

The use of captive insurers and tax havens: Implications of a UK tax court transfer pricing case

On April 22, 2009, UK's first substantive transfer pricing case was made public.¹ The UK Special Commissioners found in favor of Her Majesty's Revenue and Customs (HMRC) that non-arm's length pricing between UK's biggest electrical retailer, DSG Retail Ltd. (DSG) and a captive insurer in the Isle of Man (DISL), resulted in an understatement of UK corporation tax during the period 1996 to 2005.

In addition to its relevance for any groups that make use of captive (re)insurers, the case is relevant for any taxpayer transacting with a tax haven or low taxed country. The case looks in detail at the comparability threshold for comparable data (which would be relevant to taxpayers relying on comparable uncontrolled prices (CUPs) to support their transfer price) and also considers the applicability of the transfer pricing legislation to cases where, prima facie, it might appear it would not apply.

There is potential that this case will become a reference case in other jurisdictions outside the UK where similar arrangements are seen, especially in relation to its findings on the insurance specific aspects of the case. Also, with both sides of the case drawing evidence from a number of expert witnesses (industry experts, actuaries and economists), we expect that transfer pricing cases outside the UK will consider relying on similar testimonies more closely in the future.



The case, combined with recent work by OECD in relation to the taxation of insurance branches, is likely to bring transfer pricing of (re)insurance on the radar of tax authorities with sophisticated transfer pricing regulations.

Facts and issues

DSG's retail outlets offer customers, at the point of sale, the opportunity to purchase extended warranties on electrical goods to cover the cost of repair or replacement within a specified period beyond the manufacturer's standard warranty period. DSG's customers contracted with third parties that passed the risks of extended warranty contracts to DISL. Substantially all of the risks (and profit) on these arrangements were borne (and made) by DISL.

Court findings

Application of Transfer Pricing Legislation

Notwithstanding that there were no direct transactions or contractual arrangements between DSG and DISL and even with the insertion of third parties (as noted above), the Special Commissioners considered DSG to be a party to the overall extended warranty provision with DISL because DSG allowed the extended warranty contracts to be sold in its stores. The Special Commissioner concluded that the relevant transfer pricing legislation applies to the contractual framework amongst the parties.

¹ DSG Retail Ltd vs. HMRC, Special Commissioners TC0001, 30 March 2009.

Selection of appropriate methodology

The case considers the relevance of the OECD Guidelines² to the determination of an arm's length price, and in particular the importance of the hierarchy of transfer pricing methodologies. The taxpayer applied CUPs and the Transactional Net Margin Method (TNMM). The only other method considered by the court was the Profit Split.

Comparable uncontrolled price (CUP)

In general, the CUP approach is the most direct and reliable way to apply the arm's length principle. As stated in the OECD Guidelines, in order to apply the CUP approach, it is necessary to demonstrate that:

- no differences between the transaction being compared or the enterprises undertaking those transactions could materially affect the price in the open market; or
- reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

All of the CUPs that DSG put forward to support the overall levels of commission received in the U.K. were rejected as containing differences—market conditions and product characteristics—that could not reliably be adjusted for. The Special Commissioners drew a clear connection between:

- the overall expected profitability of the warranty cover (as indicated by the loss ratio); and

- the amount an insurer would be prepared to offer in commissions in order to access those profits.

Commission rates cited in an Office of Fair Trading report on extended warranties were also rejected on the grounds that it was anonymous and their arm's length nature could not therefore be tested.

Return of capital (ROC)

DSG put forward an alternative approach to benchmarking the arrangements with DISL, namely, a transactional net margin (or comparable profit) approach using the return on capital of Domestic and General Group plc (D&G) as an arm's length benchmark for a market return on capital for DISL. D&G is an insurer that provides domestic appliance breakdown insurance to small retailers and manufacturers.

While the Special Commissioners agreed that the ROC measure was a widely accepted way to determine "normal" levels of profitability (and that it is particularly relevant for insurance business), they did not consider D&G comparable to DISL. D&G's brand, reputation, experience and organizational capabilities are consistent with it being able to earn returns in excess of a routine level. While it may be possible to adjust for difference in capital, the Special Commissioners found there was no method of adjusting for the other cited differences.



² OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, 1999.

Conclusion

The overall finding on the case was that a profit split approach should be applied to distribute the profits of the extended warranties business between the parties according to each party's contribution to the business. The Special Commissioners considered DISL possessing only routine actuarial know-how and basic adequate capital, both of which DSG could find for itself elsewhere if it chose. Therefore, DISL was entitled to only a routine market return on its economic capital.

All residual profit earned by DISL in excess of this market rate of return was considered to be entirely attributable to DSG's assets and advantages. The parties were instructed to adjourn to consider methods to determine an appropriate measure of economic capital as well as a market rate of return on that capital. On June 25, 2009, DSG released a press statement stating that a private settlement was agreed with HMRC.

Implications

Transfer pricing analysis requires the selection of an appropriate transfer pricing methodology, which in turn almost always entails benchmarking either the transaction price or the profit margins of at least one of the parties. Generally, the party to be benchmarked is the one with the more routine risks and functions. However, difficulties can flow from the assumption that after awarding a benchmarked amount to the "tested party," the residual profit unquestionably reverts to the other party – especially if the residual profit is particularly large (or small). As such, the DSG decision is particularly important for the following reasons:

1. It contributes to increasing scrutiny of financial services transactions.

The case, combined with recent work by OECD in relation to the taxation of insurance branches, is likely to bring transfer pricing of (re)insurance on the radar of tax authorities with sophisticated transfer pricing regulations. In Canada, the Canada Revenue Agency's focus on financial services is evident in the increased audit activity, the recently enhanced disclosure of derivative transactions on its T106 form and two guarantee fee cases currently in the courts.

2. It sets a precedent on circumstances where transfer pricing legislation could apply.

The Special Commissioners found that, under the UK transfer pricing legislation, there was a non-arm's length transaction between DSG and DISL notwithstanding absence of any direct transaction between them. Consideration should therefore be given as to whether taxpayers are aware of all contractual frameworks within their group that can potentially be subject to the transfer pricing rules in the relevant jurisdictions.

3. It sheds light on the validation of transfer pricing methodology.

The case may be used as a point of reference for other tax jurisdictions to challenge arrangements that result in profits outside the taxpayer's home country (particularly those in tax havens) and where the transfer pricing is supported from one-party's perspective. The case endorses the long-held view by some tax authorities that where complex transactions appear to obscure the underlying economic reality then some form of profit split analysis is required.

4. It demonstrates the extent of economic analysis that may be required in the future.

The case demonstrates the high threshold of comparability needed if the intention is to rely on CUPs, especially if there is no satisfactory explanation on the high level profits earned by one of the parties to the transaction. In this case, the approach that if one party has been adequately benchmarked the results of the other must be correct was explicitly rejected in favor of looking directly at DISL's profits; the reason for this was the absence of very good comparables or comparables that could reliably be adjusted.

5. It has implications for benchmarking captives.

For groups with captive insurers that lack significant negotiating power, HMRC is likely to assume that an appropriate measure for determining the arm's length profit of the captive is a routine market return on its economic capital.

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