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Two key transfer pricing cases: DSG and Xilinx

Date: 28 September 2010

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Hartley Foster and Batanayi Katongera review DSG Retail and Xilinx

DSG Retail Ltd and others v HMRC [2009] STC (SCD) 397

The facts

Since the late 1970s, Dixons offered its customers, at point of sale, the opportunity to purchase an extended warranty covering repair or replacement for a period of years beyond the normal manufacturer's warranty. Following the take-over of Currys by Dixons, the DSG group entered into an arrangement with Cornhill, a third-party insurer, whereby in-store personnel would arrange warranty insurance policies for customers with Cornhill. Accordingly, a customer who decided to buy, say, a television with an extended warranty would purchase his television from DSG Retail and his insured warranty (via the Dixons sales agent) from Cornhill.

Cornhill entered into a separate administration and repair contract arrangement with another DSG company, which company dealt with the paperwork and any actual repair or replacement requirements as they arose. Cornhill reinsured 95% of the risk with another DSG company, DISL (a wholly owned group company resident in the Isle of Man) and, accordingly, 95% of Cornhill's premium income was ceded to DISL.

In 1996, it was announced that the rate of applicable insurance premium tax (IPT) would be increased from 2.5% to 17.5% with effect from April 1997. In that light of that increase (which would have had serious financial implications for the group), the DSG Group put in place a new structure whereby, instead of insurance policies being sold to consumers, non-insurance-based contracts would be entered into.

A new intermediary was introduced: ASL, an Isle of Man company owned in part by Willis Group, a third-party insurance broker. ASL entered into an administration and repair arrangement with a DSG group company and reinsured 100% of its risk with DISL.

The decision

HMRC argued that a benefit had been conferred upon DISL that would not have occurred had the parties been operating on an arm's-length basis. They argued that the insurance/service warranty contracts between customers and independent third parties only took place on the basis that back-to-back arrangements with DISL also would also be entered into; and that, accordingly, Cornhill, and subsequently ASL, acted, in effect, merely as conduits between DISL and DSG Retail.

The benefit conferred upon DISL represented the giving of a 'business facility' (under ICTA s 770 (which applied in respect of the period 1996/97 to 1998/99)) or a 'provision' from DSG Retail (under ICTA Sch 28AA (which applied from 1999/00 to 2003/04)). Accordingly, a fee should have been paid by DISL, and, having regard to the risks undertaken and functions performed by DISL, it should have constituted a very substantial part of DISL's profits.

The Special Commissioners held that the expression 'facility' in s 770, ICTA was not limited to a contract, but was something that conferred some form of benefit or advantage, possibly including the hope or expectation of profit or other advantage;

s 770 was thus potentially applicable (for the periods to which it applied). In relation to the Sch 28AA periods, there was a 'provision' made or imposed as between DSG and DISL, namely the arrangement that DISL would insure the extended warranty business written in DSG's stores on particular terms. Accordingly, Sch 28AA applied (from 1999/00 to 2003/04).

A substantial part of the reinsurance or insurance premium income was treated as profit in DISL. Although there was conflicting evidence about the level of risk to which DISL was exposed, the Special Commissioners, relying on both audited accounts and actuarial reports, found that DISL was extremely profitable.

Evidence was given on behalf of the taxpayer as to comparable uncontrolled prices (CUPs) derived from market research ('the comparables') in order to indicate that the premiums payable to DISL fell within an acceptable arm's-length range. The approach that the Special Commissioners adopted to the comparables was as follows. First, they examined the total profit in the system and the roles of each party in the arrangements.

HMRC's expert economic expert explained that where competition exists, eventually it will force higher returns ('economic profits') down to a 'normal' market level, but that if a lack of competition allows economic profits to arise, then these will be distributed between the parties according to the ability of each party to protect itself from normal competitive forces. In this regard, the Special Commissioners accepted his view that DSG had ' … almost all the long-term bargaining power'.

The point of sale advantage particularly gave DSG this ability, it being the largest electrical goods retailer in the UK. Other factors in its bargaining position were the low cost of switching insurers, its access to data on past claims and the fact that it had no need for an external brand to support its warranties.

In contrast, DISL was entirely dependent on the DSG group for its business. Having so found, the Special Commissioners analysed the comparables. A number were discounted on the basis that they were simply not sufficiently similar. In relation to those that were

potential candidates, it was not possible to make accurate adjustments to take account of the differences in relative bargaining power between DISL and DSG.

A company that provided insurance on domestic appliances had been identified by DSG as the most comparable insurance company to DISL. However, as with the other potential comparables, the relative bargaining position of DISL and DSG was key to why it was not accepted as a comparable. The Special Commissioners accepted the evidence of HMRC's expert witness that, in order to determine a CUP, comparability adjustments might have been made for differences in the capital, accounting and activities between the two companies, but could not be made in respect of bargaining power.

Having rejected the CUP method, the Special Commissioners held that a profit split methodology was appropriate, and that this should be based upon the capital asset pricing model used for calculating a return on capital. The value of DISL's contribution could be assessed by reference to the cost of equity; and, in view of DSG's bargaining position, all the residual profit could be allocated to it. The appropriate profit split would give the insurance company a return on its capital, but give the majority of the profit to the retailer to reward it for the intangibles that it possessed.

Xilinx v Commissioner of Inland Revenue

The facts

In 1995, Xilinx entered in a cost sharing agreement with an Irish resident subsidiary company, XI, to develop intangibles. The new technology that would be developed was to be jointly owned by Xilinx and XI. Under the cost sharing agreement, the parties were required to contribute towards the research and development (R & D) costs (including employment costs) of the new technology. Xilinx issued employee stock options (ESOs) to its employees who performed the associated research & development.

An Intercompany Agreement was entered into between Xilinx and XI. Under this agreement, XI employees could obtain Xilinx shares. XI was required to pay Xilinx the cost associated with the exercise of the options; and the cost equalled the market price on the exercise date over the exercise price. The costs relating to the ESOs were not included in the cost sharing agreement.

The IRS argued that, under the US's cost sharing regulations, Xilinx should have shared some of the costs of the ESOs with XI pursuant to the costs sharing agreement; and that, in order to be arm's length, the costs required to be taken into account were in respect of the options exercised by the employees using the stock market price on the exercise date over the exercise price ('the spread'). Xilinx argued that no costs were incurred in relation to the issuance of the ESOs and that unrelated parties would not share ESO costs.

The decision of the Tax Court

On 22 March 2005, Foley J released his decision. He held that the US's obligation to respect the arm's-length standard took precedence over the US's cost sharing regulations. As unrelated parties would not share the spread, the IRS's determinations could not be upheld.

Foley J quoted with approval the comments of the taxpayer's expert witness, 'in the real world, these measures [the spread] are so speculative and controversial, and the link between them and the value of R&D functions performed by the ESO holder is so tenuous, that unrelated parties in joint research arrangement simply do not agree to pay any amount for ESOs granted to the employees of an entity providing R&D services.' and also noted that, in contrast, the IRS 'did not present any credible evidence' that unrelated parties implicitly would share the spread costs.

The decisions of the US Court of Appeals

- On 27 May 2009, the US Court of Appeals reversed the Tax Court's decision, holding that the cost sharing regulations required that the ESO costs be included among the costs that must be shared by participants in cost sharing arrangements. The Court, however, similarly rejected the IRS's position that its interpretation was in accordance with the arm's length standard.
- On 15 January 2010, the US Court of Appeals withdrew its 2009 decision.
- On 22 March 2010, the US Court of Appeals released a new decision. It upheld the Tax Court's decision.

Conclusion

DSG is notable for two reasons.

First, because it is the first, and, to date, only published decision of a UK tribunal or court that contains an analysis of the UK's transfer pricing statutory code, ICTA 1988 Sch 28AA and, in particular, the methodologies necessary to arrive at an 'arm's-length price'.

Second, the case was heavily fact-dependent. The hearing lasted 15 days, and a large part of this was examination of witness (both of fact and expert) evidence and documentary evidence (there were about 40 files of documents). After the hearing had concluded, both parties provided supplemental written submissions that addressed the financial terms of the various contracts in question.

In both Xilinx and DSG, the strength of the witness evidence (and particularly the expert evidence) were of critical importance. HMRC is known to have expanded the number of transfer pricing specialists (including economists) that it employs, and it has invested significantly in training. Accordingly, DSG is unlikely to be the last UK transfer pricing dispute.

However, the authors consider that it is reasonably likely that many transfer pricing disputes will be resolved other than by means of a substantive hearing before the tax tribunal, whether by ADR or by less formal settlement means.

Indeed, it is noticeable that, recently, another very substantial dispute with a major UK multinational was settled shortly before the hearing and after some quasi-mediation assistance was provided.

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