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TRANSFER PRICING FORUM

Transfer Pricing for the International Practitioner

SEPTEMBER 2016

www.bna.com

United Kingdom

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1. What is the standard practice in selecting potential comparables? Are industry codes or key words used to accept or exclude comparables? What use is made of quantitative screens to exclude comparables?

UK statute states that the legislative rules applying the arm's length principle are to be read in such manner as best secures consistency with the OECD Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises 2010 ("the TPG").[1] As such the following TPG guidance on the selection of comparables would be followed:

> ". . .tax examiners are encouraged to take into account the taxpayer's commercial judgment about the application of the arm's length principle. . ."[2]
>
> ". . .the cost of information can be a real concern. . ."[3]
>
> ". . .there is no requirement for an exhaustive search of all possible relevant sources of information."[4]

In paragraphs 3.41 and 3.42 of the TPG two broad alternatives are discussed, namely an "additive" approach, in which further potential comparables are added to an initial set (such as the taxpayer's independent competitors), and a "deductive" approach in which a wide set of potential comparables is narrowed down using selection criteria. In paragraph 3.43 the TPG note that both quantitative and qualitative criteria may be used, and that these may include quantitative screens such as ratio of Net Value of Intangibles/Total Net Assets Value, Research and Development/Sales, Foreign Sales/Total Sales and criteria related to the relative value of inventories. The TPG neither prescribe nor criticize such quantitative screens, noting in paragraph 3.43 that their use should depend on "the facts and circumstances of each particular case." In paragraph 3.46 the TPG appear to indicate a preference for quantitative over qualitative screens when they state that:

> "Complete elimination of subjective judgments from the selection of comparables would not be feasible, but much can be done to increase objectivity and ensure transparency in the application of subjective judgments."

HM Revenue & Customs ("HMRC") has published the transfer pricing guidance to its inspectors contained in its International Manual ("INTM"). In respect of comparability adjustments, INTM484090 states that:

> "Case teams should be aware of the potential distinction between an arm's length range as extracted from a careful analysis of suitable companies and a range which consists of the results of independent companies which are no more than superficially similar to the tested party. The latter is not an arm's length range within the meaning of the Guidelines. . . A small number of strong comparables is likely to give a more accurate result than a large number of weak ones."

INTM485120 advises HMRC's inspectors to consider:

> "Is there a subset of comparables within the larger range? For example, consider a company carrying out contract R & D in the field of computer software. The transfer pricing report may contain 16 comparable companies carrying out contract R & D in the computer field (ranging from hardware, operating systems, communications, switching and software), but that there are 3 companies involved in just software R & D. Why not use just those 3 companies as a starting point? These companies should in theory be more comparable to the tested party."

INTM485110 suggests that if large comparability adjustments are required, the proposed comparables should not be used:

> "slight differences between companies can be adjusted for on a reasonably accurate basis. However, it is unlikely that significant differences can be taken into account in a meaningful manner. . . teams should be sceptical of large numbers of very detailed adjustments; it may well be found that the final adjusted comparables bear little resemblance to the starting point."

INTM485110 warns against adjustments based on certain financial ratios:

> "Some adjustments will be based on balance sheet figures, for example stock and trade debtors. These figures are snapshots and may not be representative for the whole year, particularly if the trade is subject to seasonal variations.
>
> It is difficult to compare cases on the basis of capital employed as this presupposes that the tested party has a capital structure that would be found at arm's length. If the tested party is part of a group this is a false premise and making adjustments will be difficult. It is easier to make adjustments when comparing return on assets."

2. What is the standard practice in making adjustments to improve comparability? Is very close comparability required before such adjustments are made? What sort of adjustments are usually made?

The leading UK transfer pricing decision so far is in *DSG Retail Limited and Others and the Commissioners of Her Majesty's Revenue & Customs*, before the Special Commissioners of HMRC, heard November to December 2008, released 31 March 2009

   ISSN 2043-0760

[TC00001]. This related to an arrangement in which "DISL [a related party] would insure the extended warranty business written in DSG's stores".[5] In the view of the Special Commissioners (the independent tribunal), a major factor was that "[a] retailer has a considerable advantage in selling extended warranties"[6] and that a major comparability adjustment should be made to any proposed Comparable Uncontrolled Prices ("CUPs") to reflect this, and if this were not possible, then that another method (in this case the Profit Split Method) should be used.

The thinking of the Special Commissioners on the required standard of comparability and the types of adjustment which should be made can be seen from the following comments which they gave on the potential benchmarks:

> "We are not persuaded by Mr Peacock's points that Cornhill with 5% cannot be compared directly to DISL with 95% and no reinsurance, although any such comparison must take account of the different capital requirements. . ."[7]

> ". . .it is better to consider DISL's profit directly rather than indirectly by considering commission rates unless it is possible to adjust for the point of sale advantage, in which case it might be a useful tool. There was no information on which we could make such an adjustment."[8]

> "We conclude that Orion is a potential comparable because it covered a similar range of goods for Currys and operated until the start of the Cornhill Period and Currys had the point of sale advantage possessed by the Appellant Group. Against treating it as a comparable is the fact that the agreement started in 1982, when there was little data about loss rates available, and ended in 1987, when the market for extended warranties was very different from 1993 and 1997 with which we are concerned. In particular there was limited information about the likely claims at the time it was entered into. It is also likely that the bargaining position of retailers improved with the consistently low loss ratios shown as more data became available. . . most importantly this seems to be a case of parties with more equal bargaining power because (we assume) that Orion was a substantial insurer and so it was an agreement made between equals. This is a factor for which we have no evidence enabling us to make adjustments."[9]

> "We do not regard NSS as a comparable on the basis that the agreement related principally to satellite equipment (even though it might in addition include other electrical goods), that only 1+3 policies were covered, that the warranties were not sold in stores but at the time of installation of satellite equipment, and that the agreement was terminable on one week's notice. . .Neither could we adjust for the differences: we had no data on the expected loss ratios for satellite dishes and could not see how to adjust to reflect the difference between selling a warranty in store and selling it as part of installation."[10]

> "While the Link may be a bargain between equals, this was not the position with DISL. The agreement related only to mobile phones which had a worse loss ratio than the mix of products insured by DISL. . .We conclude that The Link is not a comparable on the basis that it dealt only with mobile phones on which the risk was in 1997 clearly higher than the average relating to goods sold by DSG. It was also not clear whether the promotion of BT's products in the Link stores was a benefit taken by BT to some extent in lieu of the payment of additional warranty commission. Nevertheless one might draw the inference that in April 1997 when the agreement was made 34% was the minimum commission which would be ceded to an arm's length counterparty for this type of business. For business which was expected to be less risky one would therefore expect a greater commission. But we do not have the data to make the necessary adjustment."[11]

> "Domestic & General Group plc ("D&G") is a quoted company providing domestic appliance breakdown insurance. The majority of sales are through manufacturers although some point of sale business is generated by smaller retailers[12] . . . We are impressed by, and accept, Mr Gaysford's arguments about the significant differences between D&G and DISL, the most significant difference being in terms of bargaining power. D&G as a large public company dealt with manufacturers who did not have their own extended warranty business without a point of sale advantage and with smaller retailers. While its customers may be large in themselves their bargaining position is not solely related to their size. D&G was offering a complete service that the customers could not have obtained for themselves in the market. Customers would place considerable value on D&G's ability to offer a complete package of services and on its scale, experience and brand. DISL, on the other hand, was contracting with the largest electrical retailer in the UK which had the point of sale advantage, which D&G and its customers did not. The Appellant Group had the scale and expertise that would make it economic to undertake its own assessment of risk and to identify alternative providers and switching providers would be economic. It had a strong brand that had no need for an external brand to support its warranties. A credible option would have been for the Appellant Group to have hired its own actuarial staff and provided the service in-house. DISL was entirely dependent on the Appellant Group for its business. Mr Gaysford did not consider that there was any method of adjusting D&G's profits to eliminate this difference in bargaining power[13] . . .although no doubt D&G is the closest insurance company that there is to DISL, we do not consider that D&G is a suitable comparable to DISL or that there is a method of adjusting for the differences."[14]

Having identified these potential benchmarks, and decided that it was not possible to find a robust basis on which to make the necessary comparability adjustments, the Special Commissioners concluded that the CUP method would not give the most reliable result and recommended another method, as follows:

> "the actual provision is not at arm's length because if DISL had been independent it would have had to pay something to DSG. Accordingly there should be a formula under which additional profit would be allocated to DSG from DISL's profits that will leave DISL with a profit calculated on the lines of Mr Gaysford's method[15] [i.e., a profit split approach that depends on the comparison of the actual profits with the level of profits implied by a normal rate of return on investors' capital[16]]."

These extracts point to the following comparability adjustments being considered by a UK court:

- difference in capital requirements;
- an unusual opportunity to make sales at a higher price, as presented, for example, by a "point of sale" advantage;
- range of services provided (particularly where this was not offered by another supplier);

- state of the market when the transactions took place;
- information available to the parties when the transactions took place (both available to themselves, and available to the other party and so influencing its perception of the relative bargaining power of the first party);
- relative size of the parties (as a determinant of relative bargaining power);
- nature of the underlying product;
- nature of the services being provided in respect of that underlying product;
- the point in the supply chain at which the transactions took place (e.g., manufacturing, retailing or post-retail installation);
- contractual terms (and in particular the termination notice period);
- relative risks to each party in each transaction;
- experience; and
- brand.

Drawing on *DSG*, INTM485050 states that:

> "During the fact-finding process, case teams should consider any evidence that one entity would be in a particularly strong or weak bargaining position if it were engaging in the transactions under review at arm's length rather than with a connected party."

We can see, therefore, that in the UK the concepts of competition economics have entered into transfer pricing analysis and references will be made to concepts and sources outside the TPG, particularly where they bear on relative bargaining power. A high level of confidence in the accuracy of any comparability adjustments is required, and where this is not the case a different transfer pricing method will be preferred, including, potentially, one outside of the five main "OECD" methods.

3. How many comparables are required or preferred? Is there a desire or obligation to produce a statistically significant confidence level?

Reference may be made to the TPG and the advice there that:

> "Use of commercial databases should not encourage quantity over quality."[17]

INTM421080 states that:

> ". . .it may, in some cases, be particularly useful to take into account a range of results when using TNMM [i.e., the Transactional Net Margin Method]. A range of results may mitigate unquantifiable differences between the tested party and independent companies carrying out comparable transactions. A range would allow results which would occur under a variety of business conditions. Note however that the range of results has to be constructed from the results of companies carrying out comparable transactions. Acceptance of the existence of a range should not be taken to imply acceptance of the inclusion in that range of companies which are not comparable or which carry out transactions which are not comparable."

In *DSG*, there was no discussion of a required or preferred number of comparables, or of aiming for a statistically significant confidence level. In practice, HMRC may seek to determine an arm's length price on the basis of only one of the comparables proposed by a taxpayer, if that one is convincing.

4. In practice, is there a preference for "internal" comparables? How much effort is made to identify any such benchmarks?

In the "typical process" recommended in the TPG, in paragraph 3.4 "review of existing comparables" appears at Step 4, before "external comparables" at Step 5. At paragraph 3.27 the TPG state that:

> "Internal comparables may have a more direct and closer relationship to the transaction under review than external comparables. . ."

However, in paragraph 3.28 the TPG warn that:

> ". . .internal comparables are not always more reliable as it is not the case that any transaction between a taxpayer and an independent party can be regarded as a reliable comparable. . ."

In particular the TPG note that the volumes involved may be very different between transactions with related and with unrelated parties.

INTM485070 states that:

> "The best source of comparables can be the business itself, where a comparable transaction may exist between one party to the controlled transaction and an independent party. . . A search for internal comparables is sometimes overlooked by businesses when they are considering their transfer pricing policy and compiling documentation to demonstrate that the pricing is at arm's length. If the transfer pricing documentation makes no mention of internal comparables, case teams should establish what work has actually been done to find out if there are any. While a 'back to the drawing board' approach should be avoided, this might be necessary when this potential source of comparables has not been considered. . . Even with adjustments, internal comparables are likely to provide better evidence than the net margins of other third party companies."

Clearly, HMRC places a high degree of importance on internal comparables and they must be considered. An internal comparable was considered in *DSG*, as noted in response 2 of this discussion:

> "Since DISL took 95% of the risk and Cornhill 5% one might expect Cornhill to be a good comparable to DISL."[18]

> "We are not persuaded by Mr Peacock's points that Cornhill with 5% cannot be compared directly to DISL with 95% and no reinsurance, although any such comparison must take account of the different capital requirements. . ."[19]

> "However, Cornhill clearly had a better bargaining position than DISL and as in the case of the other possible comparables an adjustment would be impossible to make on any reasonably accurate basis, and so the conditions for applying the CUP Method are not met."[20]

Perhaps it is significant that the tribunal in *DSG* did not state that Cornhill should be preferred to the external comparables, but only that, as an internal comparable, there would be a presumption that it would be a "good" comparable.

In general, HMRC does not expect a huge effort to identify potential internal comparables, but is not enthusiastic about benchmarking efforts that comprise solely references to profit margins in a database.

5. Is there a practice to make reference to "secret comparables"?

Reference would be made to the TPG which state in this respect that:

> "Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts."[21]

INTM485080 states clearly that:

> "Case teams must not use information that is only available to HMRC."

HMRC did not attempt to introduce secret comparables in *DSG*. In our experience, HMRC inspectors only very rarely make reference to figures which they cannot share with the taxpayer.

6. Are searches for comparables made every year? To what extent is it sufficient simply to update the figures for the original set of comparables?

Reference would be made to the TPG which state that:

> ". . .it is good practice for taxpayers to set up a process to establish, monitor and review their transfer prices, taking into account the size of the transactions, their complexity, level of risk involved and whether they are performed in a stable or changing environment. Such a practical approach would conform to a pragmatic risk assessment strategy or prudent business management principle. . .For simple transactions that are carried out in a stable environment and the characteristics of which remain the same or similar, a detailed comparability. . .analysis may not be needed every year."[22]

This issue is not addressed in HMRC's International Manual and *DSG* is not instructive on this point.

It is our experience that HMRC would accept updated figures for an original set of benchmarks for several subsequent years, if they were good comparables, notwithstanding that they may not comprise the best set of comparables in the following years. Certainly there is no practice in the UK of regularly redoing comparables searches from scratch every year, and in fact it is not unusual, where circumstances have not changed significantly, simply to refer to the original figures for the original set for several years.

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NOTES

[1] The government will amend, in this year's Finance Act (with effect for accounting periods beginning on or after 1 April 2016) the existing links in the UK's transfer pricing rules, in section 164(4) Taxation (International and Other Provisions) Act 2010 and section 357GE(1) Corporation Tax Act 2010, to the OECD Transfer Pricing Guidelines, to incorporate the revisions to the Guidelines agreed in the final BEPS Actions 8 – 10 Report ("as revised by the report, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, published by the OECD on 5 October 2015"). This maintains the links between the UK transfer pricing and patent box rules and the OECD Transfer Pricing Guidelines, ensuring consensus on the practical application of transfer pricing principles.

[2] OECD Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises 2010, at para. 4.9.

[3] *Id*. at para. 3.80.

[4] *Id*. at para. 3.81.

[5] *DSG Retail Limited and Others and the Commissioners of Her Majesty's Revenue & Customs*, at para. 81.

[6] *Id*. at para. 9.

[7] *Id*. at para. 81.

[8] *Id*. at para. 99.

[9] *Id*. at para. 104.

[10] *Id*. at para. 109.

[11] *Id*. at paras. 117-118.

[12] *Id*. at para. 124.

[13] *Id*. at para. 129.

[14] *Id*. at para. 131.

[15] *Id*. at para. 154.

[16] *Id*. at para. 146.

[17] OECD Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises 2010, at para. 3.33.

[18] *DSG Retail Limited and Others and the Commissioners of Her Majesty's Revenue & Customs*, at para. 124.

[19] *Id*. at para. 81.

[20] *Id*. at para. 135.

[21] OECD Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises 2010, at para. 3.36.

[22] *Id*. at para. 3.82.