JANUARY 2011 ISSUE 5
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TRANSFER PRICING NEWS

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INTRODUCTION

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Multinational enterprises (MNEs) have regarded transfer pricing as their most important tax-related issue for many years. The ever-increasing number of countries that enact or amend transfer pricing legislation, the knowledge that tax offices have about transfer pricing nowadays and the increased interest of tax authorities in transfer pricing during tax examinations are important reasons for MNEs to put transfer pricing high on their priority list.

Recent developments within the OECD in the field of transfer pricing, for example guidance on 'business restructurings', show the importance of paying attention to transfer pricing.

Tax-efficient supply-chain management (TESCM) — where best to have functions and risks within an MNE — was the main topic of BDO's 2010 High-Level Tax Conference. Transfer pricing is the most important issue within the TESCM arena, but other tax matters, such as PAYE, permanent-establishment issues and VAT, should of course be looked at as well.

TESCM is just one of the transfer-pricing related topics that BDO's transfer pricing team can assist MNEs with. This very interesting topic will be dealt with in the next (6th) issue of *BDO Transfer Pricing News*.

BDO's Transfer Pricing Centre of Excellence is proud to present to you this 5th issue of *BDO Transfer Pricing News*, with contributions from Argentina, Australia, Egypt, Israel and the United Kingdom. It provides you an insight related to developments in the approach taken by the local tax authorities and in recent case law. The contribution on 'Customs-duty valuations' addresses an angle that is easily forgotten: the interaction between customs duty and transfer pricing.

We hope that you will find this 5th issue of *BDO Transfer Pricing News* interesting. BDO's Transfer Pricing Centre of Excellence feels that it may serve as very worthwhile reading.

Good luck with your businesses during 2011 — and on an ongoing basis — with transfer pricing in particular!

ARGENTINA

TRANSFER PRICING DEVELOPMENTS

Argentina has adopted the arm's length principle and other OECD transfer pricing rules throughout the last decade. But during 2010 there was some important news in this arena. A number of transfer pricing disputes were disposed of by the National Tax Court, while personnel from the Argentinian tax authorities announced that a circular on transfer pricing technical criteria would be released very soon.

Under Argentinian legislation, two transfer pricing returns and a transfer pricing study must be filed each year. The new developments will probably also have an impact on planning for transfer pricing and business restructuring.

Case law

The first cases related to transfer pricing issues decided on by the National Tax Court are listed in the Table:

These cases fall into two distinct classes. The first three cases were decided with respect to the old transfer pricing rules but the principles arising from them can be extrapolated to the law currently applicable. These cases all concern companies conducting manufacturing activities that involve the export of tangible goods to related parties.

The remaining four cases were decided under the current legislation. In these cases the taxpayers were manufacturing companies as well as an agriculture-commodity trading company. In general terms, in these cases the Argentinian tax authorities questioned the inclusion of some comparable companies used in the taxpayer's transactional net-margin method documentation (TNMM), some adjustments performed to the tested party in order to improve the comparability for the use of the TNMM (i.e. accounting adjustments, capacity-utilisation adjustments, extraordinary bad-debt adjustments, extraordinary severance-pay adjustments etc.). The Argentinian tax authorities also objected to the use of the TNMM in some cases where internal comparables could be used (by applying a comparable uncontrolled price (CUP) or cost-plus (C+). Finally, the relevant local authority questioned the 'date' of the transactions performed by the commodity-trading company for the application of the CUP. According to this case, transactions will have a 'fair date' only when there is an agreement supporting this fact.

Company	Industry	Date	Result
1 Laboratorios Bagó S.A.	Pharmaceutical	**11/2006**	+for the taxpayer
2 Daimlerchrysler Argentina S.A.	Automotive	**09/2009**	+for the tax authorities
3 Volkswagen Argentina S.A.	Automotive	**12/2009**	+for the taxpayer
4 Aventis Pharma S.A.	Pharmaceutical	**02/2010**	+for the taxpayer
5 Volkswagen Argentina S.A.	Automotive	**07/2010**	+for the taxpayer
6 Nobleza Piccardo S.A.C.I.Y F.	Cigars & Tobacco	**07/2010**	+for the taxpayer
7 Alfred C. Toepfler Internacional S.A.	Agricultural commodities	**07/2010**	+for the tax authorities

It is important to mention that the result of these cases was closely related to the production of sufficient evidence. In the cases in which the taxpayer offered strong evidence supporting its position, this had direct impact on the decision of the National Tax Court. Another important conclusion is that in the last year court decisions on transfer pricing issues increased significantly. Additionally, the National Tax Court has before it several further transfer pricing cases on which it is expected to decide in the near future. Taxpayers will need to be prepared to react to these decisions where necessary.

Imminent transfer pricing circular

The transfer pricing circular that the Argentinian tax authorities are expected shortly to release will have two objectives:

– facilitating transfer pricing obligations for taxpayers and

– establishing some detailed technical criteria applicable to transfer pricing issues.

Among others, the main topics of this circular will be the following:

1. Non-material intercompany transactions
The arm's length principle has to be applied to all intercompany transactions and transactions with tax havens. The Argentinian tax authorities will not allow non-material transactions to be left unexamined.

2. Multiple-year data
When applying the TNMM, financial information regarding the tested party has to be from the fiscal year under analysis. Using multiple-year data for the tested party will not be permitted. With regard to comparable companies, a three-year average of financial information will be requested (the fiscal year under analysis and the previous two, or the previous three years).

3. Internal comparables
Internal comparables are to be preferred when carrying out the transfer pricing analysis. Taxpayers should accordingly document those cases in which potential internal comparables are discarded.

4. Segregated financial information
Each intercompany transaction should be analysed separately unless there is a strong reason for a global analysis to be performed. The mixing of transactions must be properly documented.

5. Comparable-company documentation
The Argentinian tax authorities will not allow the use of comparable companies resident in tax havens nor of companies that are subsidiaries. Also, comparable companies that conducted transactions with companies located in black-list jurisdictions will be rejected. The taxpayer should document that the selected comparable companies meet these requirements.

AUSTRALIA

ATO RELEASES FINAL RULING ON THIN CAPITALISATION AND TRANSFER PRICING

The Australian Taxation Office (ATO) recently released Taxation Ruling TR 2010/7, which addresses the interaction between the transfer pricing provisions and the thin capitalisation provisions.

The issue explored by TR 2010/7 is whether the transfer pricing provisions can be applied to reduce (or deny) an entity's deductions for interest and other costs associated with its debt funding, notwithstanding that the entity does not have any excess debt for thin capitalisation purposes.

In this regard, TR 2010/7 states that where an entity does not have excess debt for thin capitalisation purposes, the transfer pricing provisions can still be applied to adjust the allowable deductions in relation to interest and other costs incurred in relation to the debt funding.

TR 2010/7 provides only limited guidance on how to determine the arm's length price in relation to debt funding advanced by an overseas related party, and generally refers readers to its earlier rulings TR 92/11 and TR 97/20. However, TR 2010/7 makes the following general comments.

In practice, the most reliable method is a 'comparable uncontrolled price' approach, which uses available data as to the pricing of a comparable loan between comparable independent parties dealing at arm's length in comparable circumstances.

In the absence of direct comparables, taxpayers may instead use market interest rates applicable to rated borrowers, typically based on a reference rate such as LIBOR or the Bank Bill Swap Rate plus an appropriate margin, to produce a measure of the arm's length consideration.

Alternatively, an arm's length interest rate could be derived from the credit rating of the ultimate parent of the corporate group, with an appropriate margin above the interest rate that the parent would be expected to pay for a comparable loan.

However, the ATO states that in using any data as to uncontrolled comparables or open market prices in determining the arm's length consideration for a related-party loan, it is necessary to take account of whether the outcome makes commercial sense in all of the circumstances of the case.

As an administrative 'concession', the Draft Law Administration Practice Statement (PS LA 3187) provides a rule-of-thumb approach to determining an arm's length amount of interest payable by an Australian subsidiary on a loan from a foreign parent. Instead of conducting their own 'arm's length' analysis, taxpayers may instead, PS LA 3187 states, use an interest rate derived from the weighted average cost of debt of the ultimate parent company, applied to the taxpayer's actual debt amount.

Hypothesising an arm's length price where there is no comparable

TR 2010/7 also provides guidance on an area that has been controversial of late — that is, how the transfer pricing provisions should apply where an entity's debt level is within the thin capitalisation safe harbour, but exceeds the maximum amount of debt that would reasonably be expected to arise between independent parties dealing at arm's length in similar circumstances.

The ATO's approach to this issue is summarised in Example 4 in TR 2010/7. In that example, the ATO considers the position of an Australian subsidiary that has AUD 400 million of assets, funded by share capital of AUD 100 million and a loan from its foreign parent company of AUD 300 million at an interest rate of 15% (generating annual interest expense of AUD 45 million).

If the loan of AUD 300 million would not reasonably be expected to exist if the Australian company and the foreign parent were independent entities dealing at arm's length with each other, the issue that arises is how to determine the arm's length pricing to apply to the loan. The ATO broadly suggests two possible approaches to this issue:

One approach is to consider the pricing that would apply under the closest alternative arm's length scenario. For example, if an analysis reveals that a loan of AUD 250 million at an interest rate of 10% might be expected to exist between independent parties at arm's length (providing that an additional AUD 50 million of share capital is raised), the ATO suggests that the interest rate of 10% could be applied to the actual loan of AUD 300 million, resulting in allowable interest deductions of AUD 30 million.

Another approach would be to derive an arm's length interest rate from the credit rating of the ultimate parent of the corporate group, and apply that interest rate to the loan of AUD 300 million.

Implications for Australian subsidiaries of multinational groups

The position the ATO takes in TR 2010/7 means that an entity must ensure that the pricing of all international related-party debt is on arm's length terms, even if the entity's total debt is within the thin capitalisation safe-harbour amount.

In situations where no comparable dealings exist (because, for example, the debt funding

arrangements in question would not take place between independent parties dealing at arm's length), the ATO suggests the funding should be priced with reference to the pricing that would apply under the closest arm's length scenario, or alternatively based on the rate of interest that the parent company would reasonably expect to pay on a similar loan.

This aspect of the ATO's approach is somewhat controversial. The ATO expects a subsidiary whose balance sheet is more highly geared (because of parent-company loan funding) than would be the case under an 'arm's length' capital structure, to hypothesise a price for the related-party loan based on an assumption that its balance sheet is more conservatively geared than is actually the case. Alternatively, the subsidiary must hypothesise that its cost of funding is similar to that of its ultimate parent company. Either method will result in a smaller debt deduction than would be the case if one were to hypothesise a price based on the actual gearing or credit standing of the Australian subsidiary.

As a result, the ATO's approach may have the result that the foreign parent becomes exposed to a transfer pricing adjustment in its home jurisdiction if the tax authorities in that jurisdiction consider the interest it receives on the loan to the Australian subsidiary to be less than the arm's length amount.

CUSTOMS-DUTY VALUATIONS

CUSTOMS VALUATION AND TRANSFER PRICING

Although customs duties have lost their importance in the past few years due to the expansion of free-trade blocs, this is still an area of interest for tax practitioners. Indeed, the pricing of imported goods has been subject to the careful scrutiny of tax authorities for years, but the policy mix of free competition and protection of domestic companies have caused governments to draw up a set of rules on determining the taxable base of customs duties (valuation) and for common understanding of customs tariffs and procedures.

It is worth mentioning that customs duties have been subject to multilateral negotiations that eventually resulted in setting international valuation rules for transactions between related parties. These rules may be seen as particular transfer pricing rules for cross-border sales of goods.

Originally, customs adjustments for imported goods were agreed by the GATT member states in 1979 as part of the Agreement on Implementation of Article VII of the GATT (also known as the Tokyo Valuation Code or the Customs Valuation Code). This agreement has as its core principle that the customs valuation of goods should be based on the price actually paid or payable for the imported goods. Based on this *transaction value*, the intention was to have a fair, uniform and neutral set of rules to determine the taxable base (also known as the *customs value*) of goods by customs authorities worldwide.

The WTO Agreement on Implementation of Article VII of the GATT 1994 (concluded within the Uruguay Round) has replaced the Tokyo Valuation Code, but there is no fundamental difference (this allow us to refer further to the Customs Valuation Code).

CUSTOMS VALUATION AND TRANSFER PRICING METHODS

Customs valuation is a fundamental concept for the assessment of customs duties and, together with the origin of goods and the nomenclature of the customs tariff, has been subject to specific agreement during multilateral free-trade negotiations.

Customs valuation is a process having as its final outcome the determination of the taxable base on which (*ad valorem*) customs-duty rates are levied. Since there is no flexibility on the rate of applicable duty, it is obvious that any reduction of the taxable base — the customs value — would generate some savings for the taxpayer (in our case,

the importer). This is the main reason for the introduction of uniform customs-valuation rules in international trade agreements (although protectionist trade policies have also been to the fore).

The Customs Valuation Code provides for a preferred method — the transaction-value method — which should be generally accepted by customs authorities (in fact the value of goods agreed between parties with some adjustments regarding some transport-related costs). However, tax authorities may reject this method when the transaction takes place between related persons (similarly to the approach to transfer pricing).

As with the OECD transfer pricing approach (prior to the last change), where the transaction value (method) is not acceptable, other valuation methods may be used, in a prescribed hierarchical order, as follows:

– Transaction value of identical goods
– Transaction value of similar goods
– Deductive method (common aspects with the price-minus method)
– Computed method (cost-plus method)
– Fall-back method

The *transaction value of identical goods method* has the same philosophy as the comparable uncontrolled-price method used for transfer pricing purposes. For example, it may refer not only to internal comparables but mainly to external comparables, respectively transactions with goods for which the transaction value has been accepted by the customs authorities as a basis for assessment. The difference between the first method and the *transaction value of similar goods method* mainly consists in the similarity (or identity) of the analysed features of goods with other goods whose customs value has previously been accepted by customs (assessed upon the transaction-value method).

Methods 3 (the deductive method) and 4 (the computed method) may be switched at the request of the importer only if the customs officers approve. They have been referred to in the past, as the *resale price* (price-minus) *method* and *cost-plus method*, which obviously suggest similarities to the OECD transfer pricing methods.

The fifth method is a residual method (last-resort method) to be set independently by each state. In this case, it should be noted that the Valuation Code does not prescribe a method but lists those methods/principles that are not allowed to serve as the last-resort method.

Associated enterprises v related persons

The Customs Valuation Code uses the expression *related persons* (comparable to the affiliated persons used within the transfer pricing literature and regulations), and states that persons are to be deemed to be related only if:

– they are officers or directors of one another's businesses
– they are legally recognised partners in a business
– they are employer and employee
– a third person directly or indirectly owns, controls or holds 5% or more of the voting stock or shares of both of them
– one of them directly or indirectly controls* the other
– both of them are directly or indirectly controlled by a third person or
– they are members of the same family.

It would be beneficial to note that the OECD Transfer Pricing Guidelines use an equivalent expression (associated persons) that includes:

– an enterprise of a contracting state participating directly or indirectly in the management, control or capital of an enterprise of the other contracting state, or
– the same persons participating directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state.

Further, each state has defined its own understanding of what constitute associated enterprises (affiliated parties), since in most cases the expression *related persons* has a meaning consistent with the definition from the Customs Valuation Code.

Similarities and differences

When analysing cross-border transactions with goods it should be mentioned that customs valuation rules could conflict with the general transfer pricing rules. In many countries, provisions of international agreements have precedence over the national transfer pricing rules (but only with regard to customs duties and other import rights). Therefore, acceptance of the transaction value (price of goods) by the customs authorities would not guarantee the same for the purposes of transfer pricing between enterprises (unless this is specifically provided by the applicable transfer pricing regulation).

It is obvious that, beside the similarities mentioned above, there are many differences between transfer pricing rules used within the customs-valuation process and the transfer pricing rules set under the supervision of the OECD.

Firstly, it should be noted that customs regulations on valuation refer to individual transactions since transfer pricing covers the full range of transactions incurred between associated enterprises.

Further, the set of rules for customs valuation (including the specific transfer pricing rules) have been set through an international convention that also created an arbitration body — the Customs Valuation Committee. By contrast, in the case of transfer pricing rules (OECD Transfer Pricing Guidelines) the settlement of conflicts is subject to bilateral negotiation carried on according to the applicable double tax treaties (as a general rule).

As a conclusion, it is a challenge for practitioners to find common features and contact points between customs valuation and the OECD transfer pricing guidelines. Once they are found, new opportunities could arise for tax compliance and cross-border planning.

*) There is an Interpretative Note (to Article 15 of the Customs Valuation Code) stating that, for the purposes of the Customs Valuation Code, one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter. The note also states that 'persons' includes a legal person, where appropriate.

EGYPT

NEW TRANSFER PRICING GUIDELINES LAUNCHED

With a view to reinforcing the transfer pricing regulations in Egypt, the Egyptian tax authorities held a conference on 29 November 2010 to launch the first part of the new transfer pricing Guidelines.

The conference was attended by the international and local accounting firms and the financial managers of multinational and local companies. The speakers at the conference were the chairman of the Egyptian Tax Authority (ETA), who outlined the current status of the Egyptian tax system and current developments. In addition, the Assistant to the Deputy Minister of Finance, Mr. Amr El-Monayer gave a presentation outlining the objectives and principles of the Egyptian transfer pricing guidelines.

The first part of the Guidelines covers the following:

1. The arm's length principle
2. Practical application of the arm's length principle
3. Comparability analysis
4. Transfer pricing methods
5. Documentation
6. Illustrative examples

Mr. El-Monayer further explained that the Guidelines are intended to serve as a guide to the application of Article 30 of the Egyptian Tax Code, and Articles 38, 39 and 40 of the Executive Regulations, which cover the transfer pricing legalisation.

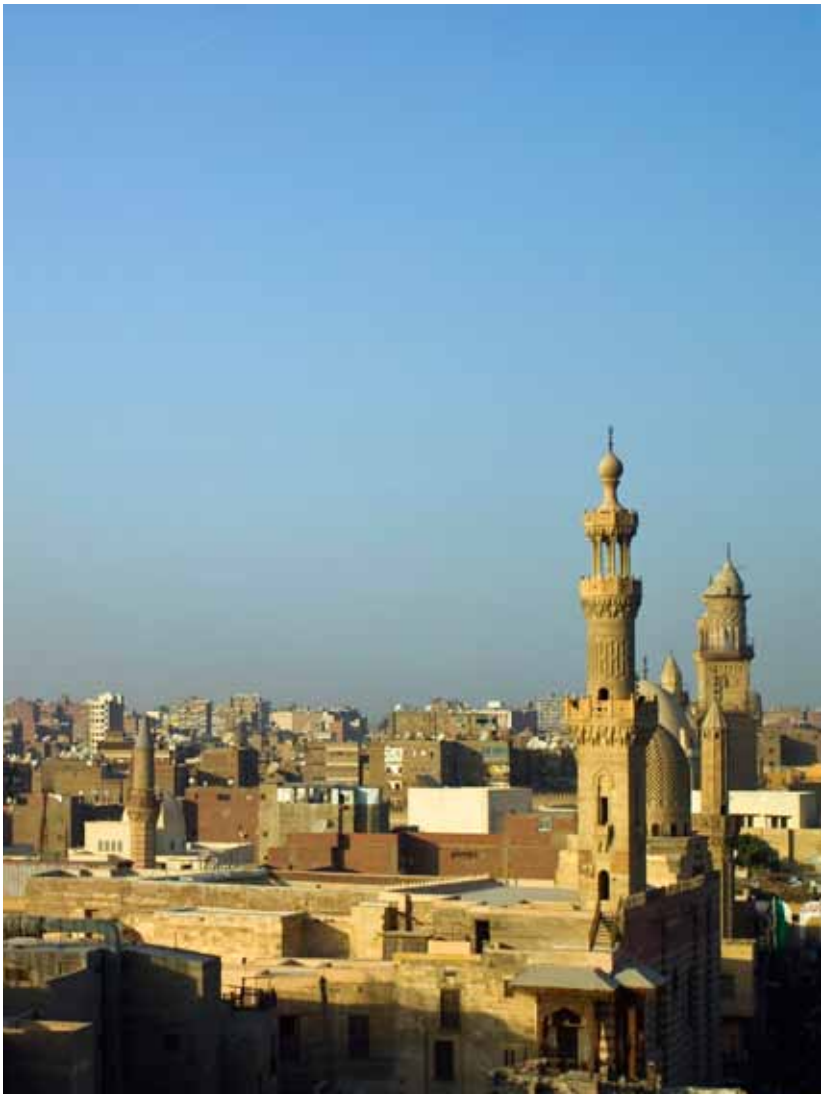
Moreover, the Guidelines provide definitions of international terms, and clarify that the approach outlined in them is neither mandatory nor prescriptive; the approach adopted by a taxpayer will still depend on each taxpayer's individual circumstances, and taxpayers are advised to follow a four-step process through which they can develop the reasoning and documentation needed to support the evaluation of their transfer prices.

The guidelines have identified the four-step approach as follows:

– Identifying any intra-group transactions and understanding the nature of such transactions by analysis of the elements
– Selecting the most appropriate pricing method(s)
– Applying the selected pricing method(s)
– Determining the arm's length amount and introducing a review process to reflect any future changes

As required by the Tax Code, taxpayers are obliged to retain all the supporting documents related to their taxable income to avoid adjustment of such income by the ETA. No comprehensive predefined set of documentation meets all taxpayers' circumstances. Taxpayers are more able to identify the documents that present a persuasive argument for TP practice. However, according to the Guidelines, the documentation must generally include the following:

– The amount of sales and operating results from the last few years preceding the transaction under review
– The taxpayer's annual reports and financial statements
– Profitability analysis with respect to the controlled transactions



During the question and answer session of the conference, we (BDO Egypt) requested confirmation that reliance can be placed on the transfer pricing documents and/or studies prepared by the parent company or headquarters, as long as the same treatment and principles are applied in Egypt. The panellists confirmed that such documentation may be acceptable, but that ETA will reserve the right to assess its applicability on a case-by-case basis.

Also among the speakers was a senior advisor from the OECD, Mr Wolfgang Büttner, who clarified that the OECD had been involved in reviewing the Egyptian transfer pricing guidelines as part of the OECD's initiatives to cooperate with non-OECD economies in order to support tax-capacity building in developing countries, promoting international consensus on key international tax issues, and providing input from the non-OECD economies into the work of the OECD.

Mr Büttner praised Egypt's TP Guidelines as a major achievement, as a standard-setting pioneer in the MENA region and beyond, showing best practice in a developing country's TP implementation and commitment to the arm's length principle. He further elaborated on the advantage of TP guidelines for both taxpayers and the tax authorities. He also provided a brief comparison between the Egyptian guidelines and the OECD Model related to comparability factors and transfer pricing methods.

We should also like to mention that, on 2 December 2010, the ETA invited BDO Egypt to attend a meeting with the IMF, as one of two selected accounting firms in Egypt, to provide the IMF delegates with our view on Egyptian tax administration, and its compatibility with international taxation practice, including transfer pricing. During that meeting we took the opportunity to outline the positive initiatives introduced as part of the Egyptian tax reform, which started in 2004, but also addressed the areas where there is space for enhancement — specifically the need for adequately qualified personnel to deal with the assessment of issues such as transfer pricing, which may involve a certain level of subjectivity.

ISRAEL

TAX AUTHORITIES PUBLISH THEIR STANCE ON BUSINESS RESTRUCTURING IN TECHNOLOGY ENTERPRISES

Israel's tax authorities have recently noted many companies in Israel, mainly companies engaged in high-technology industries, undertaking or intending to make a change in their business model (business restructuring). Business restructuring includes the transfer of intangible assets. Business Restructuring is done, inter alia, as follows:

Before undergoing restructuring, the Israeli company would typically hold and bear the risks of the intangible assets, but after the restructuring is completed, the intangible assets and the risks would be transferred to a foreign affiliate entity, usually one resident in a tax haven. Occasionally, but not invariably, the transfer would not be made in accordance with the arm's length principle.

Business restructuring may give rise to the following tax events:

Capital gain:

This may arise on the transfer of the intellectual property (owned and developed by the Israeli company) to the foreign affiliate entity. After the transfer, the Israeli company continues to provide R&D services to the foreign affiliate entity.

Royalties:

The Israeli company created the intellectual property. However, since the foreign affiliate entity steps into the shoes of the owner, the Israeli company should receive royalties from the foreign affiliate entity.

Dividends:

When the Israeli company transfers its own intangible assets to a foreign affiliate entity for no adequate consideration, the transfer could be considered as a dividend distribution, potentially attracting withholding tax.

In response to this type of restructuring, the tax authorities have announced that they will proceed as follows.

The Israeli assessing officer is instructed to conduct a detailed functions, risks and assets analysis before and after the restructuring. The functional analysis will focus on assets (including legal and economic rights) that were transferred as part of the restructuring, and help understand the motivation for the change and its details.

Special emphasis will be given to risks associated with the transfer from one related party to the other, inter alia, based on subsidiary tests, including the following:

- The actual behaviour of the parties to the transaction, with special attention to control over the transferred asset (who takes decisions regarding the asset, development directions, employment of experts etc)
- Which entity has the financial ability to bear the risk regarding the intangible asset
- The question whether uncontrolled taxpayers would behave as the Israeli company and the foreign affiliate entity behave throughout the restructuring process.
- Examination of the transfer-pricing study that was prepared by the Israeli company

The assessing officer should examine whether there is an economic justification for the restructuring, and consider whether the transaction is in fact artificial with the sole purpose of obtaining an improper reduction of the tax burden in Israel.

The Israeli tax authorities have listed factors that could indicate the existence of business restructuring that would give rise to such examinations. These factors include:

- Transition — from an Israeli company that operates as a technological company, which includes all functions necessary for developing, marketing, supporting and selling its products, to a company that operates as a provider of research and development services to a foreign affiliate entity
- Change of ownership of intangible assets
- Reduction of the number of the Israeli company's employees engaged in research and development, marketing, sales, support and production
- Decrease in the overall revenue cycle of the Israeli company
- Significant changes in the Israeli company's gross and operational margins
- Decrease in the deferred revenue balance from sales and/or related or support services
- Reduction in the Israeli company's cash flow

In the light of this, we recommend examining the tax implications in a business restructuring in which an Israeli company is involved, and especially the way the Israeli company reports international intra-group transactions in its tax return.

It should also be mentioned that the Israeli tax authorities can, under certain conditions, authorise an advance pricing agreement with respect to a business restructuring, without requiring an immediate tax payment.

UNITED KINGDOM

DSG GROUP CASE ANALYSED

The decision by the First-Tier Tribunal (Tax), published in April 2009, in the case *DSG Retail and others v Commissioners of Her Majesty's Revenue and Customs* (the DSG Group case) case offers important international tax and transfer pricing lessons for all multinational enterprises.

The DSG Group case was the first major transfer pricing case to come before the courts. The First-Tier Tribunal (Tax) (formerly the Special Commissioners of Income Tax) is the first-instance tribunal of appeal in the United Kingdom against decisions of the tax authorities.

DSG (Dixons) is a leading retailer of consumer electronic goods in the United Kingdom. When selling these goods, DSG sought to sell extended high-margin warranties to customers.

DSG used Cornhill Insurance (an independent insurance company) to insure the policies. Cornhill would reinsure 95% of the policy value with DISL, an Isle of Man company wholly owned by the DSG Group.

When a customer made a claim, DISL would pay a fee to Cornhill and Cornhill would pay MSDL, a service company also owned by DSG, to service the product.

In anticipation of an increase in the rate of insurance premium tax in 1997, a new structure was put into place (see diagram) under which ASL, a company partly owned by an independent insurance broker, entered into an administration and repair arrangement with MCSAL (another DSG Group company), and reinsured virtually all of its risk with DISL.

The key issues from a transfer pricing perspective were:

– Whether the tax authorities could treat all the transactions portrayed in the diagram as being a series of transactions (even though some are between third parties) and therefore falling within the UK transfer pricing rules?

– If so, whether the commission paid to DSG for selling the extended warranties was at arm's length?

During the period in question, there was a change in the relevant legislation. Until 1 April 1999, TA 1988 s 770 required the giving of a 'business facility' for the transfer pricing rules to apply. From 1 April 1999, this provision was replaced by TA 1988 Sch 28AA, which required there to be a 'provision' made or imposed as between related parties.

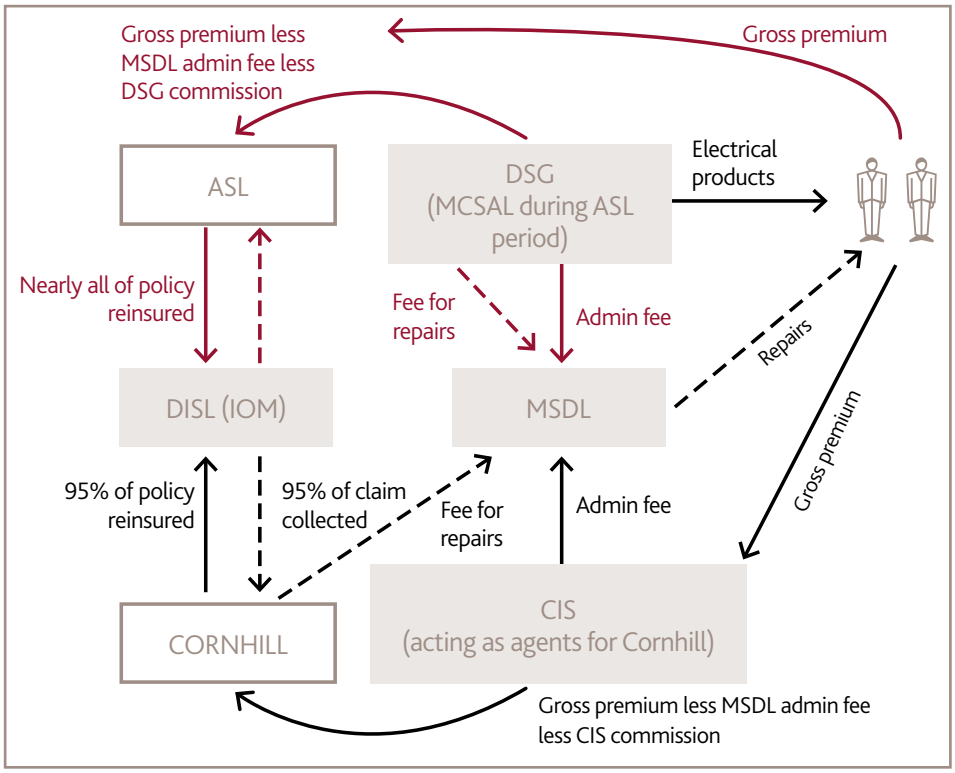
The two main questions that the Tribunal had to consider were:

Was there a 'provision' (previously, a 'business facility') between DSG and DISL?
The Tribunal held that the 'provision' (and also the business facility) was simply the arrangement that DISL would insure the extended warranties written in DSG's stores. Although the actual provision was not directly between DISL and DSG, it was manifested in the form of a series of contracts between the two companies.

If so, was that provision at arm's length?
DSG argued that it had third-party comparable uncontrolled prices (CUPs) to support the commission rate provided to DISL. HMRC (the tax authorities) succeeded in persuading the Tribunal to dismiss the CUPs on the grounds that they were not comparable to the related-party transaction.

DSG had previously been subject to a detailed investigation by the competition authority in relation to its practices of selling extended warranties to its consumers. This provided a lot of material to HMRC on the selling of extended warranties.

HMRC contended that DISL in the Isle of Man had a low level of commercial substance and had generated significant profits from its reinsurance activity as there was a low level of customer claims under the insurance policies since the electronic goods were largely reliable.



The grey boxes represent companies that were part of the DSG Group. The unshaded boxes represent third parties.
Black lines represent transactions relating to the 'Cornhill period' from May 1986 to April 1997.
Red lines represent the 'ASL period' from April 1997 onwards.
Solid lines represent the contract process, broken lines represent the claims process.

HMRC argued that the DSG Group would have had available its customer-claims history to be able to negotiate a competitive deal with a reinsurance company. The key reason for the generation of profits from the extended warranties lay in the point-of-sales advantage available to DSG. In other words, the profit was generated from the successful activities of DSG's sales staff.

Accordingly, HMRC successfully argued that DSG had a stronger bargaining position than DISL. At arm's length, DSG would have received a much higher commission level. HMRC was able to adjust the level of income received by DSG upwards.

Significance of the case, the revised OECD Transfer Pricing Guidelines and reform of the CFC provisions

– Businesses relying on the comparable uncontrolled-price (CUP) method need to ensure that a high degree of comparability exists between the CUP and the controlled transaction under examination

– The revised OECD Transfer Pricing Guidelines encourage greater rigour for the purposes of testing and establishing comparability. Whilst those objectives seek to impose a higher standard for comparables, this also means that the taxpayer's documentation burden is now more onerous. Taxpayers are also faced with the risk that (in an effort to establish greater comparability) all or most of the potential comparables may be rejected

– Businesses need to place significant emphasis on substance and their functional analysis reviews. They need to consider the level of bargaining power and what two different parties bring to a transaction. Where an entity has little substance, it is less likely that it will add less value and therefore should receive a commensurately lower reward

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