

## Pricing Knowledge Network\*

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### PKN Alert UK - UK Tax Court finds for HMRC in transfer pricing case

There have been a number of transfer pricing cases in the UK but all have been concerned with the question of whether transfer pricing (TP) legislation applies rather than with the determination of an arm's length price. The first case dealing directly with the application of the arm's length principle was heard in late 2008 and the judgement has recently been published.

The case relates to the TP arrangements between the UK's biggest electrical retailer (Dixons) and the group's captive insurer in the Isle of Man (DISL) which, ultimately, bore most or all of the risk on extended warranties or service contracts purchased by customers. This is reputed to be very profitable business although the exact details were redacted in the judgement released on 23 April 2009. Such contracts were available to customers when they purchased electrical goods in the stores of the main UK trading company, DSG Retail Ltd (DSG). The years in dispute were 1996-2004.

The principal questions in the case were:

- whether the arrangements with DISL were at arm's length; and
- if not, whether DSG could be assessed to tax on the imputed income arising.

The case was one of the last to be heard by the Special Commissioners of Income Tax, a body which is now reconstituted as the First Tier Tax Tribunal. As most of the Special Commissioners are now judges of the Tax Tribunal this case presents useful information on how transfer pricing cases are likely to be considered in the future. With HMRC taking a more focused approach on TP, further cases are expected - at least one other was scheduled to have been heard but has been postponed until later in the year.

This case is relevant for any taxpayer with a tax advantaged structure (especially one involving the transfer of risk), those relying on comparable uncontrolled prices (CUPs) and those with captive (re)insurers.

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### **Whether TP legislation applied**

In the earliest period under dispute, extended warranties were offered by a third party insurance company, Cornhill, which reinsured 95% of the risk to DISL. Arrangements changed after the introduction of Insurance Premium Tax when customers were offered service contracts rather than warranties. Under these arrangements a company called ASL which was also independent stood between DISL and the customers.

The judgement is that the transfer pricing rules applied to arrangements between DSG and DISL notwithstanding the fact that customers' contracted with third parties who passed the risk under contract to DISL. The reasoning being that DSG allowed the warranties and service contracts to be sold in its stores and that there was therefore an overall arrangement between DSG and DISL despite the lack of any specific transactions between them or, indeed, between any of the other parties and DSG.

### **Whether the arrangements were arm's length**

DSG offered evidence of independent contracts as comparable uncontrolled prices (CUPs) and expert testimony. HMRC fielded external experts of its own.

One potential comparable for the sale of extended warranties by one part of the Dixons group was rejected on the basis that it dated from the early 1980s when market conditions for insurance products of this type were held to be different. Other potential comparables were rejected on the basis that the products under warranty were different. Commission rates cited in an Office of Fair Trading report on extended warranties were rejected as these were provided on an anonymous basis and there was no evidence of whether the rates quoted were between independent or related parties.

DSG also considered a transactional net margin (or comparable profit) approach using the return on capital of an insurer that specialises in extended warranties or service contracts of this sort. The Special Commissioners agreed that return on capital was an appropriate measure (it is particularly relevant for insurance business) but rejected the independent company as a comparable noting a number of differences between it and DISL including the fact that it had its own "brand" (DISL did not, but DSG did), that it sold its services through a number of channels (DISL had only one and was reliant on DSG) and that its customers did not have to the same degree what the Special Commissioners called a "point of sale advantage".

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### Findings

Based on the industry evidence available, the judgement concludes that the amount an insurer would offer in commissions is related to the expected profitability of the insurance business being written. Accordingly, a profit split approach should be applied, using return on capital to establish a normal level of reward for DISL with DSG earning commissions appropriate to the bargaining positions and relative contributions of the parties.

In addition to the points on brand, point of sale advantage and sales channels cited above, it was also noted that it was DSG and not DISL that had the data on loss ratios that permitted an accurate evaluation of expected profitability. The conclusion of the Special Commissioners was that DISL had little beyond its capital and some routine actuarial know how that DSG could have sourced for itself. Consequently, DSG should earn commissions sufficient to reduce DISL's profits to the normal level of reward.

The case was adjourned and the parties instructed to agree what the normal level of reward for DISL would be.

### Conclusions

The implication of this case is that the Commissioners will apply a high threshold of comparability if the intention is to rely on CUPs or independent company margins that appear to give an advantageous result where there is no supporting methodology to explain the returns in the other company involved. In particular, there is a clear signal that HMRC will look to understand the overall contribution of the parties to any arrangement in order to validate the results of the transfer pricing arrangements.

The argument that if one party has been adequately benchmarked, the results of the other must be correct was explicitly rejected in favour of looking directly at DISL's profits. The reason given was the absence of very good comparables or comparables that could reliably be adjusted.

The Special Commissioners also refer indirectly to DSG's options ie that it could itself have procured the actuarial know how required, although it would be incorrect to say that it could have offered insurance products itself (unless it was a regulated insurer).

This case is likely to encourage HMRC to challenge arrangements that result in profits outside the UK (particularly those in tax havens) where the transfer pricing is supported from a purely UK perspective.

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For groups with captive insurers where the captive does not possess significant negotiating power, the case suggests that HMRC will take the line that the arm's length profit of the captive is a benchmarked return to its economic capital. However, the use of return on capital in this case should not be interpreted as a general preference for that as a profit level indicator outside the insurance industry as it is particularly relevant to insurance business. For more information, contact your PwC contact or the authors.

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