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Transfer Pricing Report™

INSIGHT: Transfer Pricing Cases of 2018

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Transfer pricing cases add detail as to how the international transfer pricing conventions can be applied, and sometimes suggest fundamental issues which merit consideration in future iterations of those conventions.

It is notable, for example, that the new draft financial transactions chapter of the OECD Transfer Pricing Guidelines has clearly been informed by certain high-profile cases. By following international transfer pricing cases we can anticipate future transfer pricing challenges and make our transfer pricing more robust.

The purpose of this article is to summarise some key transfer pricing cases of 2018 and to draw some general conclusions from them. The cases come from Canada, Denmark, the European Union, India, Israel, the Netherlands, Norway, the U.K. and the U.S.

The issues considered (sometimes with contradictory conclusions) included:

- commercial rationality;
- recharacterisation;
- compensation for termination of an activity;
- the implications of continued losses for the choice of transfer pricing method and the possible imputation of a service to related parties;
- whether the special relationship between a parent and its subsidiary can be a comparability factor in determining an appropriate parental guarantee fee;
- the grouping of different types of transactions for benchmarking purposes;
- the degree of comparability required in order to prefer the Comparable Uncontrolled Price Method to the Transactional Net Margin Method;
- the inclusion of stock-based remuneration in cost-based transfer pricing policies;
- the degree of respect which should be shown to agreements with independent investors when attributing profit to a permanent establishment;
- when loan agreements should be respected in the face of contradictory behavior;
- whether the guidance or the actual behavior of independent parties should be followed when intellectual property has been transferred as a result of a change in the commercial arrangements; and
- the implications of failure to charge for one transaction on the way in which another transaction should be characterized.

Some conclusions are included at the end of the article.

Canada

In Cameco Corporation (Tax Court of Canada, case no. 2018 TCC 195, 2 November 2018), the key issue in question was whether the sale of goods through two intermediary group companies lacked a commercial rationale and so could not be priced at all, with the implication that the arrangement should be recharacterised. A second issue was whether the Comparable Uncontrolled Price Method was the most appropriate one to use. The court decided that the arrangements were normal for the purchase and sale of a commodity, as in the case in question (partly because they had been approved by local regulators), and that it was usual to set the price in such transactions by reference to market benchmarks (i.e. Comparable Uncontrolled Prices).

Denmark

In the case of an anonymous Danish taxpayer (Administrative Tax Court decision of 8 October 2018, case no. SKM2018.510.LSR), the issue was whether the rest of its group should have compensated a Danish manufacturing subsidiary for the closure of its facility, on the basis that this closure benefitted the other group companies. The court held that no assets had been transferred as a result of the closure (for example intellectual property, or customer relationships), and therefore no transaction had occurred. Furthermore, while related parties continued to sell to the same customers after the closure, so also did unrelated companies, and they did not compensate the Danish subsidiary. Thirdly, the closed facility comprised too small a proportion of the total European capacity of the industry for its closure to have a significant impact on the economics of the other group companies. For these reasons, the court ruled in favour of the taxpayer.

In the case of a second anonymous Danish taxpayer (Administrative Tax Court decision of 8 October 2018, case no. SKM2018.511.LSR), the issue was whether the continued losses of a local distribution subsidiary implied that it was being kept in existence in order to provide a service to its related parties. A related issue was the significance of the fact that those related parties did not have direct access to the subsidiary's market and customers. The taxpayer had used the Resale Price Method whereas the tax administration proposed that the Transactional Net Margin Method should have been used, and that the losses of company would at the least have been covered by a separate marketing service fee if it had not been related to the other companies. The tax tribunal rejected this approach on the bases that (a) the taxpayer's customers were only in Denmark and only belonged to it, (b) that distributors only represent their manufacturers incidentally, and (c) that imputing a transaction was permissible only in exceptional circumstances, which was not the case in this instance.

European Union

In Hornbach-Baumarkt (European Court of Justice, case no. C-382/16, May 2018), the issue was whether it was appropriate for no fee to be charged for the provision of two parent company financial guarantees. The court concluded that a parent company's position as a shareholder may be taken into account in determining a transfer price, and that if a subsidiary lacked sufficient equity with which to expand, it could be commercially rational for the parent to provide guarantees for no fee.

India

In Amphenol Interconnect India (Private) Ltd. (Bombay High Court, case no. 536, 7 March 2018), the issue was whether two transactions involving (a) the resale of goods and (b) sales assistance services for a commission could be grouped for transfer pricing benchmarking purposes. A second issue was whether the Transactional Net Margin Method was the most appropriate to use. The court ruled that that the Comparable Uncontrolled Price Method could not be applied safely for the buy/sell transaction because of differences in location and volumes and because the goods were customized, and that the transactions could be grouped and benchmarked together using the Transactional Net Margin Method.

Israel

In Kontera Technologies Ltd. and in Finisar Israel Ltd. (Supreme Court, 22 April 2018), the issue in both cases was whether stock-based compensation should be included in the cost base when applying the Cost Plus Method. The Court decided that this should be done, on the bases that (a) such compensation was a key element of the overall compensation of the compensation of the employees of the subsidiaries, and (b) that it had been chosen over salaries for the commercial benefit of improving the quality of service and strengthening the ties between the employees and their employers.

Netherlands

In an anonymous case (Amsterdam Court of Appeal, case no. 17/00407 to 17/00410, 10 October 2018), the issue was the attribution of profit to a permanent establishment, and in particular, whether the financial arrangements agreed with third party investors should determine the profit to be attributed to the permanent establishment. The court ruled that a party could (and in this case, did) create more local profit than had been recognized in the agreement with an unrelated party.

Norway

In Exxonmobil Production Norway Inc. (National Court of Appeal, case no. LB-2016-160306, January 2018), the issue in point was whether the interest margin on a related party loan was at an appropriate level. A related issue was whether the fact that the lender had benefited from a low interest rate loan, producing a net interest rate benefit to the lender from granting the new loan, was relevant to the pricing of the new loan. The court concluded that the interest payments had not been priced on an arm's length basis because the loan to the lender was not a comparability factor (because there was no business relationship between the two loans).

United Kingdom

In CJ Wildbird Foods Limited (First-tier Tribunal, case no. [2018] UKFTT0341 (TC06556), 21 June 2018), the issue was whether a loan advanced by the taxpayer to a related party should be treated as such for tax purposes. A related issue was the significance to be attached to the fact that no interest had been paid on the debt and the taxpayer had claimed a tax deduction for it on the basis that the debt was unlikely to be recovered in the short term. A further related issue was the significance of the fact that there was a loan agreement and that it specified that there was an obligation to repay the debt on demand, and indeed any (accrued) interest. HMRC argued that the loan did not have sufficient loan characteristics to be treated as such for tax purposes, on the basis that in practice it was not repayable, did not carry interest, and was not an ordinary business transaction. In support of its arguments, HMRC noted that the borrower had never made a profit and so had not had the capacity to pay interest (or to repay the principle). The tribunal found for the taxpayer on the basis that there was a legal obligation to repay the debt, that the debt arose from a transaction involving the lending of money, and that whether it was actually repaid was irrelevant.

United States

In Altera Corporation and Subsidiaries (US Court of Appeals for the Ninth Circuit Court, cases no.s 16-

70496 and 16-70497, 7 August 2018), the central issue was whether a cost should be calculated for the stock options which had been used to pay employees and then included in cost sharing agreement calculations. A related issue was the significance that should be given to the fact that agreements between independent parties to share costs did not include the cost of awarding stock options to employees. On 24 July the court had decided that the costs should have been included in the calculation, but withdrew its decision on 7 August.

In Medtronic, Inc. and Consolidated Subsidiaries (US Court of Appeals for the Eighth Circuit, case no. 17-1866, 16 August 2018), the issue was whether certain intellectual property had been transferred to a related party manufacturer for no charge, and whether this meant that the manufacturer (which paid a benchmarked fee to manufacture under licence) should be treated as a contract manufacturer for transfer pricing benchmarking purposes. The IRS proposed that the Comparable Profit Method (similar to the Transactional Net Margin Method) should be used to test the transfer price, rather than the taxpayer's Comparable Uncontrolled Price Method. The Tax Court had found for the taxpayer (but with modifications to its Comparable Uncontrolled Price Method). However, the Court of Appeals vacated that decision on the grounds that insufficient functional and comparability analysis had been carried out for the best method and appropriate comparability adjustments to be determined.

Themes Arising

The decisions of the courts in 2018 indicate the following (sometimes controversial) approaches to the transfer pricing issues involved:

- the insertion of intermediary companies into a transaction should be respected if it is usual for that type of transaction in that industry;
- a pricing method should be respected if it is the usual one for the type of transaction in that industry;
- closure of an activity only merits compensation from related parties if (a) something of material value has been transferred to them, and (b) if unrelated parties who also benefited compensated the party in question;
- continued losses by a distributor do not imply an undisclosed service to the manufacturer because distributors only represent manufacturers indirectly, and especially if the manufacturers do not have any other access to the customers in question;
- the position of a parent company as shareholder should be taken into account when determining a financial guarantee fee, and could point to a zero fee if this were commercially rational for the parent;
- the robust application of the Comparable Uncontrolled Price Method requires a high degree of comparability in terms of location and volumes, and the extent of customization of the items concerned; where these conditions are not met, it is permissible to bundle the transaction with a broadly similar transaction and to benchmark the combined result using the Transactional Net Margin Method;
- where stock-based compensation is an important element of employee remuneration in an industry, and this is for clear commercial reasons, then it should be included in cost-based transfer pricing calculations;
- an allocation of profit between jurisdictions that may have been agreed with independent parties does not have to be respected when attributing profit to a permanent establishment;
- the existence of a loan to a lender is not a comparability factor that should be considered when pricing a loan by the lender, unless there is a business relationship between the two loans;
- the legal form of a loan agreement should be respected, even if the debt is not repaid; and
- decisions regarding stock-based compensation, potential intellectual property transfers and recharacterisation of licensing arrangements are being withdrawn or vacated, reflecting the uncertainty in these areas.

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