract manufacturer and the licensed manufacturer (or full-fledged manufacturer) consists of the contract manufacturer selling the manufactured goods to the latter manufacturer, which deviates from the above-described routine manufacturer (see Figure 2 for illustration). Typically, the contract manufacturer is compensated by the licensed/full-fledged

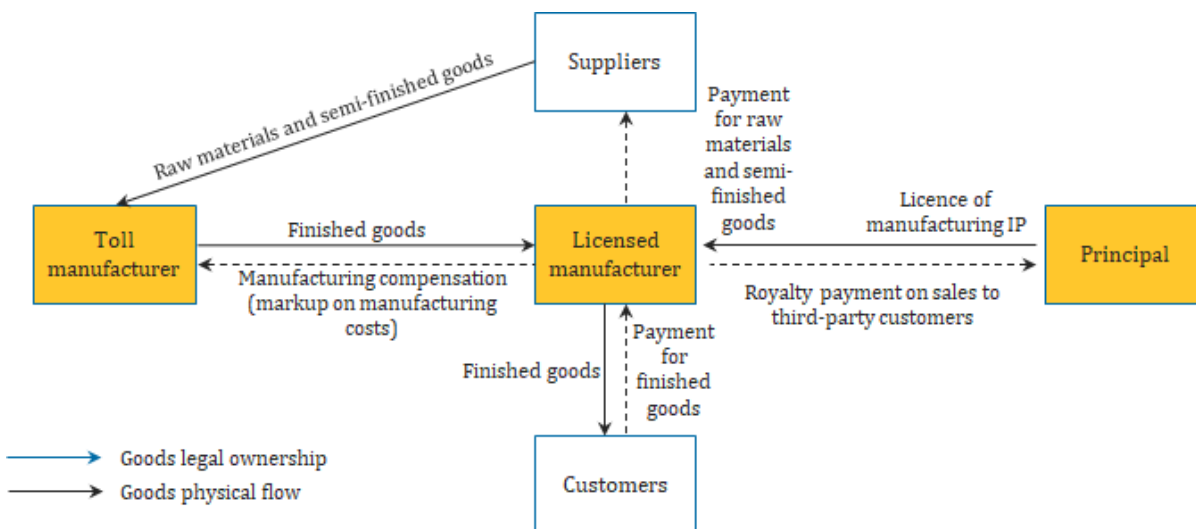
manufacturer through a return that allows the contract manufacturer to earn an arm's length markup on total costs, meaning a return on value-added manufacturing services as a return on its capital investment and investment in raw material inventory. See [Figure 3](#).

Figure 3 – Contract manufacturer structure



Toll manufacturing frameworks provide that the principal or licensed/full-fledged manufacturer retains ownership of the raw materials, work-in-process and finished goods during the manufacturing process. In this framework, the principal or licensed/full-fledged manufacturer owns the raw materials and provides them to the toll manufacturer for processing (i.e. the toll manufacturer does not acquire ownership of the raw materials). A common third-party transaction consists of the licensed/full-fledged manufacturer selling the manufactured goods to local customers. This is illustrated in [Figure 4](#). Thereby, the toll manufacturer provides the processing services and is compensated for this by the licensed/full-fledged manufacturer through a service fee, which is usually charged as a profit markup on the processing costs. Risks related to the warehousing of raw materials and finished products and the final demand and price risk are borne by the licensed/full-fledged manufacturer.

Figure 4 – Toll manufacturer structure

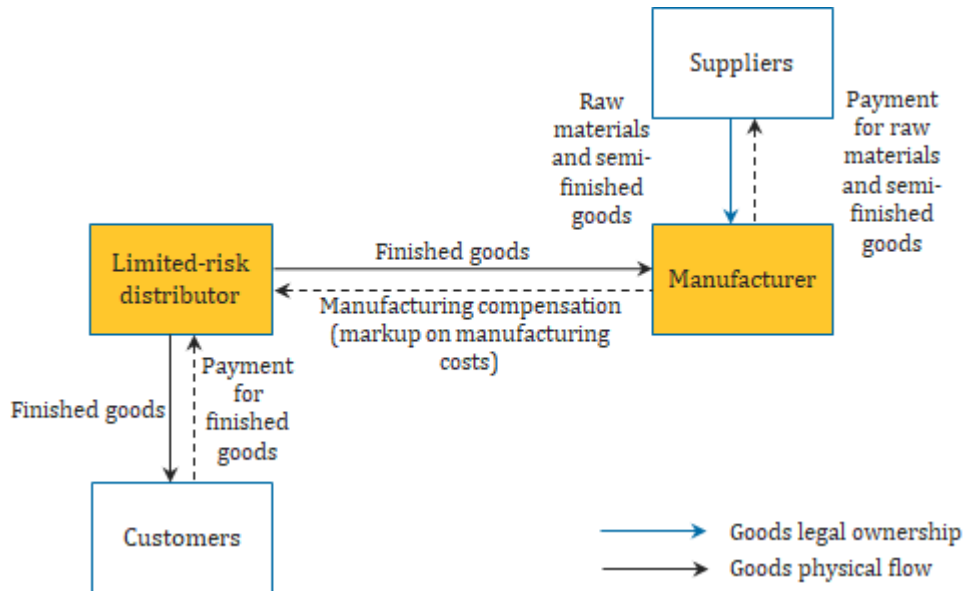


3.5. Limited-risk distributor

A limited-risk distributor is responsible for the sale of the goods to the customers while the principal or licensed/full-fledged manufacturer directly bears the risk of demand and final customer prices. If existent, the limited-risk distributor sells directly to third-party customers at market prices, instead of the licensed manufacturer/full-fledged manufacturer/routine manufacturer. The limited-risk distributor generally employs sales personnel, owns the finished products, and it has customer receivables. Thus, it bears the risks associated with finished

goods inventories and receivables. In order to ensure the generation of low but relatively stable profits from the performance of routine functions, the limited-risk distributor may generate profits based on the benchmarked profitability of functionally comparable companies, whereas it is not entitled to the residual profits (or losses) from the value chain. In the automotive supplier industry, limited-risk distributors are, however, very rare. See Figure 5.

Figure 5 – Limited-risk distributor structure



4. Key Themes in Transfer Pricing

4.1. Intangibles

In transfer pricing analysis involving intangibles, it is essential to:

- (1) Identify with specificity the intangibles involved.
- (2) Identify the owner and those that contribute to the value of the intangibles.
- (3) Characterize the transaction involving the use or transfer of intangibles.
- (4) Determine the arm's length conditions of the transaction involving intangibles.

The following paragraphs provide an overview of the most common peculiarities and issues that may arise in the context of a transfer pricing analysis of an MNE group in the automotive supplier industry.

4.1.1. Identification of significant/valuable intangibles

Chapter 6 of the OECD Guidelines defines the intangible as “something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.^[7] In addition, according to the OECD Guidelines, “the identification of an item as an intangible is separate and distinct from the process for determining the price for the use or transfer of the item under the facts and circumstances of a given case” and “that not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances”.^[8]

Generally speaking, in the automotive supplier industry (but not only), the identification of the intangibles involved in intercompany transactions that deserve compensation is complicated by the following specificities:

7. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022), para. 6.6., Primary Sources IBFD [hereinafter OECD Guidelines].
8. Para. 6.10 *OECD Guidelines*.

- usually the bundle of technological intangibles shared among associated companies is formed by product and/or process know-how and experiences that may be patented or not and, depending on circumstances, for smaller MNEs unregistered know-how may not be properly identified and formalized, being it embedded in habits, unwritten procedures or simply certain key employees making it, therefore, difficult to show and prove the existence of actual valuable know-how;
- especially for those OEM suppliers that sell customized products to their clients (i.e. products specifically developed for – or jointly developed with – each OEM based on the characteristics of the vehicle and the technical requirements of the OEM), the technological intangibles are the sum of different instructions, procedures and operating manuals on how a specific product should be designed, developed and mass-produced based on previous project/experiences, so it might be actually complicated to identify each time the intangibles actually used or shared in a controlled transaction and the value of such intangible for the specific product developed for the OEM client;
- among the technological intangibles put at the disposal of the group entities, there might be know-how and technical solutions that might be employed only in the future, while having little or nil value in a specific fiscal year;
- the value of OEM suppliers' trademarks is generally limited or even absent and, in any case, it cannot be considered and evaluated in isolation from the technological intangibles. Considering that it is a B2B transaction, the technological content and the design, development and mass-production capabilities are more valuable to the OEM; and
- any process know-how should not be confused with any potential location-specific advantages from the manufacturing activities (e.g. lower labour, energy and in general production cost).

The above list shows that within an MNE group that supplies products to an OEM it might not always be straightforward to identify and evaluate the intangibles shared among group entities, especially in those situations where more than one group entity is actually a contributor to the value of the intangibles: this is a typical situation that can be seen when the MNE group supplies to the OEM products specifically designed and developed for such OEM and such design and development is performed at the local manufacturer level based on know-how located at the central level.

4.1.2. Identification of the owner of the intangible and contributors to the value of the intangibles

According to the OECD Guidelines, the allocation of the return derived by the MNE group from the exploitation of intangibles, and the allocation of costs and other burdens related to the intangibles among members of the MNE group is accomplished by compensating members of the MNE group for functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.^[9]

This is true also for transfer pricing analysis of OEM suppliers, where, however, as anticipated, the identification of the contributors to the value of the intangibles (and the evaluation of such contributions) may not always be a straightforward exercise, especially for those OEM suppliers that adopt a decentralized operating model where local manufacturers have an entrepreneurial role (usually as licensed manufacturers). Generally OEM suppliers that supply products/components directly to an OEM (so-called Tier 1 suppliers) have a large role in the design of parts/components for vehicle manufacturers since they are usually awarded contracts for the life of a vehicle model and they are involved since the early stages in the design of the products and of the relevant processes; moreover, due to the globalization and the just-in-time production processes, Tier 1 suppliers have been pushed in the recent decades to locate their production facilities close to the ones of their OEM clients. Such characteristics of the automotive supplier industry combined with the peculiarities of decentralized operating models (with a local manufacturer with an entrepreneurial role) may give rise to complexities in identifying and evaluating the contributions of local manufactures to the value of the intangibles.

Such complexities are typically related to the cross-fertilization of IPs and R&D processes and to know-how developed locally and then shared within the group. Notably, in the industry at stake, the product development process generally involves several functions that may be located in different subsidiaries within the group and it relies on previous experience and know-how acquired by the different subsidiaries of the group and/or on specific researches carried out at the central/regional level: these different flows of transfer of know-how within the group (from HQ to local manufacturers and/or vice versa), can make it quite complex to identify the contributions and the level of the contributions of the different members involved. Another source of complexities derives from know-how (typically process/manufacturing know-how) developed over the years at a local level and then exported within the group for new local operations: also in these circumstances, it is essential to understand the role (performance of functions, use of assets and more importantly the management of the risk related to the DEMPE activities) of the local manufacturers and HQ in the development of such know-how to understand who is actually entitled to the return of the intangible.

4.1.3. Characterization of the transaction involving intangibles

The characterization of intercompany transactions involving intangibles is crucial for the performance of the comparability analysis (i.e. identification of the controlled transaction and comparison with transaction between independent parties) and ultimately for determining

9. Para. 6.32 *OECD Guidelines*.

the arm's length conditions of such intercompany transactions. Moreover, although the OECD Guidelines acknowledge that the characterization of a controlled transaction for transfer pricing purposes is not relevant for the purposes of the definition of royalties in accordance with article 12 of the OECD Model Tax Convention,^[10] it is, however, reasonable to assume that, in particular with reference to the distinction between the supply of know-how and services,^[11] the characterization of a transaction for transfer pricing purposes should be ultimately reconciled with the characterization according to the principles of article 12 of the OECD Model Tax Convention, or that in any case the principle of such article can be of assistance in the characterization also for transfer pricing purposes.

According to the OECD Guidelines,^[12] the transactions involving intangibles can be characterized in the following two general types:

- (1) transactions involving transfers of intangibles or rights in intangibles; and
- (2) transaction involving the use of intangibles in connection with the sale of goods or the provision of services.

With specific reference to the situation of automotive suppliers groups, in the case of decentralized operating models (with local manufacturers with an entrepreneurial role), the transaction involving intangibles between the HQ licensee and the licensed local manufacturer usually does not raise particular characterization issues, being generally characterizable as a true licence agreement and therefore falling ordinarily in the first category (transactions involving transfers of intangibles or rights in intangibles); conversely, in the case of more centralized operating models, the transactions involving intangibles between the HQ and the local manufacturers certainly give rise to more doubts.

As previously highlighted, generally OEMs require automotive suppliers to establish their plants (and therefore manufacturing subsidiaries) nearby the OEM's production facilities and to invoice to the OEM's local production facilities directly from the automotive suppliers' local subsidiaries, regardless of whether they are licensed manufacturers or routine manufacturers. Although for both licensed manufacturers and routine manufacturers the formal set-up may formally appear the same (with the licensed manufacturer and the routine manufacturer making a payment to the HQ for intangibles and services), the actual characterization of the intercompany transactions with the HQ assumes a different meaning depending on the functional profile of the local subsidiaries and consequently the extent of the involvement of the HQ in the management and control of core functions and risks.

Notably, while the transaction between a HQ licensee and a licensed local manufacturer usually is limited to the transfer of intangibles and therefore characterizable as a pure intangibles licence agreement (usually supporting services rendered by HQ to the licensed manufacturer are separately formalized and remunerated), the transaction between the HQ and a local routine manufacturer definitively exceeds a pure licence agreement and usually includes several core services (e.g. commercial, operations, etc.). Depending on the actual complexity of the routine manufacturer's functional profile and notwithstanding both the licensed and the routine manufacturers sell directly to third-party OEMs, such transaction can be either characterized:

- as a transfer of limited right in intangibles in combination with the supply of tangible assets and/or services, when the local routine manufacturer is more involved in the management and control or core activities and risks. In this case, the transaction assumes the form of a bundled transfer of limited rights on intangibles and intra-group services, with generally a fixed (or with limited/capped fluctuation) remuneration granted to the HQ; or
- as a transfer involving the use of intangibles in connection with sales of goods or performance of services when the functional profile of the routine manufacturer is so limited that the actual nature of the relationship with the HQ is the one between a contract/toll manufacturer and a principal (with the routine manufacturer substantially providing to the HQ/principal manufacturing services and invoicing services). In this last situation, the transaction between the routine manufacturer and the HQ will take the form, depending on the case, of:
 - floating royalties and service charges from the routine manufacturer to the HQ/principal in case there is residual profit to be attributed to the HQ/principal; or
 - flexible contributions from the HQ/principal to the local manufacturer when the latter does not achieve the routine manufacturing arm's length return.

4.1.4. Determination of the arm's length conditions of the transaction involving intangibles

The different characterization of the transactions between a local manufacturer and its HQ has a huge impact on the process and method selection for the determination of the arm's length conditions: in the case of transfer of limited right in intangibles (e.g. licence transactions), even in combination with other business transactions, it is appropriate to determine directly the arm's length conditions of the transaction (or transactions in the case of other transactions connected) while, in cases where there is a substantial intra-group transfer involving the use of intangibles in connection with performance of services (e.g. deemed contract manufacturing services notwithstanding the direct invoicing from the manufacturer to the OEM clients), it might be appropriate to determine the arm's length conditions of such bundled transaction indirectly (on a residual basis) after having attributed to the routine manufacturer a routine return for its functions.

^{10.} Paras. 8 to 19 *OECD Model: Commentary to Article 12*.

^{11.} By way of example, the distinction between the supply of know-how and services (see paras. 11 to 11.6 *OECD Model: Commentary to Article 12*).

^{12.} Para. 6.87 *OECD Guidelines*.

It can be fairly stated that the direct evaluation of intangibles in the case of transfer of intangibles (or limited rights on intangibles) gives rise to more complexities and sources of controversies with tax authorities compared to the indirect evaluation of intangibles in the case of use of intangibles in connection with sales of goods or performance of services.^[13]

In cases involving the transfer of intangibles or rights in intangibles, according to the OECD Guidelines, the CUP method and the transactional profits split method are the transfer pricing methods that most likely prove useful for direct evaluation of the intangibles (or rights in intangibles) transferred,^[14] while one-sided methods are generally considered not reliable.^[15] With specific reference to the application of the CUP method, it is worth highlighting that in the automotive supplier industry (as well as in many other industries) the identification of reliable comparables may be very difficult if not impossible when internal comparables are not available. Indeed, considering the limitations^[16] of the mostly used commercial databases (e.g. RoyaltyStat, BvD TP Catalyst, ktMINE, etc.) and the (usually not adjustable) comparability issues of the potential comparables derived from such databases, the CUP method based on external comparables usually is not able to achieve a sufficient level of accuracy and reliability of the comparability analysis and it might prove useful, based on a practical and flexible approach, merely to supplement or corroborate the indications deriving from the application of other appropriate methods.

Conversely, in most cases, a CUP analysis based on internal comparables proves to be sufficiently reliable and robust, considering the direct and closer relationship between the controlled transaction and the internal comparable. However, it is worth mentioning that even internal comparables rarely prove to be fully reliable comparables because, in most instances, it is impossible to retrieve a transfer of rights of intangibles with third parties involving the same intangibles or the same combination (or all the intangible of a group) of intangibles to be used in the very same industry for the core business of the MNE, as it happens within a group (indeed, MNEs do not share with third parties in their industries the same combination of intangibles, e.g. jointly all their technological and marketing intangibles). Therefore, in most cases, the internal comparables that can be retrieved are observations with a more limited or partial content (in terms of intangibles, geographical scope, industry/product scope, etc.) compared to the controlled transactions. Notwithstanding the above, also the OECD Guidelines recognized that the difficulties and complexities should not preclude the possible application of the CUP method, and that “practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy”.^[17]

As per the application of the profit split method in the case of licence transactions, the OECD Guidelines state that it can be utilized to evaluate the respective contributions of the parties to the consolidated profits when reliable uncontrolled comparables are not available.^[18] In transfer pricing analysis of MNEs in the automotive supplier industry, considering the complexities highlighted above in terms of identification of valuable intangibles transferred within the group and of contributors to the value of the intangibles, the level of integration of the activities of the group entities and the potential comparability issues of the internal CUPs, it can prove useful also in conjunction with or as a supporting/corroborative method to the internal CUP method since it can actually provide a practical solution taking into account specific facts and circumstances of the controlled transactions that may not be present between independent parties. However, it is to be noted that in practice, including in the automotive supplier industry, the profit split method has still limited application among taxpayers and by the tax authorities especially in the context of unilateral or bilateral APA, due to the inherent complexities in its application.

4.2. Manufacturing

Risk delineation and assumption is at the heart of transfer pricing comparability analysis since it allows to determine which party is in control and, consistently with this outcome, the compensation for risk management.^[19] The OECD Guidelines provide a six-step analysis to detect risk in a given transaction aimed at identifying the risk management function which consists of three elements: (i) capability to make decisions in relation to the risk assumption; (ii) capability to decide whether and how to respond to the risk; and (iii) capability to mitigate risk.

This approach requires that, at arm's length, it is possible – given a specific risk category – to identify the entity that effectively exercises control over risk, meaning that it has:

- (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.^[20]

It is important to note that:

13. In this last case, the source of the controversies with the tax authorities is generally related to the actual characterization of the transaction, as explained in the previous paragraph.

14. See para. 6.145 *OECD Guidelines*.

15. See para. 6.141 *OECD Guidelines*.

16. Mostly in terms of sources, geographical perimeter and available information of the observations.

17. Para. 2.17 *OECD Guidelines*.

18. Para. 6.152 *OECD Guidelines*.

19. Para. 1.56 *OECD Guidelines*.

20. Para. 1.65 *OECD Guidelines*.

- the actual capability of control over a specific risk depends on the degree of information that the parties involved in a specific intercompany transaction possess, which on the one hand depends on assessing the “foreseeable downside and upside risk outcomes” of a decision and, on the other hand, requires “competence and experience in the area of the particular risk for which the decision is being made”;^[21] and
- not all risks can be managed since they “... are a general condition of commercial activity affecting all businesses undertaking that activity. For example, risks associated with general economic conditions or commodity price cycles are typically beyond the scope of an MNE group to influence” [emphasis added].^[22]

In this respect it is common background among transfer pricing practitioners that the COVID-19 crisis impacted on transfer pricing policy and necessitated introducing some departures from the transfer pricing ordinarily applied. This was due to the fact that the arm’s length principle functions mostly where the economic cycle is characterized by a certain degree of stability. In the case of an unpredictable downturn, the possibility to consistently apply the arm’s length principle by mirroring independent parties’ behaviour is no longer an option. In light of this, the OECD published a document dealing with the application of the arm’s length under the pandemic crisis^[23] whose main take-aways can be summarized as follows:

- the lack of availability of information regarding contemporaneous uncontrolled transactions may justify the use of alternative approaches to test the arm’s length (e.g. take into account information that becomes available after the close of the taxable year, use of more than one transfer pricing method, inclusion in the benchmark of loss-making comparables);
- given the relevance of the crisis, independent parties may not strictly hold another party to their contractual obligations, particularly if it is in the interest of both parties to renegotiate the contract or to amend certain aspects of their behaviour;^[24] and
- allocation of operating or exceptional costs would follow risk assumption and how third parties would treat such costs.^[25]

We are now facing a further crisis that is not linked to the demand side but starts from the supply side and will impact the production capabilities. This will be especially true for capital-intensive industries (such as the automotive one) where increased energy costs will not easily be automatically shifted to the OEM and, hence, the automotive suppliers will need to determine if and how to adapt their transfer pricing models.

It is first of all necessary to understand whether such kind of risk may represent a general economic condition (which, as stated above, cannot be controlled) or, if, conversely, this represents a risk that may be managed. If one takes the first view, then (likewise for the COVID-19 experience) a departure from the arm’s length can be justified regardless of the transfer pricing model applied (e.g. licence-based models where all the entities are acting as entrepreneurs and principal-based models where there is just one entity acting in such capacity).

The main consequences of such approach may be depicted as follows. Under a licence-based model the main issues will be whether to adjust the royalty rate to reflect the decrease in the net margin incurred by the manufacturer of automotive components due to increased operational costs. In a nutshell is possible to state that if the licensee is acting transfer pricing wise as a full-risk entrepreneur, consistently one would assume that the royalty rate should not be modified.

However, this position may trigger distortions in light of different factors: (i) royalty rates are generally benchmarked relying on comparables selected in ordinary market circumstances; (ii) the amount of royalties to be paid to the licensor is based on the value of the net sales but the added value of the licensed intangibles economically is heavily impacted by the increased operational costs; (iii) *coeteris paribus*, royalty rates (which approximate a profit split mechanism) should reflect a proper allocation of the relevant risks between the parties, i.e. in the ordinary bargaining position the licensee would agree on the amount of the royalty to the extent they are expecting to get part of the extra-profit deriving from the exploitation of the relevant intangibles (for instance, in the case at stake, product know-how); (iv) the unpredictable increase in the energy costs (which does represent a part of the market risk) does not fall under the control of the licensee who is not in the position to undertake concrete actions aimed at lowering the magnitude of such risk.

Moreover, the kind of risk does not appear to be one that can be influenced by the MNE’s decision.

In light of this, one could argue that royalty rates should be reviewed to reflect the modified economic circumstances and:

- either provide for an integration of the determination of the royalty rate using as a floor the net marginality that should be left to the licensee at least to remunerate its routine functions; or
- provide for reduction of the royalty rates in the same percentage represented by the impact of the energy costs on the sales.

21. Para. 1.66 *OECD Guidelines*.

22. Para. 1.67 *OECD Guidelines*.

23. OECD, *Guidance on the transfer pricing implications of the Covid-19 pandemic* (18 Dec. 2020), available at <https://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm> (accessed 30 Nov. 2022).

24. *Supra* n. 23, para. 43.

25. *Supra* n. 23, para. 48.

In certain circumstances it could be even envisaged that royalty payments may be suspended until the ordinary market conditions are restored to the extent that the detrimental effect of such kind of risk (general unforeseeable conditions) may cause a business discontinuity to the licensee.

In the case of principal-based models, it can be debatable whether extra operational costs should be included in the cost base of manufacturer entities (either contract or toll manufacturers). In this regard some guidance can be found in the work on the impact of the COVID-19 pandemic developed by the OECD where in dealing with exceptional costs the following approach is suggested: (i) exceptional costs should generally be excluded from the net profit indicator except when those costs relate to the controlled transaction as accurately delineated; (ii) when determining a cost basis it is important to consider whether the basis should include or exclude exceptional costs that are deemed to relate to the controlled transactions and, if included in the cost basis, whether such costs should or should not be treated as pass-through costs to which no profit element should be attributed; and (iii) accounting consistency may be required to improve comparability.^[26]

Since the issue related to whether or not a limited-risk entity may incur losses exceeds the scope of the present contribution, in light of the position expressed by the OECD with reference to the COVID-19 crisis one could propose two different approaches:

- (1) including in the price setting also loss-making comparables; or
- (2) using an outcome testing approach and allowing compensating adjustments.

4.3. Services

Automotive suppliers operate many plants that have been established nearby the OEM's production facilities, which receive technical, managerial and/or sales support from centralized service providers. The volume of intra-group services is likely to continue to increase in the future, especially due to the need to increase efficiency. This will be accompanied by an increased potential for conflicts within the automotive supplier. On the one side, this will likely be caused by the nature of internal cost allocation between units providing and plants receiving services. On the other side, the tax-compliant determination and allocation of service fees is also decisive. In practice, the cost-plus method clearly dominates the setting of transfer prices for intra-group services. Although several issues are often the focus of tax disputes with the tax authorities, such as issues in determining which services are chargeable, how to distinguish them from non-chargeable shareholder expenses, and the profit markup, tax auditors question the cost basis of charging for intra-group services particularly critically. In this respect, automotive suppliers are also confronted with many permanent establishment risks. In practice, plants are sometimes supported by central engineering teams which provide on-site support. In addition, agency permanent establishment risks are a major topic for automotive suppliers because their local plants invoice directly to the OEM's local production facilities, while automotive suppliers' entities, which are in close proximity to the OEMs' headquarters, provide local sales and marketing support or negotiate commercial terms of supply. These risks could be mitigated by the establishment of limited-risk distributors, which therefore could become more relevant in the automotive supplier industry, at least in selected countries.

^{26.} In these terms, *supra* n. 23, paras. 52-54.



About IBFD

The global source for accurate, independent tax publications.

The International Bureau of Fiscal Documentation (IBFD) is the world's foremost authority on cross-border taxation. We offer tax professionals high-quality information and education that enable them to work on the basis of up-to-date and accurate tax knowledge.

Our customers, ranging from multinational corporations to leading universities, tax advisories and government tax agencies, come to us for comprehensive international tax information that helps them achieve the best solutions to their taxation needs.

Interested in subscribing to our online Journal collections? Check our website (www.ibfd.org) or contact our Sales team (sales@ibfd.org).
