



Viewpoint

A Publication of NERA Economic Consulting's Global Transfer Pricing Practice

NERA Economic Consulting's Global Transfer Pricing Practice has launched *Viewpoint*, a new publication series to mark the start of the new decade. The aim of the series will be to provide regular commentary on developments in the world of transfer pricing from the viewpoint of economists who specialise in transfer pricing. We will provide insights into new ideas and thinking brought to bear by NERA's experts, and a round-up of news from the firm's Global Transfer Pricing Practice.

Pim Fris (Editor)
 +32 2 282 4355
 pim.fris@nera.com

NERA's Transfer Pricing Practice Global Locations:

Frankfurt
 Geneva
 London
 Madrid
 Paris
 Chicago
 Los Angeles
 New York City
 Toronto
 Washington, DC
 Beijing
 Shanghai
 Tokyo

In this first issue of *Viewpoint*, we review recent notable transfer pricing decisions, and highlight a number of points for transfer pricing practitioners.

First, the cases highlight how important it is for practitioners to consider and define clearly how the arm's length principle should be applied. Too narrow, or too wide, a focus can potentially result in misleading answers. It is therefore vital that practitioners follow the arm's length principle closely and do what it asks—i.e., keep everything else the same, and relax only the condition that the parties are related.

Second, these cases further illustrate how the bar is being raised in comparability analysis and the making of adjustments. This is an area where practitioners and taxpayers will have to focus more attention going forward, and it seems likely that the OECD will strengthen requirements following its release of a discussion draft on proposed changes to the Transfer Pricing Guidelines.

Third, the cases demonstrate how economics can, and is, being used to challenge and dismiss the positions advanced by taxpayers or tax authorities. This makes it very clear how "economic analysis" needs to extend beyond sections or chapters of reports that deal with constructing a range from comparables data. Rather, economic analysis needs to be part of every aspect of a transfer pricing study, particularly where a significant amount of tax is at stake for obvious reasons.

Last, it is worth noting that tribunals and tax courts do, on occasion, appear to arrive at somewhat puzzling conclusions. This may be because the application of economics to transfer pricing is still in its infancy compared, for example, to antitrust. The lesson here is that taxpayers should not only conduct a thorough analysis (including the use of economics) where the stakes are high, but they should do so first.

DSG Retail Ltd (UK)

In April 2009, the Special Commissioners found in favour of HMRC in a landmark transfer pricing case. In the decision, the taxpayer's transfer pricing was found not to be arm's length and the UK corporation tax to have been understated. The case was settled for an amount understood to be in excess of £50 million.

The case concerned captive (re)insurance arrangements entered into by a retailer, but has much wider ramifications. Specifically, it set a high standard for comparability and highlighted the potential role played by bargaining power in transfer pricing analysis.

Background

The case related to transfer pricing arrangements between a major electrical retailer, DSG Retail Ltd (Dixons), and an associated company in the Isle of Man, Dixons Insurance Services Ltd (DISL). The arrangements involved:

- Dixons acting as a sales agent for extended warranty or service contracts that were made available to customers at the point of sale, such contracts being entered into with a third party;
- the third party entering into repair and administration agreements with an associated company of Dixons; and
- the liability to customers being insured or reinsured by the third party with DISL (the model changed during the enquiry period for indirect tax reasons).

HMRC's challenge focused on the premiums paid to DISL, even though there actually were no direct transactions or contractual arrangements between Dixons and DISL.

The Decision

The decision arrived at the by Special Commissioners centred around two key points. The first concerned whether the arrangements entered into by Dixons and its associated companies were caught by the UK's transfer pricing legislation. During the period under question, this legislation changed. Section 770 of the Income and Corporation Taxes Act 1988 (s.770) applied until the Finance Act of 1998 introduced new legislation—i.e., Schedule 28AA (sch. 28AA), which applied to accounting periods ending after 30 June 1999.

In the decision, the Special Commissioners found that DISL had been granted a "business facility" under s.770 on the grounds that Dixons was in a position to decide whether DISL would get any business, and on what terms. It was also found under sch. 28AA that a "provision" existed between Dixons and DISL by way of a series of transactions. Particular emphasis here was given to paragraph 2 of sch. 28AA, which states that the schedule must be construed in a manner that ensures consistency with "the OECD model." In this context, the implication was that the term "provision" should be given a meaning similar to that of "condition" in Article 9 of the OECD Model Tax Convention.

The second key point addressed was whether the "business facility" or "provision" was arm's length. To support its position, Dixons advanced a number of purported comparable uncontrolled prices (CUPs) and one transactional net margin method (TNMM) observation. These potential reference points were subject to a great deal of scrutiny by HMRC's expert economist witness, and the Special Commissioners rejected each of the purported CUPs because:

- one potential comparable was too old and market conditions had since changed;
- the property insured was not comparable and contractual terms and economic conditions differed substantially;
- reliable adjustments could not be made to account for differences in bargaining power, economic conditions, and contractual terms; and
- comparables could not be relied upon where their identity and the terms of contracts were not known.

Given the above, the purported CUPs were dismissed. Similarly, in the case of the TNMM observation, the Special Commissioners found that the company in question provided services that DISL did not and had considerably greater bargaining power. Therefore, and again since it was found not to be possible to make reliable adjustments, the comparable was dismissed.

In the absence of reliable CUP data, the Special Commissioners agreed with HMRC's expert that a residual profit split method was appropriate. A curious point here was that although the Special Commissioners accepted the view that DISL bore relatively little risk (loss ratios became well understood) and played a relatively "routine" role, they concluded that a residual profit split method should be



applied. In such circumstances, awarding a routine return on capital might be seen as more usual, and certainly more practical when setting terms and conditions *ex ante*.

The Special Commissioners did not go as far as determining the arm's length outcome. Instead, this was left to the parties, and a settlement was subsequently announced.

Société Man Camions et Bus (France)

The Administrative Court of Appeal in Versailles released its judgment in May 2009 of an appeal lodged by the Ministry of Budget, Public Accounts, Public Service and State Reform (French Tax Authority) against the judgment reached by the Administrative Tribunal of Versailles in 2008 in favour of the taxpayer.

This ruling focuses attention on the potential challenge faced by a party that bears the burden of proof—in this case the French tax authority—in proving that data put forward to support its case can in fact be seen as comparable. It also highlights the danger in assuming that data taken from different geographical markets can be relied upon.

Background

MAN Camions et Bus is a French company that distributes trucks in its domestic market, and is part of MAN Nutzfahrzeuge, a German group that manufactures and sells trucks, buses, and engines.

The prices paid by MAN Camions in 1997 and 1998 were determined using the resale price minus method. More specifically, the prices it paid were set to allow it to retain a gross margin of 28.86% in 1997, and 31.71% in 1998. These percentages were based on a study conducted by the taxpayer of the gross margins earned by a sample of nine French companies that distributed vehicles.

The comparables put forward by the taxpayer were rejected by the French Tax Authority on the grounds that the activities of the comparables were not wholly comparable, and because MAN Camions et Bus had been loss-making for several years. In a tax assessment, it then adjusted the

taxable income of the French company using the TNMM and its own set of comparables.

In March 2008, the Administrative Tribunal of Versailles overturned the assessment and imposed additional taxes, charges, and penalties on MAN Camion et Bus. The French Tax Authority then appealed.

The Decision

In its decision, the court rejected the appeal of the French Tax Authority and upheld the ruling of the Administrative Tribunal of Versailles. Two reasons were given for this.

First, the court found that the fact that MAN Camions et Bus was loss-making over several years was not sufficient proof of profits having been transferred out of France, given that such losses could be due to other economic factors or market penetration strategies.

Second, the court found that the French Tax Authority had not adequately established the market value of the considered transactions. It not only failed to conduct a functional analysis for the comparables it put forward, but also did not prove that they were comparable.

A key point in the case was that the French Tax Authority had the burden of proof, and it failed to show that market conditions in the European countries the comparables were from were the same as those in France. MAN Camions et Bus successfully argued, for instance, that a particular competitor (Renault Industrial Vehicles) had a strong market position in certain markets and would have been able to influence local prices. The French Tax Authority was unable to disprove this. MAN Camions also argued that none of the purported comparables were exclusively distributors of heavy trucks. Two comparables were further revealed as not being independent.

Glaxosmithkline (Canada)

In May 2008, the Canadian Tax Court found the Canadian subsidiary of the UK-headquartered GlaxoSmithKline Group (GSK) had overpaid a Swiss affiliate for supplies of an active ingredient for a pharmaceutical product by more than five times the arm's length result. The case is currently under appeal.

At first glance, the ruling might be taken as a straightforward application of the CUP method. However, a number of critical issues were at stake in the case, not least being the importance of defining the scope of what is being addressed and the factors that are relevant to a comparability analysis.

Background

The case concerned the price paid by a Canadian company, Glaxosmithkline Inc. (Glaxo Canada), to a related party in Switzerland, Adechsa S.A., for supplies of the active ingredient used to make a particular form of ulcer medication sold by GSK and a number of other companies. GSK sells the medication under the brand name Zantac.

Glaxo Canada was engaged in secondary manufacturing—i.e., taking the active ingredient and putting it into its final form (e.g., tablets, gels)—as well as the sale and marketing of the final product, Zantac. The price the company paid for the active ingredient was determined by the resale price method, and the Canadian entity earned a gross margin of approximately 60%. This was reported to be after the payment of a 6% trademark royalty. The underlying licence agreement required Glaxo Canada to purchase the active ingredient from approved sellers, both of which were group companies.

A key fact underlying the decision was that at all relevant times, Canada had a system of compulsory licensing. This allowed independent parties to manufacture and sell generic versions of the drug, and their ability to do so was strengthened by the country having a system of mandatory substitution of generic alternatives to brand name pharmaceuticals in its provincial formularies. Glaxo Canada's generic competitors were reported to have paid amounts several times lower to their suppliers of the active ingredient than Glaxo Canada.

The Decision

The judge agreed with the tax assessment made by the Minister of National Revenue, which limited the prices paid by Glaxo Canada for the active ingredient over the period 1990-94 to the highest prices paid by the generic competitors.

The decision was based on the judge's finding that the generic pricing data was an appropriate comparator and that the CUP method was the preferred approach. This finding was based on a detailed examination of the applicability of each OECD-approved transfer pricing method with the exception of the profit split method. Presumably, this omission was because the profit split method was not put forward by the expert economist on either side, and at the time it was a less preferred method in the OECD Transfer Pricing Guidelines.

Two points stood out in the discussion on methodology. These points were in fact crucial to the whole decision.

The first was the conclusion that the respective purchases of the active ingredient were comparable because the branded and generic final products competed in the same economic market. The fact that Glaxo Canada and its generic competitors sold their respective final products at markedly different prices was dismissed as irrelevant.

Second, the judge also dismissed as irrelevant the wider commercial relationships between Glaxo Canada, its parent company, and its affiliates. In particular, he rejected consideration of the fact that the Canadian entity was required to purchase the active ingredient from approved sources. The fact that similar contractual terms are seen in third-party circumstances appeared not to have been discussed.

Given the above, the respective transactions being considered—i.e., purchase of the active ingredient—effectively were considered in isolation, thus ignoring the context of the broader commercial and financial relations between the parties involved. This seemingly admitted little scope for consideration of total system profits or the profit made by Glaxo Canada (despite some examination in the TNMM approach), the relative contributions made by the respective parties to the value chain, or to the corresponding importance of relative bargaining power. Were these factors taken into account, it is entirely possible that a different outcome may result.



Commentary

A number of important points emerge from the above cases. What is also relevant is that they are not isolated points; they are echoed by developments on the international stage and represent a foretaste of what is to come.

The first noteworthy point is that a detailed economics-based analysis was either conducted, or in *MAN Camions et Bus*, would have been needed for the French tax authority to sustain its position (i.e., an analysis of market structure for the countries' potential comparables, plus an examination of the reasons why MAN Camions et Bus had made sustained losses). In this respect, it is also significant that expert economists were engaged on both sides in the *Dixons* and *Glaxo Canada* cases, and that concepts were discussed that thus far have played a relatively minor role in transfer pricing. It is worth noting, however, that these concepts are used routinely in fields where economics has a longer history of deeper involvement—e.g., a definition of the relevant market (competition economics and antitrust cases), identification of a normal rate of return (industrial economics and finance), and bargaining power (industrial economics and game theory, US patent infringement cases). Bargaining power, it should be noted further, appears now to be seen as a crucial factor in transfer pricing analysis by HMRC. This is evidenced, for instance, in its recent article "Transfer Pricing Litigation" (HMRC, *The Tax Journal*, 28 September 2009).

The second point of note is that each case set a particularly high threshold for satisfying comparability criteria and/or demonstrating the acceptability of a particular transfer pricing method. This seems very clearly to anticipate key elements of the proposed revision to Chapters I-III of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations that was released for discussion on 9 September 2009. Amongst other things, the proposed revision includes the introduction of a comprehensive 10-step, iterative process that is described as "good practice" in comparability analysis, which would run through every aspect of transfer pricing studies from start to finish. Here, the proposed revision could arguably be improved further by drawing on the lessons provided by the cases discussed above. In the US, meanwhile, the Joint Committee on Taxation is reported to have recommended that Congress adopt legislation barring the use of the comparable uncontrolled transaction (CUT) method for

The conclusion was that the respective purchases of the active ingredient were comparable because the branded and generic final products competed in the same economic market.

pricing intangible transactions unless there were exact comparables (*BNA Transfer Pricing Report*, 18:587, 22 October 2009). Whether any such legislation is passed remains questionable. Nevertheless, where a significant amount of tax is at stake, or sizeable risks are concerned, it is clear that taxpayers would be well advised to look beyond a "vague categorization of one of the parties to the controlled transactions followed by the use of lightly examined comparable companies," to use a phrase from the OECD's discussion draft on comparability. Further consideration of profit split analysis is also warranted, also something put forward in the OECD proposals through the removal of the last resort status of profit-based methods.

A third point that emerges quite clearly, in particular by contrasting the expansive definition of a "business facility" or "provision" in *Dixons* to the rather narrow focus adopted in *Glaxo Canada*, is that considerable uncertainty remains about how the arm's length principle should be interpreted and applied. In *Glaxo Canada*, the narrow focus arguably led to a decision that would not otherwise be expected, and further consideration of the wider context of the commercial and financial relationship between the parties may have led to fundamentally different conclusions—e.g., that a profit split analysis would have been more appropriate. The case remains under appeal. In *Dixons*, the whole case rested on the Special Commissioners taking a holistic view of the commercial relationships that existed between the different parties. Similar questions about the meaning and application of the arm's length principle have been raised in two further cases, *Xilinx* in the US, and *GE Capital* in Canada. These cases will be addressed in subsequent issues of *Transfer Pricing Perspectives*.

The fourth point to note is that elements of two of the decisions—*Dixons* and *Glaxo Canada*—were quite puzzling. The advancement of a residual profit split method in *Dixons* when DSL appeared not to bear particular risks or possess valuable intangibles seemed unnecessary. The dismissal in *Glaxo Canada* of economic conditions surrounding the controlled and potential CUP transactions as irrelevant—i.e., the prices of final products and profits of the parties concerned—remains troublesome, and certainly seems at odds with proposed revisions to the OECD Guidelines. This highlights the uncertainty inherent to contentious dispute and litigation, which is partly due to transfer pricing being a field where there have been relatively few cases, certainly fewer than in antitrust. In this regard, it is perhaps true to say that the application of economics to transfer pricing is still in its infancy. Given this, it will often make a lot of sense

for taxpayers to make the first move by conducting detailed economic analyses in order to establish a base position, and possibly also by pursuing APAs and advanced rulings.

Conclusion

In recent years, there has been a steady procession of transfer pricing cases through different courts and tax tribunals. This should come as no surprise, since transfer pricing is moving beyond an initial phase of documentation and compliance, and tax authorities have become more sophisticated. A review of the more significant cases suggests that practitioners need to think differently about transfer pricing. Practitioners certainly face greater challenges, but also the opportunity to derive more robust solutions by taking a different approach.

News

Takashi Asayama Joins Global Transfer Pricing Practice as Special Consultant

Mr. Asayama, a transfer pricing and tax specialist based in NERA's Los Angeles office, has broad expertise in the economic analysis of international tax concerns for multinational Japanese firms. Project work for Mr. Asayama's clients has included numerous US Internal Revenue Service (IRS) examinations, and bilateral and unilateral advanced pricing agreement programs between the US IRS and the Japanese National Tax Administration.

Prior to joining NERA, Mr. Asayama was a Partner with Ernst & Young LLP's International Tax Department and a Partner in KPMG's Tax Corporation in Tokyo.

Mr. Asayama is a Certified Public Accountant and holds a degree in economics from Yokohama National University of Japan.

Dr. Jennifer Shulman Joins Global Transfer Pricing Practice as Vice President

Dr. Shulman, an expert in international transfer pricing based in NERA's Toronto office, specialises in the fields of transfer pricing, international trade, and political economy. Prior to joining NERA, Dr. Shulman was a Managing Director in KPMG LLP's Chicago office's economic valuation and transfer pricing practice, where she specialised in domestic and cross-border transactions involving complex transfer pricing issues. Prior to KPMG, she worked for Ernst & Young LLP's international transfer pricing group.

Dr. Shulman has been a speaker at several transfer pricing and international tax conferences. She received her PhD and MA in political science from the University of Michigan, with a major in international political economy and a minor in statistical and quantitative methods. She earned her BA with honors from McGill University.



Guide to the World's Leading Transfer Pricing Advisors

Five members of NERA Economic Consulting's Global Transfer Pricing Practice have been included in the latest edition of the Legal Media Group's *Guide to the World's Leading Transfer Pricing Advisors*. Nominations included Global Practice Leader Harlow Higinbotham in the US, Pim Fris and Alexander Voegele in Europe, Nobuo Mori in Japan, and Emmanuel Llinares in Paris/Geneva.



Events

First Annual EATI Transfer Pricing Congress

London, UK
11 June 2010

The Fourth Annual Tax Journal Conference: The Future of UK Tax

London, UK
1 July 2010

Transfer Pricing for Surviving the Economic Downturn

Lunch Session organized by
NERA Economic Consulting
Madrid, SPAIN
12 July 2010

"Transfer Pricing in France 2009"

Sébastien Gonnet and
Julien Monsenego of Dechert LLP
Tax Planning International Transfer Pricing

"Guidance on Relocation of Functions"

Dr. Alexander Voegele
BNA International

"The Connection Between Transfer Prices and Value-Oriented Management"

Dr. Alexander Voegele
Zeitschrift Controlling

"The State of the Art in Comparability for Transfer Pricing"

Pim Fris and Sébastien Gonnet
International Transfer Pricing Journal

"Transfer Pricing More Demanding"

Pim Fris and Graham Poole
Tax Journal

"Lasting Implications of Global Crisis: Firm Decisions and Transfer Pricing"

Amanda Pletz and Artur J. Bonifaciuk
Transfer Pricing International Journal



Publications

"Coping with the Economic Downturn"

Dr. Seen Meng Chew and Dr. Harlow Higinbotham
International Tax Review

"OECD Transfer Pricing Guidelines (TPG) for Multinational Enterprises and Tax Administrations"

Dr. Harlow Higinbotham and Pim Fris
Comments on Proposed Revision of Chapters I-III

Key Contacts

Frankfurt
Alexander Voegele
+49 69 133 8532

Geneva
Emmanuel Llinares
Jean-Sébastien Lénik
+41 22 819 94 94

London
Pim Fris
+44 20 7659 8500

Madrid
Victoria Alonso Cantero
+34 91 212 64 00

Paris
Emmanuel Llinares
Jean-Sébastien Lénik
Pim Fris
+33 1 70 75 01 95

Chicago
Harlow Higinbotham
+1 312 573 2803

Los Angeles
Takashi Asayama
Nihan Mert-Beydilli
+1 213 346 3000

New York City
Stuart Harshbarger
+1 212 345 3000

Toronto
Jennifer Shulman
+1 416 868 7317

Washington, DC
Richard Rozek
+1 202 466 3510

Beijing
Yasunobu Suzuki
+86 10 6533 4395

Shanghai
Yasunobu Suzuki
+86 21 6103 5544

Tokyo
Nobuo Mori
+81 3 3500 3290

About NERA

NERA Economic Consulting (www.nera.com) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

The opinions expressed herein do not necessarily represent the views of NERA Economic Consulting or any other NERA consultant. Please do not cite without explicit permission from the author.