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Long arm of the law

THE VALUE OF ECONOMICS IN TRANSFER PRICING

A recent legal decision on transfer pricing represents a landmark victory for the UK tax authorities and an important demonstration of the value of economic analysis in the area of international taxation. This bulletin explains how economic analysis played a central role in the case and sets out the basis of the legal decision.

Transfer pricing concerns the prices that related businesses charge each other for goods and services. It can pose a tricky problem for companies and tax authorities because, where related businesses operate in separate tax jurisdictions, transfer prices may have a major effect on where profits end up – and where they are taxed.

The member countries of the Organisation for Economic Co-operation and Development (and a number of non-members of the OECD) have agreed on a basic approach for addressing this issue, known as the “arm’s length principle”¹. In simple terms, this says that transfer prices between associated enterprises



should be determined, for tax purposes, as if they were agreed between independent enterprises operating at arm's length from each other.

The application of this “simple” principle may, however, raise complex issues. A recent decision by the UK tax tribunal – the Special Commissioners – is a landmark. This was the first UK case to address transfer pricing methodologies, and it is likely to have an impact on the analysis of transfer pricing for some years to come.

The case concerned a dispute between Her Majesty's Revenue & Customs (HMRC) and DSG International plc (DSG), the largest electrical goods retailer in the UK. Extended warranties sold through DSG stores were insured by a DSG subsidiary based on the Isle of Man. The Isle of Man business was not subject to UK corporation tax and was effectively able to operate tax-free.

Both the UK DSG business and the Isle of Man subsidiary contracted with a third party, who managed the administration of claims, payments and repairs between the two businesses and the related (UK-based) DSG repairs business.

The extended warranty business was highly profitable, and as a result of the set of contracts in place, a large proportion of these profits ended up in the Isle of Man subsidiary. HMRC contended that the arrangements were not consistent with the arm's length principle and that a larger share of profit should be recognised in the UK group and taxed accordingly. The case boiled down to two issues:

- whether the arrangements between DSG and its Isle of Man subsidiary were consistent with the arm's length principle; and
- if not, what the appropriate transfer prices should be, and what impact they would have on profits recognised in the UK.

START WITH THE GUIDEBOOK

The OECD's guidelines on transfer pricing are a natural starting-point for analysis². These set out a general framework for applying the arm's length principle and identify two groups of methods that can be used to determine transfer prices: “traditional transaction methods” and “other methods”.

There are three traditional methods, which focus on identifying some form of comparable transaction to the one being assessed. The “comparable uncontrolled price” (CUP) method is based on identifying a price for an arm's length transaction sufficiently similar to the one being assessed that the prices would be expected to be the same, or could be explicitly adjusted to make them so. The “resale price” and the “cost plus” methods both also depend on finding comparable transactions, but rely on either gross margins (on resale prices) or mark-ups (on cost) as the basis for comparison.

Where it is difficult to apply these traditional methods reliably, the OECD guidelines suggest a number of other methods. These include looking at the way that profits are split between the parties (the “profit split” method), and comparing net margins on an appropriate base (e.g. assets or costs) with those on a comparable transaction.

DSG put a number of comparators (in the form of CUPs) to the Special Commissioners and suggested that the OECD traditional transaction methods could be relied upon. Its arguments were supported by transfer pricing reports produced by accounting firms which identified a number of potentially comparable transactions. Work by Frontier supported HMRC's argument that no reasonable comparator could be identified and the guidelines pointed to the use of a profit split method based on an economic analysis of the transaction.

GETTING TO THE POINT

From an economist's perspective, it is essential to understand the nature of the UK market for extended warranties on electrical goods in order to select the right method and achieve reliable results. The UK competition authorities have conducted several reviews of the sector which set out a great deal of evidence on the historic profitability of warranty services, and how contracts between providers at different parts of the value chain can be struck³.

It is widely recognised that electrical goods retailers who offer warranties at the point of sale have an inherent competitive advantage over other warranty sellers. As a result, the profitability of warranties is typically in excess of the normal rates of return seen in more competitive retail markets. Conversely, the provision of insurance, administration and repair services to back extended warranties are arguably more competitive businesses. As a result, the high levels of profitability associated with the extended warranty business in the UK are commonly ascribed to the benefits of the "point-of-sale advantage".

However, the variety of different electrical goods retailers and different electrical goods sold means that not all contracts for the provision of warranty services are the same. Simple measures of margins on warranties for different appliances (such as fridges or televisions) may give very different results. This can make attempts to draw comparisons between the pricing of warranty services relating to different products or retailers difficult. Further, the bargaining positions of different types of business may also be very different. A small, independent electricals shop may be happy to sell a simple "off-the-shelf" warranty product, supplied by a well-known insurance business, in exchange for a small margin. But a large, national electricals chain, whose point-of-sale advantage is worth hundreds of millions of pounds, might bargain very hard with any insurer offering a relatively straightforward service that the same retailer could readily provide in-house.

HMRC relied upon economic analysis of the sources of bargaining power and profit in the sector to support its arguments on the validity of DSG's proposed comparators and on the use of a profit split approach in their place. One of the comparators put forward by DSG was a large independent provider of extended warranties (Domestic and General). While this had many apparent similarities to the Isle of Man insurance business, consideration of its bargaining power, relative to many of the small independent retailers to which it sold "off-the-shelf" warranties, revealed a very different situation to that between DSG and an arm's length insurer. And further, the bargaining power of DSG relative to an insurer had clear implications for the likely split of profit between the two.

A STAKE IN THE GROUND

The Special Commissioners concluded that the transfer pricing arrangements between DSG’s UK and Isle of Man businesses were not consistent with the arm’s length principle. They also rejected the comparators put forward by DSG. Instead they supported the use of a profit split formula, of the type put forward by HMRC, that allowed the Isle of Man insurance business a normal rate of return, based on its cost of equity, and attributed residual profits above this level to the UK business. (There, it followed, they would be liable to UK corporation tax)⁴. In doing so the commissioners dismissed arguments put forward by DSG that the economic analysis was overly theoretical and was not consistent with the OECD guidelines. Rather, they noted that they “...consider that it is necessary to take economic analysis into account in view of the Transfer Pricing Guidelines’s requirement of using an ‘economically valid basis’ in applying the profit split method”⁵.

As this was the first decision by the Special Commissioners on transfer pricing methodologies in the UK, it was a landmark case and an important victory for HMRC. As well as validating the use of transfer pricing methods beyond the traditional transactional methods – where reliable comparisons cannot be made – it also underlined the importance of sound economic analysis when considering approaches such as the profit split method. And it has been seen by many as an important signal from HMRC of its willingness to engage in litigation and complex technical argument, where it believes that simple comparators do not stand up.

Frontier Director Simon Gaysford was instructed by HMRC as an expert economist.

SOURCES

- 1 *The formal articulation of the arm’s length principle can be found in paragraph 1 of Article 9 of the OECD Model Tax Convention.*
- 2 *“Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”, OECD July 1995*
- 3 *For example, the 2003 Competition Commission report “Extended warranties on domestic electrical goods”.*
- 4 *The Special Commissioners drew attention to the existence of a retrospective profit claw-back arrangement as one contractual way of achieving this result.*
- 5 *Para 143, DSG Retail Ltd vs HMRC, Special Commissioners Decision No. TC0001, 30 March 2009.*

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