TRANSFER PRICING: THE CUP –
CASE STUDIES: AUSTRALIA, US, UK, NORWAY AND CANADA

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All transfer pricing regimes give priority to the comparable uncontrolled price (CUP) method. Despite declarations that transfer pricing is a search for the “best method” or “most appropriate method,” all systems concede that the search is over when an exact comparable is found because a CUP is preferred over all methods. The best CUP is an exact CUP because it provides an arm’s length price that is not calculated. The price emerges directly from the comparison.

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1 Biographical information.
2 Both the US Treasury regulations and OECD Guidelines have nearly identical definitions for the comparable uncontrolled price method. Treas. Reg. §1.482-3(b) indicates:
The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm’s length by reference to the amount charged in a comparable uncontrolled transaction.

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

3 Treas. Reg. §1.482-3(b)(1) indicates:
Best method rule – The arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. (emphasis in original)

4 OECD, Guidelines (2010) indicates:
The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognized methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. (emphasis added)

5 Treas. Reg. §§1.482-3(b)(2)(i)(A) and 1.482-9(c)(2)(ii)(A); OECD, Guidelines (2010), ¶2.3.
6 For example, the Mumbai Appellate Tax Tribunal recently ruled in Serdia Pharmaceutical (India) Private Ltd. v. Assistant Commissioner of Income Tax [2011-T11-02-ITAT-MUM-TP] that even though there is no formal priority given to the CUP method under the Indian Tax Act and India incorporates the OECD’s “most appropriate method” rule, the TNMM was not preferable to the CUP when the taxpayer could apply both methods in an equally reliable manner.

7 For example see: Woodward Governor Co. v. Commissioner, TC Memo 1999-220 (determining the price for the F-104 Starfighter power generators [the main fuel control for GE-built engines] sold to its Swiss distribution subsidiary based on the price charged to GE when it distributed the same power generators to foreign OEMs); Diefenthal v. United States, 367 F.Supp. 506 (ED La. 1973) (determining that the price a related party charged for “voyage charters” used to transport scrap metal to Japan was an arm’s length price because it was the same or lower price than a shipping broker was charging at the same time for the same
CUPs have traditionally been the most commonly applied method\(^8\) for both taxpayers and the government. CUPs tend not to be preferred, however, when Advanced Pricing Agreements (APAs) are negotiated. In these situations, the parties favor the transactional net margin (TNMM) or comparable profits method (CPM).\(^9\)

In contemporary practice, the TNMM appears to be the rising star among all methods. There is anecdotal evidence that in some jurisdictions more than 50% of companies now use the TNMM as their tax return filing position.\(^10\) This suggests that the TNMM is replacing many companies’ traditional reliance on CUPs but this trend does not carry over into the courts. It seems that when things get very serious CUPs re-emerge as favorites.

CUPs are the judicial gold standard. They hold sway even when they are constructed. This judicial preference is underscored in two recent cases (\textit{Alberta Printed Circuits Ltd. v. Her Majesty the Queen}\(^11\) and \textit{SNF (Australia) Pty. Ltd. v. Commissioner of Taxation}\(^12\)). In these cases a CUP contended with a TNMM. In both cases, the CUP won convincingly.\(^13\) The \textit{Alberta} CUP was exact; the \textit{SNF} CUP was constructed.

\(^8\) \textit{See: US Treasury, Study of Intercompany Pricing ("White Paper") 1982-2 CB 458, 462-64 (roughly confirming this observation on frequency with seven government and private sector studies measuring the frequency with which each § 482 pricing method was used, indicating that among the three traditional and the fourth "unspecified" method the CUP was used approximately 27\% of the time, resale price 12\%, cost-plus 22\%, and other methods 36\% of the time).}

\(^9\) Profit methods, most notably the transactional net margin method (TNMM) / comparable profits method (CPM) are the most common methods used in APAs. Joel Cooper & Rachit Agarwal, \textit{The Transactional Profit Methods in Practice: A Survey of APA Reports}, INT. TRANSFER PRICING JOURNAL (Jan/Feb 2011) 10 (Based on years 1999 – 2009, covering 260 APAs this study indicates that the TNMM comprised 93\% of the South Korean APAs, 59\% of the Australian, 53\% of the Italian, and 39\% of the Canadian APAs. In the US, the profit (CPS and PSM) methods taken in aggregate represent 65\% of the APAs dealing with tangible and intangible property and 45\% of the APAs dealing with services. The Japanese data was limited because the TNMM was not accepted in Japan until March 2004 but since then the TNMM has grown in popularity, accounting for 35\% of the APAs in 2005, 63\% in 2007, and 72\% in 2008.).

\(^10\) \textit{India: CBDT Resisting TNMM, Pushing CUP Method, Demanding Affiliates’ Data, Practitioner Says}, 13 TAX MANAGEMENT TRANSFER PRICING REPORT 627 (Oct. 13, 2004) (citing officials from the Central Board of Direct Taxes that the TNMM was the most popular pricing method among Indian taxpayers, approximating 50\%, even though the CBDT prefers the CUP method).


\(^12\) [2010] ATC 20-190, [2010] FCA 635.

\(^13\) This inclination to find a CUP is evident in \textit{Seagate Technologies, Inc. v. Commissioner}, 102 TC 149, 239 (1994) where Judge Wells tries to find support for a CUP methodology he believes represents is the best approach to the case before him, but cannot find sufficient facts in the evidence submitted to do so: [T]hird party sales of disk drives were substantial in frequency and volume. Seagate Singapore sold the same disk drives models to Seagate Scotts Valley that it sold to third party customers. It would appear reasonable to conclude that the comparable uncontrolled
Whenever constructed CUPs are involved, as in SNF, trial argumentation invariably centers on the adjustments. While exact CUPs require no adjustments, the constructed CUP’s persuasive value is based on the quality of the adjustments made. Constructed CUPs produce calculated results, and so the concern is with the precision of the calculation. Both US regulations\(^{14}\) and OECD’s *Transfer Pricing Guidelines*\(^{15}\) permit constructed CUPs. Adjustments are required under both regimes where material differences\(^{16}\) have a definite and reasonably ascertainable effect on price.\(^{17}\)

This paper aligns five cases, each from a different country, to paint a multi-jurisdictional picture of the continuing importance of CUPs in transfer pricing. The first case is Australian, *SNF (Australia)* Pty. Ltd. v. Commissioner of Taxation.\(^{18}\) It involves inexact comparables. The court is very receptive to the taxpayer’s effort to construct a CUP at trial in support of a filing position that was explained as not much more than an educated guess.

The next case is a US Tax Court decision involving a taxpayer that filed under a traditional cost-plus method, but which changed methodology at trial to a CUP. At the time the *Compaq Computer Corporation* v. Commissioner\(^ {19}\) case was considered reasonably groundbreaking because it underscored the Tax Court’s receptiveness to constructed CUP if the adjustments were well reasoned.

The third case is taken from the UK. *DSG Retail Ltd. v. Commissioners for Her Majesty’s Revenue and Customs*,\(^{20}\) demonstrates what happens when a court is convinced that adjustments are needed to inexact comparables, but when well reasoned adjustments are not offered. Thus, where *SNF* and *Compaq* involve successful CUP constructions, *DSG* is about CUP failures, six of them, along with a TNMM. In each case results are rejected because credible adjustments for unequal bargaining position are not offered. price method should be appropriate for the instant case. The record, however, does not establish whether the circumstances surrounding any of the third party transactions were sufficiently similar to the circumstances involved in the controlled sales. Consequently, we are unable to consider the third party sales prices, after any reasonable adjustments, as comparable uncontrolled prices.

\(^{14}\) Treas. Reg. §1.482-3(b)(2)(ii)(B) (listing eight factors that may require adjustment).

\(^{15}\) OECD, *Guidelines* (2010), ¶¶2.15 & 2.16.

\(^{16}\) A material difference is any difference that affects the price. See: *PPG Industries* v. Commissioner, 55 TC 928 (1970) (to determine the price for plate glass cut to size that was sold to a Swiss subsidiary the price for whole sheets of glass sold un-cut to third parties was adjusted to reflect the cost to cut the glass to the correct size).

\(^{17}\) Contrast: *Paccar, Inc.* v. Commissioner, 85 TC 754 (1985) (the Tax Court rejects a CUP because the taxpayer did not provide information on the costs a subsidiary incurred which were necessary to calculate the adjustments) with *Compaq Computer Corporation* v. Commissioner, T.C. Memo 1999-220 (July 2, 1999) (the Tax Court accepts numerous adjustments so that the taxpayer can construct a CUP); and with *Perkin-Elmer Corp.* v. Commissioner, TCM 1993-414 (the Tax Court indicates that the taxpayer could have overcome difficulties it encountered demonstrating a CUP if it had made adjustments supported by “statistical sampling of actual parts or through more specific testimony.”)


\(^{19}\) T.C. Memo 1999-220.

\(^{20}\) (2009) UKFTT 31 (TC).
Courts do not see a significant difference between cases like DSG, where comparables *could be proven* but are not, and a case like *ConocoPhillips Skandinavia AS and Norske ConocoPhillips AS v. Oljeskattekontoret,²¹* where comparables are literally *impossible* to find. The fourth case in this study, *ConocoPhillips,* is Norwegian. The CUP proposed is illusory. That is, the court and the taxpayer involved make every effort to find a CUP, which intuitively seems like it *should be* available, but in fact is not possible. Failure in this case, like in DSG, results in a profit split.

The fifth case is Canadian, *Alberta Printed Circuits Ltd. v. Her Majesty the Queen.*²² The case is unusual. The Canadian Revenue Authority’s (CRA) decision to litigate its adjustments, supported by a TNMM, in the face of the taxpayer’s exact CUP is difficult to explain unless the big picture is considered. The CRA could not overcome the authority of an exact CUP. What the CRA missed in the larger fact pattern was the front end of a business restructuring. Assets, employees and intangibles were sent to a tax haven in years that were out-of-statute, and the CRA sought to recover some of this value through a TNMM.

(1) *SNF (Australia) Pty Ltd. v Commissioner of Taxation*²³

**Constructed CUP – Inexact comparables**

In *SNF (Australia)* the full Australian Federal Court of Appeals rejected the government’s A$13 million adjustment (US$11.7 million) supported by a TNMM, even though the distributor had reported losses for eleven years, and had paid no income tax in thirteen. The decision upheld the earlier decision of a single judge of the same court.²⁴

Although Australia is a member of the OECD it has not directly incorporated the OECD *Transfer Pricing Guidelines* into statute.²⁵ As a result, the court indicated that it did not feel compelled to apply “with exactness the CUP method as described in the 1995 guidelines.”²⁶ Instead, the court felt it was required to directly apply Australian law as this was, “the burden imposed upon it under Div. 13 of the ITAA.”²⁷ This position made the case one of evidence and persuasion under a very practical understanding of an arm’s length price. For the trial court, and the full court the core issue was one of evidence.

²⁶ [2010] ATC 20-190, [2010] FCA 635 at ¶66. Also at ¶58 indicating that the OECD *Guidelines* were simply a guide and “… do not dictate to the Court any one or more appropriate methods, and are just what they purport to be, guidelines.”
²⁷ Id.
“All that the taxpayer needs to put before the Court is sufficient evidence to demonstrate true comparability.”28

Facts. SNF (Australia) is the wholly owned subsidiary of SNF (France), a multinational chemical manufacturing company. SNF (Australia) manufactured and distributed chemical products, notably flocculants and coagulants that it sold to mining, paper, and sewage treatment industries in Australia.

Although the SNF Group was profitable and SNF (Australia)’s sales were expanding, SNF (Australia) reported no profit throughout the audit period 1998 to 2004. In fact SNF (Australia) had experienced trading losses for eleven straight years and had paid no income tax for thirteen years.29

The Commissioner contended that these losses … would have forced an independent operator from the market … [To the Commissioner these losses] suggested that the taxpayer's motive was to make losses in Australia and to move profits to France by transfer pricing.30

The flocculants and coagulants SNF (Australia) resold were purchased from related-party suppliers in China, France and the US.31  In practice, the inventory purchase price was not based on a transfer pricing study but was rather an educated guess of what the correct price should be. SNF (Australia) indicated that it paid “universal prices” based on a “global price list.”32  Third parties and related parties used the same list for the same products so the Australian prices seemed right.

The Commissioner nevertheless contended that the prices SNF (Australia) paid were too high and therefore not arm’s length. This must be true, the government argued, because an independent firm would insist on lower prices so that it could make a profit. In their view, losses for thirteen years did not make sense if the inter-company prices were right.33

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28 Id., ¶143.

29 [2010] FCA 635 at ¶163.


31 SNF France, Chemtall Inc., Pearl River Inc., and SNF (China) Flocculant Co. Ltd were the related suppliers.

32 [2011] FCAFC 74 at ¶38.

33 The fundamental problem with a TNMM is that it attributes all irregularities, variances, or overall differences in losses between the related parties and the comparables to prices. But it is clear that SNF Australia suffered from low sales per sales person, stock losses due to embezzlement and poor management.

The unstated conclusion [of a TNMM] is that the losses were being generated by the excessive prices paid by the taxpayer for its polyacrylamides. But the trial judge found as a fact that this was not so; and rather that the losses had been caused by unreasonably low levels of sales, by competition in the Australian market, by excessive stock losses and by poor management. Ground 6(d) of the notice of appeal attacked that conclusion but no arguments in its favor were advanced by the Commissioner either in writing or orally. The taxpayer noted that failure in its submissions. The ground was not pressed in this Court.

[2011] FCAFC 74 at ¶130.
SNF’s CUP argument. At the Federal Court of Appeals, SNF constructed three CUPs based on internal comparables: (a) five independent foreign firms – these were external firms that bought the same products from SNF (France) as SNF (Australia) purchased from related entities, (b) three Australian and New Zealand independent firms – these external firms bought the same products from within the same product groups from SNF (USA) as SNF (Australia) purchased from related entities, and (c) twenty independent firms – these were external firms that bought the same “high volume” products from SNF (France) as were purchased by SNF (Australia) in high volumes from related parties.

CUP #1 – Five independent firms. Mr. Karoudjian, the customer services manager at SNF (France), presented this CUP to support his testimony. Screening the SNF (France) database, Mr. Karoudjian analyzed the product groups and determined that SNF (France) had thirteen different product groups. He then determined which groups matched the SNF (Australia) purchases and identified the independent firms that made high volume purchases within these groups. In his final step, Mr. Karoudjian narrowed his purchasers-list to those that were also distributors. This better aligned his group with SNF (Australia), which also was a distributor. This step narrowed his list to five independent firms.

Mr. Karoudjian then made several adjustments. First, all currencies were converted to euro at the invoice date. Secondly, adjustments were made to harmonize the contract and shipping terms (i.e. CIF, CBE, EXW). Thirdly, all transportation costs were harmonized. Mr. Karoudjian then calculated an average price for each product group in each year. Placing this data in tables he then testified, “… not altogether without variation … the prices paid by [SNF Australia for the same products] were lower than those paid by the five companies …”34

The Commissioner objected to Mr. Karoudjian’s CUP. The firms were not comparable according to the Commissioner. The Commissioner demanded more adjustments overall, and more precise adjustments whenever they were made.

In particular, the Commissioner argued: (1) Averaging – Mr. Karoudjian’s comparables were based on averages, and significant variations can and do occur within the averaged groups.35 (2) Distributor – There was insufficient proof that Mr. Karoudjian’s comparables were distributors.36 (3) Functional differences – There were serious functional dissimilarities between Mr. Karoudjian’s group and SNF (Australia). Most notably the size of each comparable Mr. Karoudjian selected was much larger than SNF (Australia).37 Finally, (4) Business activities – Each of the five firms were engaged

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36 [2011] FCAFC 74 considered generally at ¶¶16 – 29 and finally rejected at ¶30 with credible testimony from several witnesses and examination of annual reports.
in different business activities in different markets than the Australian market SNF (Australia) specialized in.\(^{38}\)

The Commissioner’s arguments and requests for further adjustments were turned down.\(^{39}\) The adjustments made by Mr. Karoudjian appeared adequate to the court. One gets the impression that the court was attracted to the possibility that it had a workable CUP to solve the case. A CUP was something that would intuitively appear reasonable. In other words, “rough justice” rather than mathematical precision was the standard.

**CUP #2 – Three Australian and New Zealand independent firms.** In this instance the taxpayer tried to reconstitute the Commissioner’s research, and present the Commissioner’s own findings as a CUP. Dr. Becker, the Commissioner’s expert, had identified three Australian and New Zealand companies that purchased the same products from SNF (USA) as SNF (Australia) purchased from related parties. An invoice search by Dr. Becker uncovered these companies. Seven common product types were identified that SNF (USA) sold to the Australian and New Zealand companies. The pricing information showed that SNF (Australia) almost always paid less than the price the Australian and New Zealand companies paid for the same goods.\(^{40}\)

However, the Commissioner’s expert, Dr. Becker, never offered these companies as comparables and never performed a comparability analysis on them.\(^{41}\) Dr. Becker used the Australian and New Zealand firms, as examples of what he felt Mr. Karoudjian’s comparables (in CUP #1) *should look like.* Dr. Becker was arguing that *if there were comparables* then those comparables must be geographically similar firms located in Australia and New Zealand that purchased from SNF. Dr. Becker was not making a statement of comparability. The trial court disregarded this point, but the full court on appeal did not. It indicated: “… the trial judge should not have relied on this second set of comparables even in the limited way he did.”\(^{42}\) The Commissioner made a number of other arguments against the CUP #2 comparables.\(^{43}\)

**CUP #3 – Twenty independent firms.** Mr. Seve, the lead partner in KPMG’s Global Transfer Pricing Services Practice, approached the CUP issue from a different direction. He isolated the top twenty products by volume that SNF Australia purchased.

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\(^{38}\) [2011] FCAFC 74 considered at ¶¶32 – 39 and answered through an analysis of the market, which the court accepts as “global” not regional. SNF holds 38% of the global market and as a result negotiates consistent prices within customer groups throughout the world. Thus, an Australian subsidiary of a Chinese company would pay the same price for the same product from SNF regardless of delivery location.  

\(^{39}\) [2011] FCAFC 74 at ¶47 concluding, “It follows that the Commissioner’s contention that the first set of comparables were not sufficiently proved is incorrect and must be rejected.”  

\(^{40}\) [2011] FCAFC 74 at ¶50.  

\(^{41}\) [2011] FCAFC 74 at ¶52.  

\(^{42}\) [2011] FCAFC 74 at ¶52, noting the trial court at [2010] FCA 635 at ¶146.  

\(^{43}\) The Commissioner noted that (1) average, not exact prices were used [2011] FCAFC 74 at ¶15; (2) product groups were relied upon with no functional analysis, [2011] FCAFC 74 at ¶52; (3) there was no proof that the purchasers were distributors, [2011] FCAFC 74 at ¶52; (4) the sample size was exceptionally small because the products compared constituted only 3% of the products SNF Australia distributed, [2011] FCAFC 74 at ¶52 and; (5) no comparability analysis was performed on any companies, [2011] FCAFC 74 at ¶52.
He then searched through SNF France’s invoices to find independent parties buying the same products. Mr. Seve concluded that “… the prices [SNF Australia] paid for these precisely identified products were generally less than the prices paid by the comparable purchasers he identified.” Mr. Seve used the five OECD comparability factors to determine comparability.

On appeal the Commissioner objected to these comparables because the trial judge did not adequately analyze them on comparability grounds. Under the Commissioner’s analysis eighteen entities were in fact not comparable. The full court agreed with the Commissioner on this point, and only twelve of the twenty companies were potential comparables.

However, the court found that the twelve remaining companies were indeed comparable. Based on these comparables the full court found that SNF (Australia) paid prices that were lower than the prices that comparable parties paid for the same products over the same time period. When the Commissioner objected that these companies covered only 35 to 40% of SNF Australia’s purchases, the Court rejected this argument indicating generally that the Commissioner was “unpersuasive.”

Commissioner’s strategic objections. Faced with a taxpayer who had two or possibly three CUPs based on inexact comparables, and with none of its own, the Commissioner decided to raise the bar. The Commissioner’s trial strategy was to try to convince the court that a CUP under Australian law is very narrowly defined. So narrow in fact that it would be almost impossible for a CUP based on inexact comparables to make it over. Adjustments needed to be comprehensive and exceedingly precise.

First, the Commissioner argued that a CUP must be identical to the taxpayer in all respects with the sole exception being that it is independent. In other words, a CUP is “… a comparator with all of the qualities of the taxpayer save its membership in the SNF Group [which] on the particular facts of this case will confine comparable purchasers to those who had a similar [13 year] history of losses …” Secondly, the Commissioner argued that, “… the taxpayer was obligated to specify a particular figure which was the arm’s length consideration …” If a particular figure could not be specified, then the taxpayer’s adjustments were neither comprehensive or precise enough.

The Commissioner argued that if the taxpayer could not meet these requirements, then its CUP must fail. If the Commissioner could convince the court of this position, then the case would naturally fall back on the only other viable method before it, the Commissioner’s TNMM. There are two elements to the Commissioner’s argument.

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44 [2011] FCAFC 74 at ¶¶53-54.
45 [2011] FCAFC 74 at ¶¶67 and 68.
47 [2011] FCAFC 74 at ¶92.
Element One: limiting CUPs to exact CUPs. The Commissioner alleged that placing tight limits on CUPs derived from an understanding of comparability under the OECD Guidelines.\textsuperscript{49} According to the Commissioner, UK\textsuperscript{50} and Canadian\textsuperscript{51} case law supported this interpretation. The full court disagreed, as did the trial judge.

Under Australian law, the arm’s length test is objective (what is the product’s value) not subjective (what is the product’s value to the purchaser). An objective standard is found in a marketplace. It is not copied directly from exact clones of the taxpayer. There is no way to construct a marketplace standard if market participants are required to be identical with taxpayer. Justice Middleton, the trial judge, indicated:

I do not accept the Commissioner's submission that the test is to determine what consideration an arm's length party in the position of the taxpayer would have given for the products. The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where those transactions are undertaken at arm's length, or if not taken at arm's length, where suitable adjustment can be made to determine the arm's length consideration that would have taken place if the acquisition was at arm's length.\textsuperscript{52}

Element Two: the exact price. The Commissioner also believed that Australian case law\textsuperscript{53} required the taxpayer to identify a specific price, a numeric amount that was the exact arm’s length price. If a taxpayer was unable to do this, then the Commissioner believed the taxpayer’s CUP would fail. Once again, the full Federal Court disagrees:

Where there is more than one arm's length price (as often there will be), the Commissioner may determine which he will apply. Correspondingly, in review proceedings the taxpayer will be entitled to succeed if it shows that the prices paid by it were arm's length prices or less than arm's length prices. If it pursues the latter course there is no need for it to establish a particular price as the arm's length price. It will be sufficient to show that it paid less than an arm's length price.\textsuperscript{54}

\textsuperscript{49} See: [2011] FCAFC 74 at ¶106. Indicating that the OECD Guidelines do not support the Commissioner’s “crystalline perfection” [at ¶102]:

On no reading did [the OECD Guidelines] support the Commissioner's submission that one was required to examine only putative purchasers who were in the same circumstances as the taxpayer.

\textsuperscript{50} The court considered and rejected DSG Retail Ltd. v. Commissioner for Her Majesty’s Revenue and Customs (2009) UKFTT 31 (TC) at [2011] FCAFC 74 ¶105.


\textsuperscript{52} [2011] FCAFC 74 at ¶93 (emphasis added) citing [2010] FCA 635 at ¶44.

\textsuperscript{53} W.R. Carpenter Holdings Pty. Ltd. v. Federal Commissioner of Taxation (2008) 237 CLR 198 (containing dicta that suggested that a taxpayer needs to prove the actual arm’s length consideration). The court rejects this reading as “incompatible” and “confined.” [2011] FCAFC 74 ¶126-28.

\textsuperscript{54} [2011] FCAFC 74 at ¶128.
Conclusion: SNF demonstrates the persuasive power of a CUP in a jurisdiction with a developed understanding of transfer pricing, but not one that is necessarily wedded to the OECD Guidelines. The persuasive power of a CUP is based on evidence and argument; the standard is objective valuation.

Under Australian law a CUP based on inexact comparables can be just as persuasive as a CUP based on exact comparables, but only if an effort (sometimes a substantial effort) is made to provide the court with adjustments for material differences. Once again, the standard is for persuasive adjustments, not necessarily adjustments with the arithmetic precision needed to calculate an exact price. There are multiple “correct” answers.

This approach is very compatible with the OECD Guidelines. The full Federal Court of Appeals does insist that Australian law stand on its own, and that the OECD Guidelines are just that – guideline. The parallel provisions in the Guidelines indicate:

[A]n uncontrolled transaction is comparable to a controlled transaction … for purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. …

Where differences exist … it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented … Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.55

(2) Compaq Computers (1999)

constructed CUP – inexact comparables and very large net adjustments

Prior to Compaq56 when a CUP was presented in US litigation it was almost always an exact CUP. Constructed CUPs, or CUPs based on inexact comparables were rare. The most notable exception is the 1994 decision in Perkin-Elmer Corp. v. Commissioner.57

57 T.C. Memo 1993-414 (1994) (This case concerned a possessions corporation that manufactured various instruments which were sold to the US parent for distribution to end users. The Puerto Rican subsidiary procured all the parts needed to assemble instruments from “kits” that the parent sold it at standard cost plus 10%. Completed instruments were sold to the parent at list price less a 25% discount. One transfer pricing issue concerned the price charged for the kits. The IRS argued for a cost-plus method while the
Compaq is important because in this case the Tax Court accepted the taxpayer’s constructed CUP even though the adjustments were twice as large as the transactions themselves. The IRS argued that the adjustments were too extreme. They made the CUP more hypothetical than real. The IRS stated that Compaq’s proposal was “… not based on actual transactions and, therefore, [did] not satisfy the applicable regulations.” The IRS lost the argument. CUPs are very persuasive when carefully constructed and argued well.

Facts: Compaq manufactured central processing units (CPU’s) for its personal computers (PC’s). Among the materials required to manufacture CPU’s were printed circuit assemblies (PCA’s), the electronic circuitry inside a CPU that allow the PC to operate.

Compaq acquired PCA’s from three sources: (a) Compaq US manufactured some PCA’s in Houston, Texas (b) Compaq purchased PCA’s from Compaq Asia its wholly owned turnkey subsidiary in Singapore, and (c) Compaq purchased PCA’s on consignment from several unrelated subcontractors primarily located in the US. Compaq Asia provided half of Compaq’s PCA’s and the transfer pricing issue in this case concerned the appropriate price that Compaq should pay for them.

Methods: Compaq’s filing position used the cost-plus method. Cost-plus also supported the Service’s statutory notice of deficiency. Cost-plus remained the Service’s method at trial, but Compaq changed. Rather than defend its’ cost-plus method, Compaq decided to construct a CUP. If successful, Compaq would clearly win, because the regulations in place mandated priority for the CUP. The court noted the traditional hierarchy:

First, if comparable uncontrolled sales exist, the regulations mandate that the CUP method be used. If there are no comparable uncontrolled sales, the resale price method must be utilized if the standards for its application are met. If the standards for the resale price method are not satisfied, either that method or the cost-plus method may be used, depending upon

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taxpayer argued for an imperfect CUP. The court agreed with the taxpayer’s argument that by establishing an arm’s length price for each separate part in a kit and then aggregating these amounts that it could determine the kit’s arm’s length price. The court accepted this “construction” as a CUP. There were no complete kit parent sales to independent parties so there were no exact internal CUPs. In addition, similar kits were not sold among independent parties – thus, there were no exact external CUPs. An upward adjustment for purchasing, inventory and freight forwarding services was added.)

58 Between 1990 and 1993 Compaq purchased 3.6 million PCA’s from 14 unrelated subcontractors at an aggregate price of $197,535,045 on a consignment basis. Adjustments of $399,576,598 were needed to convert these transactions to turnkey equivalents.


60 Id., at *12 (emphasis added).

61 In the notice the IRS determined that Compaq Asia should have a mark-up of 7.5% on its manufacturing costs. Id., at *9.

62 The Service’s expert advanced a lesser mark-up at trial (6.5% on manufacturing costs). Id., at *9.
which method is more feasible and is more likely to result in an accurate estimate of an arm's-length price.\textsuperscript{63}

\textit{IRS position}: The Service contended that CUPs were not available, the resale price method did not accurately measure prices, and thus cost-plus is the proper method. The IRS hired Clark J. Chandler as its external economic expert, and with his assistance determined the “plus” in two different ways with IEC Electronics Corporation\textsuperscript{64} selected as comparable. Chandler determined the “plus” first with ratios of operating profits as a percent of average operating assets, and then also employed a ratio of operating assets divided by total assets. Adjustments were made for accounting differences.

Chandler’s analysis was not convincing. The court rejected it because it was based on, “… unrealistic material, labor, and overhead markups … [and] if markups in the range of industry markups are used, the results of Chandler’s analysis bear no recognizable relation to respondent’s notice amounts.”\textsuperscript{65}

\textit{Compaq’s position}. Compaq contended that a CUP was the appropriate method. There were very minor physical differences between the PCA’s purchased from Compaq Asia and those purchased from independent parties. Contractual relationships were different, Compaq Asia was a \textit{turnkey} operation, and the independent contractors were on \textit{consignment}. Compaq believed that adjustments could be made for these differences.\textsuperscript{66}

Two classes of adjustments were made, a basic adjustment and then seven additional adjustments. First, because Compaq Asia was a turnkey operation, a \textit{basic adjustment} converted consignment\textsuperscript{67} pricing to turnkey\textsuperscript{68} equivalents. Secondly, \textit{additional adjustments} were made to account for minor differences in property or circumstances.

\textit{Basic adjustment}. The basic adjustment started with the consignment prices Compaq paid to unrelated subcontractors, compensating them for labor and overhead and a profit component.\textsuperscript{69} Added to this were standard materials costs (plus a mark-up).\textsuperscript{70}

\textsuperscript{63} \textit{Id.}, at *12. It needs to be noted that the regulations had changed in 1994 when the \textit{Compaq} decision was issued, removing the mandatory hierarchy and substituting it with the “best method rule” which does not have clear and unambiguous preference for the CUP.

\textsuperscript{64} IEC was one of several independent subcontractors from which Compaq purchased PCA’s on a consignment basis. \textit{Id.}, at *7.

\textsuperscript{65} \textit{Compaq v. Commissioner}, T.C. Memo 1999-220 at *12.

\textsuperscript{66} Treas. Reg. §1.482-2A(c)(2) (1968)

\textsuperscript{67} In consignment transactions Compaq consigned raw materials and components to the subcontractor, and the consignment price Compaq paid compensated unrelated subcontractors for their labor and overhead costs plus a profit on the labor and overhead.

\textsuperscript{68} In turnkey transactions, unrelated subcontractors purchase materials and components from suppliers on the Compaq authorize vendor list (AVL) and pay the same prices as Compaq. The turnkey price Compaq pays unrelated subcontractors includes materials, labor, overhead and a profit mark-up.

\textsuperscript{69} Because subcontractors were primarily in the US, this adjustment captured Compaq Asia’s labor and overhead savings.

\textsuperscript{70} By using Compaq’s US standard materials costs, labor, and overhead Compaq Asia was allowed to retain all its’ location savings. The basic adjustment essentially eliminated the $232 million proposed deficiency.
Additional adjustments. Additional (relatively minor) adjustments were made by the court for:

- Minor physical differences in specific PCAs;\(^{71}\)
- Payment terms;\(^{72}\)
- Risk for PCA cancellation and obsolescence costs;\(^{73}\)
- Set-up and cancellation charges;\(^{74}\)
- Freight;\(^{75}\)
- Duties;\(^{76}\) and
- Quality [as reflected in the lower costs Compaq incurred in reworking fewer Compaq Asia PCAs than those for comparables].\(^{77}\)

No additional adjustments were made for:

- Volume;
- Market Level; and
- Geographic market.\(^{78}\)

Conclusion. Compaq demonstrates that inexact comparables can be used to construct CUPs under US rules, and that they have as much persuasive force as an exact CUP.

The problem is that the adjustments take time and effort. They are much more difficult to do than are the database searches that support TNMM/CPMs. This may be why both SNF and Compaq are about constructed CUPs that are constructed at trial, not constructed CUPs that support filing positions. As Steve Hannes observed soon after the Compaq decision was announced:

Applying the type of constructed CUP that prevailed in Compaq may require a more time-consuming and fact-intensive effort than do CPM-type approaches.\(^{79}\)

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\(^{72}\) Differences in payment terms had worked against Compaq Asia. Asia was paid in 90.9 days as opposed to the independent parties that were paid 30.3 days. This adjustment resulted in an additional $8.9 million in payments to Compaq Asia. Id., at *12.

\(^{73}\) Obsolescence and cancellation charges generated a $4.2 million increase in compensation for Compaq Asia. Id., at *16.

\(^{74}\) Compaq had not paid Compaq Asia for $2.9 million in set-up and cancellation charges. Id., at *16.

\(^{75}\) Freight differences resulted in $2.6 million in additional costs for Compaq. Id., at *15.

\(^{76}\) Duty charges also resulted in extra costs for Compaq, requiring a $2.9 million reduction in Compaq Asia’s price. Id., at *15.

\(^{77}\) Compaq did not charge Compaq Asia $1.3 million for reworking PCAs, thus an adjustment was made. Id., at *12.

\(^{78}\) Volumes were sufficient, sales were made to the same market level, and the market was global rather than local so adjustments were needed. Id., at *15.

SNF and Compaq also stand for another proposition. If a taxpayer is raising a CUP against an assessment it is not necessary to prove an exact transfer price. It is sufficient for the taxpayer to prove that an arm’s length price would have been greater or less than the price actually paid.

(3) DSG Retail (2009)
Failing to construct a CUP – inability to adjust inexact comparables

DSG Retail Ltd. v. Commissioners for Her Majesty’s Revenue and Customs\(^ {80}\) is an exceptionally important case. It is the first case the Special Commission of Income Tax heard (now the First-Tier Tax Tribunal), and it is the UK’s first substantive transfer pricing decision. The case is almost entirely about the adjustments needed when using inexact comparables to construct a CUP.

Factually, DSG is not a simple case. In DSG, the Court is not trying to determine the arm’s length price for a simple binary exchange between two related parties. The question is more complex than either SNF\(^ {81}\) or Compaq.\(^ {82}\)

DSG involves a triangular fact pattern. Substantially all the risks and profits in a point-of-sale warranty program on retail goods are transferred to a wholly owned re-insurance subsidiary. The transfer occurs through an independent, third-party insurance company, and there is considerable evidence that this “independence” is mere form rather than substance. No goods or services transfer directly between the retailer and re-insurer. Everything transfers through the middleman, who acts as a buffer.

The Special Commission struggles to make clear that the problem is not simply about the proper price on a set of binary transfers. In the statute’s language, DSG is instead about a “provision” made by the retailer on behalf of the re-insurer. Value is transferred. The case is about the consideration that should be paid for the “provision.” Because the “provision” confers a UK tax advantage that otherwise would not be available, Income Tax Act (1988) Schedule 28AA applies and as such the Commissioners are allowed to determine the arm’s length price.\(^ {83}\)

\(^{80}\) (2009) UKFTT 31 (TC).
\(^{81}\) The question posed in SNF was simply what is the arm’s length price that SNF (Australia) should pay for flocculants and coagulants manufactured by related entities in China, the US and France?
\(^{82}\) The question posed in Compaq was simply what is the arm’s length price for PCA’s manufactured in the Singapore subsidiary that were subsequently sold to the US parent?
\(^{83}\) This statement oversimplifies. The tax years at issue in DSG are 1997 through 2004, and Schedule 28AA is effective from July 1, 1999. The prior statute §§770 to 773 Tax Act (1988) was similar, but differed in two important respects. Rather than applying the where “provision (‘the actual provision’) has been imposed between any two persons” [Schedule 28AA § 1(1)(a)] the prior statute turned on “giving business facilities of whatever kind” [§773(4) defining the operation under the Tax Act (1988)] §770. Secondly, only Schedule 28AA at § 2(1) includes an instruction to interpret the schedule in “in accordance with the [OECD] transfer pricing guidelines.”

The Special Commissioners devotes some considerable time to distinguishing the two provisions, but essentially concludes that it is a distinction without a difference (or if a difference arose, then the Court would work to prevent double taxation or non-taxation because of it). A numeric example for a potential difference is provided [at DSG (2009) UKFTT 31 (TC) ¶79]. Even with respect to the OECD Guidelines,
**Facts:** The DSG group is the largest electronics retailer in the UK, encompassing the Dixons, Currys and PC World retail chains. DSG offers customers extended warranties at check-out. For a fee at times approaching the goods cost, consumers are offered a one or multi-year warranty contract that will commence following the usual 12-month manufacturer’s warranty.

DSG in-store personnel function as agents for the third-party insurer (Cornhill) and arrange warranty insurance policies for DSG customers on goods purchased at DSG retail stores. When acting as agents for Cornhill the DSG employees are technically performing services on behalf of Coverplan Insurance Services (CIS), another DSG entity. Cornhill Insurance plc is an Isle of Man company. In 1997 Appliance Service Plan Limited (ASL) replaced Cornhill in this triangle as the “insurance” program was recast as a “service” plan. This change did not otherwise change DSG’s tax planning.

Cornhill did not hold the full risk on the insurance contract. 95% of the risk was re-insured. In all cases the reinsurer was another DSG company, Dixons Insurance Services Limited (DISL), another resident of the Isle of Man. Cornhill purchased separate administration and repair contracts from yet other DSG companies to process the paperwork and to make necessary repairs and replacements related to claims.

Thus, Cornhill effectively ceded 95% of the proceeds from the extended warranty contracts back to the DSG group through DISL using a network of contracts with various DSG Group parties to do so. Cornhill received a 4% “ceding commission” from DISL for premiums up to £25 million in a 12 month period, 3% for premiums between £25 million and £50 million, or a 2% for premiums above £50 million. These fees did not remain fixed. Several one-year contract modifications were negotiated between the DSG group and Cornhill that progressively reduced this commission. Other renegotiated financial details included a retrospective profit commission payable from Cornhill to CIS, and a reduction in the minimum assets DISL was required to be kept in trust to cover claims.

The Court indicates that under the old regime “… the OECD model is a useful aid which we should apply in the absence of any other guidance as they are the best evidence of international thinking on the topic.”

[DSG (2009) UKFTT 31 (TC) ¶77].

This is the statutory juncture that the Australian Commissioner focused on in SNF. The Commissioner argued that Australian law which makes no reference to the OECD Guidelines, is more like the older UK provision under §§770 to 773 Tax Act (1988) than current UK law under the Income Tax Act (1988) Schedule 28AA. The full Federal Court held, like the Special Commission in DSG, that this was a distinction without a difference and the OECD Guidelines even in Australia offer helpful “guidance.”

The court reports a “conflict in evidence” on this point. Some evidence points to the fact that Cornhill was not willing to accept more than 5% of the risk while other evidence point to the fact that 5% is the minimum standard fee for a “fronting insurer” to take. DSG (2009) UKFTT 31 (TC) at ¶11.

84 The court reports a “conflict in evidence” on this point. Some evidence points to the fact that Cornhill was not willing to accept more than 5% of the risk while other evidence point to the fact that 5% is the minimum standard fee for a “fronting insurer” to take. DSG (2009) UKFTT 31 (TC) at ¶11.

85 DISL was not authorized to write insurance in the UK.

86 Importantly, even though these negotiations systematically resulted in a reduction in Cornhill’s profits, and an increase in DISL’s income (a) the negotiations did not occur between DISL and Cornhill – they occurred between DSG and Cornhill, and (b) Cornhill did not attempt to pass on these “costs” to the DSG group. DSG (2009) UKFTT 31 (TC) at ¶16.
DISL and Cornhill were both exempt from income tax in the Isle of Man. As a consequence, the only UK tax directly imposed on DSG’s extended warranty program was the Insurance Premium Tax (IPT).

Methods: The taxpayer proposed six CUPs and a TNMM. The Commissioners argued that there were no comparables and that the only reasonable resolution is a profit split. The case is resolved when each of the taxpayer’s proposed comparables is rejected and a profit split adopted.

The Special Commission looked at each proposed comparable with the same question in mind. How does this comparable explain the huge profits DISL earns with only three employees performing routine tasks and with minimal bargaining power? No comparables explains this. Bargaining power is a material difference between the controlled parties and the proposed comparables, and it has a direct effect on price. An adjustment is needed, and none is provided. The failed CUPS and TNMM are detailed below:

[1] Currys-Orion. The first CUP is an internal comparable dating from the 1980’s. The Special Commission rejects this CUP because it responds to economic conditions in an entirely different market. The market for extended warranties was untried in the 1980’s but was mature and well functioning in the 1990’s. By then, there was considerable data on risks and exposure ratios. Almost no data was available in the 1980’s. Although the retail goods were similar and the point of sale advantage similar, there was limited information about the Curry-Orion relationship, and even less information about insurance claims actually made.

The Special Commission believed that the retailers bargaining position improved over time as consistently low loss ratios were progressively demonstrated in retail data. It became apparent that the extended warranty business was a very profitable and insurable risk. Thus, the Currys-Orion CUP was rejected. The Special Commission observed that:

… retailer[s] by [1990 were] in a much stronger position, and [DSG] Group’s position improved again in 1993 … this [Curry-Orion relationship] seems to be a case of parties with more equal bargaining power [than DISL, Cornhill/ASL and DSG] because (we assume) that Orion was a substantial insurer and so it was an agreement made between

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87 DISL was a non-resident for UK income tax purposes, and paid no UK income tax. The UK CFC rules did not apply in this context, because DISL carried on “exempt activities” and the premium income it received was from an unrelated party.
88 *DSG (2009) UKFTT 31 (TC)* at ¶100 (considering an agreement entered into between Currys – before it was acquired by the DSG group – and Orion for the provision of extended warranties on brown and white electrical goods through the Curry retail outlets).
89 *DSG (2009) UKFTT 31 (TC)* at ¶104.
90 For example, there was no copy of the Curry-Orion agreement available for the Special Commission to consider. *DSG (2009) UKFTT 31 (TC)* at ¶100.
91 *DSG (2009) UKFTT 31 (TC)* at ¶104.
92 *DSG (2009) UKFTT 31 (TC)* at ¶104.
equals. This is a factor for which we have no evidence enabling us to make adjustments.93

[2] CIS-National Satellite Service. The second CUP was also an internal comparable. CIS (at the time called Dixons Finance plc) entered into an agreement with National Satellite Service Limited (NSS) whereby CIS would act as NSS’s agent for selling warranty contracts primarily on satellite dishes. Cornhill once again provided the insurance. In this case Cornhill did not re-insure the risk with an off-shore NSS subsidiary, thus the comparable is offered to indicate an arm’s length price for Cornhill’s services (or Cornhill’s appropriate profit margin with DSG).94

The Special Commission rejects the CIS-NSS comparable because the warranties were not sold at the retail point of sale but rather at installation. In addition the agreement related mostly to satellite equipment rather than a wide range of electronic goods.95

Finally, the CIS-NSS contract was terminable on one-week’s notice. To the court this indicated that the CIS-NSS relationship was inherently short-term. Both parties may have wanted to gather data before making a decision before entering a longer-term relationship. In fact, the CIS-NSS contract was terminated in only one year. The court could not adjust for the missing data on risks and exposure ratios, the contract’s short-term nature, and the limited goods involved. The CUP was therefore rejected.96

[3] Office of Fair Trading Report. A third external comparable was offered from statistics the Office of Fair Trading (OFT) gathered. The OFT used three unidentified retailers and reported on commission rates the retailers paid on “Extended Warranties on Electrical Goods.” The Special Commission rejected this comparable because the retailers were unidentified.97

The next three proposed CUPs violate the rule that you cannot determine the arm’s length price in a controlled transaction by examining other controlled transactions in the same group.98 The Special Commission never reaches this rule because it determined that the proposed companies were simply not comparable.

[4] The Link. A fourth internal CUP involved Link Stores, a mobile phone retailer. BT Cellnet (40%) and the DSG group (60%) formed Link Stores as a joint

93 DSG (2009) UKFTT 31 (TC) at ¶104.
94 DSG (2009) UKFTT 31 (TC) at ¶105.
97 DSG (2009) UKFTT 31 (TC) at ¶111.
98 Lufkin Foundry & Machinery Co. v. Commissioner, 468 F2d. 805 (5th Cir. 1972) (Lufkin sold oil field machinery to Lufkin International, a wholly owned US subsidiary which sold on to third parties and other wholly owned Lufkin subsidiaries [Lufkin Canada and Lufkin Overseas]. Lufkin also sold directly to Lufkin Overseas, Lufkin International, and Lufkin Canada at the same discount from list or at an equivalent commission. The Appeals Court overturned the Tax Court decision [Lufkin v. Commissioner, T.C. Memo 1971-110], determining that the various internal sales were not CUPs for one another.
venture. Insurance-based extended warranties were offered to mobile phone customers. Once again, Cornhill was the insurance provider and DISL re-insured the risk. This is the identical fact pattern, with the same controlled parties, barring only a minority interest BT Cellnet held in the retailer.

The Link’s commissions-on-warranty/sales ratio was variable and not a reliable measure without adjustments. There were: (a) changes in commission rates, (b) changes in relative prices for products, (c) changes in the sales ratio with/without warranty, and (d) the changes in the non-mobile phone product sales on which warranties were not offered. All of these changes directly impacted sales volume and profit measures. Adjustments for these variables were not made available to the Court.

The Special Commission rejected Link Stores as a comparable because not only was the insurable risk limited to mobile phones, the risk itself (cell phone loss or damage) was clearly higher than the risk associated with the electronic goods DSG sold. No adjustments were provided for these differences. The Link, like DSG, was considered to be in a strong bargaining position but the Court believed this bargaining was “among equals.” The Link was therefore rejected as a comparable.

[5] DSG Ireland Limited. DSG Ireland was offered as an internal CUP. Although smaller in size than the UK operations, the Irish stores offered extended warranties at point-of-sale on the same goods as DSG UK. Cornhill provided insurance for the risk and DISL re-insured. Once again this is the identical fact pattern as the case under scrutiny except for substituting DSG Ireland for DSK UK as the retailer.

In this instance, however, Cornhill was able to prospectively negotiate for an 80% loss ratio with DSG Ireland. This is an outcome that would be completely impossible with DSG UK. The Special Commission rejected DSG Ireland as a comparable because this loss ratio was more than double that DSG experienced over the previous eleven years. The court was not offered a mechanism to adjust for difference.

[6] Cornhill. Cornhill itself was offered as an internal CUP for DISL. Cornhill holds 5% of the same risk that it passes to DISL. If Cornhill was truly an independent entity with real negotiating power in its relationship with DSG and DISL, then this CUP might have merit. DISL, however, earned a return on capital that was 16.05 times that of Cornhill even though the industry norm is for a fronting insurer to earn proportionately more on its capital than the re-insurer. This anomaly needed to be explained in an adjustment. The Special Commission noted that Cornhill should have been in a better

99 DSG (2009) UKFTT 31 (TC) at ¶112.
100 DSG (2009) UKFTT 31 (TC) at ¶115.
101 DSG (2009) UKFTT 31 (TC) at ¶118.
102 DSG (2009) UKFTT 31 (TC) at ¶119.
103 DSG (2009) UKFTT 31 (TC) at ¶122.
104 Although nominally independent, Cornhill appears to be under DSG’s control. Their unequal size and Cornhill’s inability to negotiate a better financial relationship suggest DSG’s economic control. Unfortunately, the Special Commission does not address this issue.
105 DSG (2009) UKFTT 31 (TC) at ¶132.
bargaining position than DISL. The Court held, “… an adjustment would be impossible

to make on any reasonably accurate basis, and so the conditions for applying the CUP

method are not met.”\textsuperscript{106}

[7] \textit{Domestic & General Group, plc}. Domestic & General Group plc (D&G) was

the largest independent off-the-shelf extended warranty products provider in the UK and

its return on equity was offered in a TNMM context. D&G provides domestic appliance

breakdown insurance directly to manufacturers and smaller retailers customers’ at the

point-of-sale.

D&G’s return on capital was offered as a profit level indicator to benchmark the

market rate of return on capital for DSG. The Special Commission agreed that

calculating the return on capital is a widely used performance measure in the insurance

industry but it considered D&G a poor comparable. It found: (a) the companies’

functional profile is different and (b) the bargaining dynamics were inverted. D&G

provided insurance to many small retailers whereas DISL was a DSG wholly owned

subsidiary with no capacity to engage in serious bargaining.

According to the OFT Report, D&G was a better comparable than the general

insurance industry. D&G’s brand, reputation, experience and organizational capabilities

made it appropriate for D&G to earn returns far exceeding routine. DISL, however, was

a three-employee operation that had no similar capabilities. The Special Commission

was not able to adjust for differences and D&G was rejected as a comparable.

\textit{HMRC’s profit split}. HMRC argued that all the comparables DSG offered were

inadequate and a profit split should be used instead. The Special Commission agreed and

required that the profit be distributed among the parties (DSG, Cornhill/ASL, and DISL)

in accordance with their relative capital contributions.\textsuperscript{107}

The Special Commission believes that this solution conforms to the OECD

\textit{Guidelines}.\textsuperscript{108}

Mr. Gayford’s method was in accordance with the OECD Guidelines. In

terms of the Guidelines we consider that Mr. Gayford is using a profit split

method based on total profit with a mixture of contribution analysis and

residual analysis approach. … It is a mixture of the contribution analysis

and the residual analysis in that no first stage return is allocated to DSG,

which makes sense here since because of their bargaining position … all

the residual profit will be allocated to [DSG] … The only factor used by

Mr. Gayford which is not in accordance with the Guidelines was that he

used hindsight.\textsuperscript{109}

\begin{flushleft}
\textsuperscript{106} \textit{DSG} (2009) UKFTT 31 (TC) at ¶ 135, citing the OECD \textit{Guidelines} at ¶ 2.7.
\textsuperscript{107} “… [T]he basic idea of a return on the required capital is the same as Mr. Gayford’s [HMRC’s expert] which in our view takes more relevant factors into account.” \textit{DSG Retail v. HMRC, TC 00001} (March 31, 2009) at ¶ 142.
\textsuperscript{108} \textit{DSG Retail v. HMRC, TC 00001} (March 31, 2009) at ¶ 143.
\textsuperscript{109} \textit{DSG Retail v. HMRC, TC 00001} (March 31, 2009) at ¶ 153.
\end{flushleft}
**Conclusion:** There are two dominant themes in *DSG*. First, *DSG* demonstrates how much detail needs to go into *adjustment analysis* when inexact comparables are being used to construct a CUP. *DSG* shows that courts are very attentive, but they are also very demanding when a CUP is proposed.

The problem in *DSG* is that the taxpayer mistook quantity for quality. It would have been far better for the taxpayer to have spent time developing solid metrics for adjusting its best CUP (Currys-Orion) than it was for it to roll out five more inexact CUPs and a TNMM each of which needed adjustments it was not prepared to offer.

Secondly, *DSG* repeatedly emphasizes the need for a bargaining power adjustment. Most of the proposed CUPs in *DSG* had material differences in bargain position relative to *DSG*. Only The Link presented a similar bargaining profile.

One additional thing is clear after this consideration of *DSG*. The judiciary is very receptive to transfer pricing arguments based in inexact comparables and the construction of CUPs. Australia’s independent transfer pricing analysis in *SNF*, the US Tax Court’s analysis under the Treasury Regulations in *Compaq*, and the UK’s Special Commission of Income Tax’s OECD *Guidelines* analysis in *DSG* all converge. The key of course is the evidence and persuasive argument, or in transfer pricing terminology the key is in the *adjustments*.


**Phantom CUPs**

ConocoPhillips Scandinavia AS (COPSAS) and Norske ConocoPhillips AS (NCOPAS) are Norwegian members of the ConocoPhillips Group. In Oslo District Court sizable transfer pricing adjustments were upheld against COPSAS\(^ {111}\) and NCOPAS.\(^ {112}\)

Both COPSAS and NCOPAS participate in the ConocoPhillips cash pooling system along with more than 150 other ConocoPhillips companies.\(^ {113}\) Each company in the pool maintains multiple cash accounts in different currencies. The net position for the entire pool constitutes the “top account” which is placed with the Bank of America.\(^ {114}\) The COPSAS/NCOPAS account balances are significantly positive. In 2004 net deposits average NOK 3.8 billion.\(^ {115}\)


\(^{112}\) NOK 6.7 million (2004) [US $ 1.21 million].

\(^{113}\) ConocoPhillips Skandinavia AS at 2 (of 12).

\(^{114}\) ConocoPhillips Skandinavia AS at 2 (of 12).

\(^{115}\) ConocoPhillips Skandinavia AS at 2 (of 12). At today’s exchange rate this amount is $686 million in US dollars.
Under the ConocoPhillips cash pooling arrangement withdrawals are made based on needs. Each participant can draw down its own funds, and if necessary access the other ConocoPhillips participants reserves fully independent of a line of credit with any external financial institution. The top account receives interest income or pays out interest expense based on the aggregate activity in the top account. Bank of America treats the ConocoPhillips group as one client with one account for each currency. The group’s treasury company, ConocoPhillips Treasury (UK) Ltd. manages the pool.

Under the agreement with Bank of America, a positive balance in the top account attracts interest at the LIBID (London Interbank Bid Rate) minus 25 basis points. A negative balance or overdraft position results in an interest charge at LIBOR (London Interbank Offer Rate) plus 25 basis points. In practice, the top account is never negative and the COPSAS/NCOPAS accounts within the top account are also never negative.

The parent entity, ConocoPhillips Inc., guarantees the accounts. Each pool member is also joint and severally liable for the account. By acting in this manner ConocoPhillips achieves significantly better cash pool rates (higher interest income and lower interest expense) than prevails in the market.

There are a couple of unique transfer pricing aspects to the ConocoPhillips fact pattern. Both the government and the taxpayers agree on the following points:

- Cash pooling is a business structure unique to corporate groups and there is no possibility of identifying independent firms that enter into similar arrangements.
- The interest income that COPSAS/NCOPAS earn on their excess cash deposits exceeds what either entity could have secured independently through an ordinary bank deposit.

Transfer pricing in Norway. Norway’s transfer pricing regime is based on the arm’s length principle. Taxpayers may be assessed if income is reduced because of a
community of interest with another party.\textsuperscript{123} If the other party is non-Norwegian then the OECD Guidelines (1995) are followed.\textsuperscript{124} However, the Norwegian tax administration does not consider the TNMM to be a valid method.\textsuperscript{125}

\textbf{COPSAS/NCOPAS filing position:} On their returns COPSAS/NCOPAS reported pool interest income based on their respective balances at the same rates, and in the same manner, as they would have if they received interest income directly from deposits at Bank of America under the same terms and conditions secured by the pool.\textsuperscript{126} In other words, COPSAS/NCOPAS treat their participation in the pool as a bank account with Bank of America.

The taxpayers have an internal CUP to support this position. COPSAS/NCOPAS can demonstrate that the rate of interest that the taxpayers receive from related parties in the cash pool is the same rate of interest that the cash pool receives from Bank of America. The tax authority rejects this CUP.

\textbf{COPSAS/NCOPAS litigating position:} At trial the taxpayers offered a number of CUPs from ordinary commercial bank accounts. Each CUP indicated that an independent enterprise in the taxpayer’s position would not earn a higher return on excess cash if it were invested in the market at the time under review.

In fact, these CUPs indicate that by recording interest income at the Bank of America rate for the pool, the taxpayers earned significantly more income than they would have if they had placed their funds on deposit in ordinary commercial accounts.\textsuperscript{127} Based on these findings the taxpayers argue that there should be no adjustment.

\begin{itemize}
\item \textsuperscript{123} Community of interest is not defined in Norwegian legislation, but case law it essentially means a connection is needed among the parties and one party is able to use that connection to control the other party (personally of economically).
\item \textsuperscript{124} ConocoPhillips Skandinavia AS at 8 (of 12) (referencing the Norwegian Supreme Court for earlier years, and as of 2008 in the Tax Act § 13-1, fourth paragraph).
\item \textsuperscript{125} Sktl. §13-1(4); Bernsen et. al., supra note 122, at 274.
\item The Norwegian rules state that the OECD methods should be used in determining inter-company pricing. Under the OECD Guidelines, the preferred methods are the traditional transaction methods. The TNMM should, in principle, be acceptable in Norway as an auxiliary method of ensuring an arm’s length remuneration. However, both in audits and in a recent series of articles, the Norwegian tax authorities have aggressively argued that the TNMM is a form of profit targeting that is not in accordance with the arm’s length principle.
\item ConocoPhillips Skandinavia AS at 3 (of 12).
\item The court indicates at ConocoPhillips Skandinavia AS at 4 (of 12): They [COPSAS and NCOPAS] presented a transfer pricing methodology (comparable uncontrolled price, CUP) showing that the group account scheme gave both deposit rates and borrowing interest rates that were significantly better than the best independent alternative. The companies, in other words increase their interest income as a result of a controlled transaction, compared with the income that would have been reported if they had chosen an external solution. The State may not, pursuant to the Tax Act § 01.13 require that the income for tax purposes will be increased further.
\end{itemize}
Making the same point in a different manner, the taxpayers argue hypothetically that if the deposit rates in the pool were adjusted to match those of the CUPs, then the taxpayers’ interest income would need to be lowered. In addition, if the borrowing rates in the pool matched those of the CUPs, then interest expense to other members of the pool would need to be increased.

In addition, the net result of these adjustments is that each party in the cash pool will receive less income and the pool will have a profit. This amount reflects a return on the pool’s coordination function. The coordination profit would essentially be the profit that a bank would receive if it engaged in the same activity. The taxpayers contend that the coordination profit should be allocated to the Treasury function, because it was the Treasury for ConocoPhillips Inc. that created the pool.

The tax administration’s litigation position: The tax administration argues that it is wrong to consider the cash pool as a series of uniform deposit and loan transactions [LIBID minus 25 basis points; LIBOR plus 25 basis points], and it is also wrong to compare the cash pool to a series of deposit and loan transactions at ordinary banks at ordinary rates. There is something entirely different going on. These are profit generating pooling transactions.128

Much as in the DSG case, the costs and benefits of the cash pool need to be split among pool participants based on relative bargaining power. The taxpayers’ CUPs should be rejected. They are not based on comparable transactions. They ignore what is actually taking place. The reality of this arrangement is that the pool has net depositors, and these net depositors are creating profit opportunities for the other companies.

Decision – profit split. The court agreed with the government. Different rates should apply to different deposits and different borrowings [not the universal LIBID minus 25 basis points; LIBOR plus 25 basis points].

Arm’s length rates for borrowing transactions should be determined based on normal commercial risk factors applied to the separate entity borrower. Arm’s length rates on deposit transactions should reflect the net depositor’s bargaining power as a separate entity depositor. Coordination gains should be identified. These gains should be allocated, but not to the pool creator or pool manager. Instead the allocation should be to the net depositors in accordance with their relative bargaining power.129 Thus, the court applied a profit split. Relative bargaining positions determine the allocation percentages.

128 The court indicates at ConocoPhillips Skandinavia AS at 5-6 (of 12):
It is not correct to compare the interest rates on ordinary bank deposits, as the appellants claim. Using this as a basis of comparison ignores the pool system as the actual transaction and the question of distribution of benefits among participants.

129 The court indicates at ConocoPhillips Skandinavia AS at 11 (of 12):
After the [District] court's opinion, it is a natural result that the economic benefits associated with the pool system is distributed among the participants in a way that takes into account each company's contribution. … none of the traditional pricing methods that follow the OECD guidelines are directly applicable in our case. Therefore discretionary analysis must be applied and an allocation based on the specific
Conclusion: The critical point in ConocoPhillips is that not all multi-national enterprise attributes can be replicated with independent parties. The ConocoPhillips cash pool is just one example. The taxpayers, tax administration, and the court all agree that in this case there is no possibility of finding a comparable pool scheme among independent parties. Thus, not only are there no CUPS, but also there are no true comparables. There is not even an inexact comparable that could be heavily adjusted as in SNF and Compaq. ConocoPhillips is resolved like DSG is resolved.

The OECD recognizes that the arm’s length principal and the methods set out in the OECD Guidelines will not answer every question in every case. ConocoPhillips presents such a case. The problem is, even though the OECD identifies the problem, it offers no solutions to it. Resolution is left to the courts. The OECD observes: A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm’s length.

As a result, in a case like ConocoPhillips where the rate on excess cash deposits looks at first as if the current rate exceeds the arm’s length rate (base on an internal CUP structured on the rates paid/charged in the Bank of America relationship), it turns out to be 0.5% below the arm’s length rate based on a relative bargaining position profit split.

(5) Alberta Printed Circuits Ltd. v. Her Majesty the Queen (2011)
An exact CUP closing out a business restructuring

Alberta Printed Circuits is the most recent Canadian Tax Court case on transfer pricing. It is the kind of transfer pricing case one does not expect to see. It involves an exact CUP.
The exact CUP in *Alberta* is not only the taxpayer’s filing position; it is the taxpayer’s audit position; its litigation defense; and the basis of the Tax Court’s decision in its favor. Exact CUPs are the gold standard in transfer pricing; they reveal an arm’s length price that is *not calculated*. They are rarely litigated, and even more rarely litigated when they are at the core of a dispute.

Analytically, *Alberta* is the polar opposite of ConocoPhillips. Where an exact CUP is impossible to find in ConocoPhillips; an exact CUP is the very premise of *Alberta*. Unlike SNF, Compaq, and DSG, in *Alberta* there are no difficult adjustments to inexact comparables. The CUP is clear and transparent on its face.

*Alberta* did not arrive at the Tax Court to resolve a technical transfer pricing question. *Alberta* made it to the Tax Court because the Canadian Revenue Authority (CRA) saw that Alberta Printed Circuits (APC), a fully domestic company since 1984, suddenly experienced a huge increase in cost of sales entirely attributable to purchases of services from a newly established related party, Alberta Printed Circuits International (APCI) in a tax haven. For the three years at issue APC’s cost of sales were:

- 1999 -- $2,042,722
- 2000 -- $2,450,854
- 2001 -- $2,182,673

In each audit year, more than two-thirds of these costs represent payments made to APCI for set-up services. These amounts and their percent of total sales for the three years at issue are:

- 1999 -- $1,377,197 – [67.4% of total cost of sales]
- 2000 -- $1,568,398 – [63.9% of total cost of sales]
- 2001 -- $1,417,694 – [64.9% of total cost of sales]

The CRA audit denied almost the full deduction for payments made to APCI in each year. Those amounts and the percent of payments to APCI are:

- 1999 -- $1,066,073 – [77.4% of payments to APCI]
- 2000 -- $1,065,727 – [67.9% of payments to APCI]
- 2001 -- $1,422,775 – [100.3% of payments to APCI]

The deficiencies were substantial. The CRA presumes that the reason for the increase is that the price charged for services between APC and APCI is wrong. In fact, the problem may have been that *Alberta* underwent a business restructuring in 1996, and a fully functional business unit was transferred to Barbados without paying adequate compensation back to APC.

**Facts:**  APC manufactures custom prototype printed circuit boards using a manufacturing process its majority (75%) shareholders, Wayne and Geraldine Bamber

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135 The deficiencies were: CAN$1,066,073 (1999); CAN$1,065,727 (2000); CAN$1,422,775 (2001).
developed. The company was formed in 1984. Producing a custom circuit board involves receiving customer data, preparing it for use in manufacturing (the “set up” process), and then physically manufacturing the board.

A minority (25%) APC shareholder, Daniel McMuldroch, performed the “set up” activities as an APC employee. As a minority shareholder/employee, McMuldroch developed unique processes for “set up” and was involved in both critical software development and integrated web design. Essentially McMuldroch developed the software that allowed the set up to be fully automated.

In 1996 APC began severing the set-up function from the company. It was to be transferred to APCI, a newly formed Barbados company. APCI was exempt from income tax in Barbados. Soon after APCI’s incorporation the Bambers bought out McMuldroch’s shareholdings in APC, followed in 1997 with McMuldroch severing his ties with Canada and becoming a Barbados resident. McMuldroch ran APCI.

An agreement between the Bambers and McMuldroch split APCI’s profits with one-third going to McMuldroch, and two-thirds to the Bambers. This agreement, together with (1) behavior not reflecting arm’s length dealings and (2) interchangeable management convinced the court that there was a community of interest between the Bamber and McMuldroch families that was inconsistent with arm’s length dealings.

After McMuldroch departed for Barbados there was no one left in Canada who could perform set ups for APC. APC told the court that without APCI it would not be able to meet its production schedule. APCI entered into four annual contracts with

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137 *Alberta Printed Circuits*, 2011 TCC 232 at ¶11-12.
139 *Alberta Printed Circuits*, 2011 TCC 232 at ¶15 & 23-28 (discussing the tax planning behind this move and how these plans were made clear to lawyers and accountants advising APC).
140 The ownership of APCI was unusual. An insurance company in Guernsey owned APCI, but the shares were assigned to policies belonging to the Bambers and McMuldroch. *Alberta Printed Circuits*, 2011 TCC 232 at ¶25-26.
143 For example, APC paid for software development but took the position that McMuldroch owned the software, because it had been developed under his direction. The court found that this was not the way parties behave at arm’s length.
144 The Bambers and McMuldroch effectively managed both APC and APCI regardless of their legal ties (or technical absence of legal ties) to one or the other entity. The court found that this was also inconsistent with arm’s length dealings.
145 The court spends considerable time on this point. It looked at the Supreme Court of Canada’s affirmation in *McLarty v. Her Majesty the Queen*, 2008 SCC 26, [2008] 2 S.C.R. 79 (S.C.C.) of the Federal Court in *Peter Cundhill & Associates v. Her Majesty the Queen*, [1991] 1 C.T.C. 197 (Fed. T.D.) as it followed Revenue Canada, *Interpretation Bulletin*, IT-419 at ¶31. The essentially criteria for a non-arm’s length relationship being: (1) a common mind which directs the bargaining for both parties to a transaction, (2) parties to a transaction acting in concert without separate interests, and (3) de facto control.
APC that essentially replicated the “missing” set-up function at APC. APCI was required to provide three services:

- Develop, supply, and maintain the production database
- Provide “set up” functions to replace the APC’s “set up” department
- Develop and maintain APC’s website

There were two payment arrangements under these contracts. First, there was a fixed fee based on the set-up type. Secondly, there was a “square inch fee” which was also called an annual bonus payment to compensate APCI for all the non set-up services. The first payment was identical to the fixed-fee APC charged to its independent customers for the same service.

Seen from APCI’s perspective, what happened in 1997 was that APCI received a fully functioning business unit from APC (product knowledge, a secure customer base, and a workforce). APCI did not compensate APC for the transfer of this going concern.

There are two ways to deal with this transfer. The CRA could argue directly (a) that uncompensated values were transferred during the restructuring and that an arm’s length price needs to be determined for these values, or the CRA could argue indirectly (b) that these values should be off-sets embedded in the prices charged for the set-up services. The direct approach involves the very difficult task valuing a going concern. The indirect approach involves using a profit-based method to allocate APCI’s profits between Bermuda and Canada. The CRA selected the second approach, and applied a TNMM with APCI as the tested party.

Taxpayer’s CUPs. APC presented the court with internal and external CUPs to price the services. APC’s internal CUP is very simple. When a customer contacts APC for a custom designed circuit board, APC uses APCI to perform the set-up, and APCI’s charge is passed directly on to the client without markup.

Essentially, APC provides set-up and manufacturing services to clients that are billed separately. The fact that the set-up services are outsourced to APCI is immaterial, but the fact that APC chose not to mark-up these services creates an exact CUP. APC was content to make its profit on manufacturing skills and chose not to bundle these services with set-up services.

There is no requirement in Canada to test a transfer pricing methodology with another method. If the best method has been used and if it “fits” the facts, then you are

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147 Richard T. Ainsworth & Andrew B. Shaet, Transfer Pricing and Business Restructurings – Intangibles, Synergies and Shelters, TAX NOTES INTERNATIONAL (discussing Chapter IX of the Guidelines, and suggesting that the OECD needs to give more consideration to the intangible assets created during a restructuring, how to value these assets, and how to determine an arm’s length consideration for their transfer).
149 Alberta Printed Circuits, 2011 TCC 232 at ¶185.
done. APC nevertheless performed additional tests and identified external CUPs that confirmed the accuracy of its internal CUP.

_Government’s need to eliminate taxpayer’s CUPs._ The CRA largely ignored the taxpayer’s CUPs on audit. The TNMM was selected very early on as the preferred method, and the reasoning for this was not convincing to the court. The taxpayer simply reaffirmed and strengthened its CUPs at trial.

This presented the CRA with a strategic problem. CUPs are universally preferred over the TNMM, so if the CRA hoped to succeed in this case it needed to convincingly eliminate the taxpayer’s CUPs.

The same scenario was apparent in _SNF_. In _SNF_ the taxpayer used inexact comparable and a large number of adjustments to construct three CUPs. _SNF_ was able to persuade the full Federal Appeals Court (Australia) that that its CUPs prevailed over the Commissioner’s TNMM, even though the firm had reported losses for eleven years, and had paid no income tax in thirteen.

_In Alberta_ the CRA argued that the taxpayer’s CUPs failed because: (1) APCI did not sell to independent parties, so its prices were inherently suspect or non-market transactions. (2) APC did not buy set-up services from independent parties, so its payment agreements were not trustworthy measures of the market. The CRA also argued (3) that APC and APCI were in different levels in the market; APC was selling at retail and APCI provided services at a wholesale level. In addition (4) because APC continued to provide some set-up services in Canada, its pass-through of APCI services at cost was not reliable, and (5) the taxpayer’s CUP failed because APC had inappropriately unbundled an integrated transaction.

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152 A letter from Star Electronics provides a quote for the same set-up services that APCI performs for APC. The prices charges by Star Electronics exceed those of APCI. _Alberta Printed Circuits_, 2011 TCC 232 at ¶202. In addition, the taxpayer’s economics expert performed a comparable search that uncovered two more external CUPs. In these cases too the independent party charged a higher price for the same services performed by APCI. The experts also indicated that other comparables were available on the internet, one of whom Western Index Manufacturing, testified at trial to the same effect – APCI’s prices were lower for the same service. _Alberta Printed Circuits_, 2011 TCC 232 at ¶209.


154 _Alberta Printed Circuits_, 2011 TCC 232 at ¶213 (indicating that the CRA’s expert selected the TNMM because “total cost information was available,” and that the other methods were rejected either because there were not adequate comparables for a CUP or that financial data for ACPI was not segmented sufficiently for a cost-plus method).

155 _Alberta Printed Circuits_, 2011 TCC 232 at ¶184.

156 _Alberta Printed Circuits_, 2011 TCC 232 at ¶185.

157 _Alberta Printed Circuits_, 2011 TCC 232 at ¶129 & 166.
The CRA was not persuasive on any account. The first two objections conflicted with published CRA notices.\(^{158}\) Evidence at trial refuted the other three.\(^{159}\) As a result, the court saw no reason to reject the taxpayer’s exact CUP, nor did it see a reason to reject the taxpayer’s external CUP.\(^{160}\)

The court accepted that the external CUPs functioned well as tests of the exact internal CUP.\(^{161}\) In doing so, the court was highly critical of the CRA. It appeared to the court that the CRA simply refused to investigate the taxpayer’s CUPs, even though it knew about them in advance. The bulk of the information the CRA needed was available on the internet and the CRA just did not look for it.\(^{162}\)

**Government and taxpayer TNMMs.** The taxpayer’s expert witness Matthew Wall left no stone unturned rebutting the government’s TNMM analysis. Mr. Wall not only questioned the government’s expert witness Deloris Wright’s assumptions, he turned the problem around, applied his objections to the facts, and developed his own competing TNMM. Not surprisingly, Mr. Wall’s TNMMs comes to very different conclusions.

The experts (Wall and Wright) disagree on which party should be the “tested party.” Mr. Wall believed that APC presents the simplest facts\(^{163}\) and Ms. Wright contends that APCI was the simplest.\(^{164}\) There were disagreements about whether or not APC continued to do set-ups after APCI was established;\(^{165}\) whether or not APC or APCI owned the valuable and unique intangibles involved in the set-up function;\(^{166}\) and whether one or both APC and APCI were exposed to significant market risks\(^{167}\)

\(^{158}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶¶186-88 (citing to Canadian Revenue Authority, Information Circular 87-2R (September 27, 1999) indicating that a CUP can be found when “another member of the group sells the particular product …” [emphasis added]).


\(^{160}\) The CRA’s challenges to APC’s external CUPs were also turned aside by the court. These challenges were largely based on claims of insufficient information. The CRA said that Star Electronics CUP could not be proven simply with the letter submitted at trial. The letter did not provide data or analysis on how the Star Electronics and APCI work processes compared or whether their set-up fees were comparable. Similar objections were raised against the other two potential comparables the taxpayer’s expert witness identified, even though in this case a full comparability analysis was developed. *Alberta Printed Circuits*, 2011 TCC 232 at ¶¶208-11.

\(^{161}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶212.

\(^{162}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶209-212.

\(^{163}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶215 (indicating that APCI bore the greatest risks because it had only one customer, owned the critical software intangibles, and had the technical know-how to perform the most difficult part of the business – set-up).

\(^{164}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶215 (indicating that most intangibles, the manufacturing function, part of the set-up overall management, marketing sales, invoicing, and shipping were all performed at APC, thereby making APCI the simplest party)

\(^{165}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶216 (indicating the expert’s contrary assumptions on the set-up function with the judge agreeing with the taxpayer).

\(^{166}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶217 (indicating that intangible ownership is not resolved in the case and = one or the other or by both parties could own the intangibles suggesting that this alone argues against using the TNMM).

\(^{167}\) *Alberta Printed Circuits*, 2011 TCC 232 at ¶218 (indicating that relative market risks are not clearly distinguishable and it is likely that both parties had significant risks).
In addition, Mr. Wall identified competitor companies in the printed circuit board businesses that were comparables. Ms. Wright, who searched for “… publicly traded companies that provided set-up as a part of their business activities, and [could] not find[ing] any …” took a much broader view. She surveyed service businesses with employees performing more general services, with skill and technical know-how at or below the skills of APCI employees, as well as some with skills well above those at APCI.

The court concluded that the TNMMs were being applied in far too subjective a manner to be useful. If, however, one of the two TNMMs needed to be used, then the court preferred the taxpayer’s.

This analysis demonstrates the incredibly subjective aspects of TNMM, as not only are the assumptions made by each expert in applying the method different, but the market comparables go from direct competitors, i.e., printed circuit board manufacturers, to businesses in broadly comparable service industries, a far more general and indirect comparison. Dr. Wright seems to have ignored the value of having direct or substantially similar comparables in favor of an approach using broadly comparable factors, one which, in my view, leads to the inevitable conclusion that such an approach is the more unreliable of the two TNMM analyses.

Conclusion. In one sense, Alberta is about the persuasive authority of an exact CUP. There is very little left to do once the judge agrees that the APC’s resale of APCI set-up services to customers is an exact internal CUP for the APC/APCI transaction. The court holds:

To conclude on this issue, in my view, the transfer pricing rules, policies and processes enunciated in the OECD Guidelines and the Department's IC 87-2R clearly set out the overwhelming preference for analysis of the highest methodologies first, before consideration of lower methods, and a preference for adjustments to prices where comparability factors justify a price differential. The evidence in this case is clearly that internal CUPs existed and were inappropriately ignored by the Respondent. I find the Appellant's use of the internal CUP both acceptable and clearly within the preferred mechanisms of the rules and that the Respondent has not justified any adjustments to the Appellant's finding that the prices paid to APCI for the set-up services based on the fixed rates charged, were arm's length prices.
This result however, does not seem to fully explain *Alberta*. If we step back a bit then what *Alberta* is really about is a reorganization; a reorganization that places a significant portion of APC’s profits overseas in a tax haven. APC has accomplished this by transferred a going concern for nothing.

A fully functional business unit (the set-up department) and critical intangible assets (the Lavenir set-up software that was developed in Canada\textsuperscript{173}) were transferred at no cost. The transfer pricing question this fact pattern raises is: How much would an entrepreneur be willing to pay at arm’s length to acquire this fully developed business?

For some reason the CRA was unwilling to ask the business restructuring question directly. OECD analysis supporting this line of argument is set out in the new OECD *Guidelines* Chapter IX.\textsuperscript{174} This is a project that the OECD had been working on for over seven years.

The CRA’s mistake in *Alberta* may have been in trying to extract a payment for transferring the set-up department as a going concern as an off-set against the price paid for set-up services. It was fatal to try to reach this result via the TNMM when the taxpayer opposed it with an exact internal CUP. CUPs are simply too powerful when the evidence to support them are strong.

**Conclusion**

The traditional preference for CUPs in resolving transfer pricing disputes is alive and well in the courts. There is, however, a noticeable rise in the TNMM particularly in APA contexts, but also to support filing and litigation positions. The reason for this is at least in part attributable to the ease with which the database searches used in TNMMs can be conducted.

The OECD has become critical of *database dumps*, defined as extensive automated financial database searches used primarily to support the TNMM. The search is for *potential comparables*, but instead of further analysis the results in this instance are simply *dumped on* (or presented to) tax authorities as-they-are.\textsuperscript{175} This practice is

\textsuperscript{173} The Lavenir software was developed by McMuldrough while he was an employee of APC in Canada. It made very significant, “… improvements to the [set-up] processes [by] reduc[ing] data input times through synchronization of information and revolutionized the manufacturing process from a 7 to 10 day timetable, to 24 hours, leading to a radical reduction in the number of panels used per project and large cost savings.” *Alberta Printed Circuits*, 2011 TCC 232 at ¶44.


\textsuperscript{175} OECD, *Guidelines* (2010) at ¶3.33 indicates (emphasis added):

*Use of commercial databases should not encourage quantity over quality.* In practice, performing a comparability analysis using a commercial database alone may give rise to concerns about the reliability of the analysis, given the quality of the information relevant to assessing comparability that is typically obtainable from a database. To address these concerns, database searches may need to be refined with other publicly available information, depending on the facts and circumstances. Such a refinement of the database search with other sources of information is meant to promote quality over
problematical because the search is being offered as a substitute for meaningful analysis. There is anecdotal evidence that this kind of *dumping* has become a common practice.\(^{176}\)

Some jurisdictions, like New Zealand, have pushed back on this practice.\(^{177}\) Others, like Norway, simply refuse to accept TNMMs.\(^{178}\) The courts too appear to be pushing back, particularly the courts in Canada and Australia where TNMMs have done poorly against inexact and exact CUPs. The Australian cases are very clear on this. In *Roche Products Pty. Ltd v. Commissioner of Taxation*,\(^{179}\) the court indicated:

> One of the problems of profit-based methodology [the TNMM is used in *Roche*] is that, when applied to transfer pricing, it *inevitably attributes any loss to the pricing*. Where operating expenses are higher these may place some of the emphasis of the cause of the loss on the wrong area. After all, it is certainly true that there are companies which make losses for reasons other than the prices for which they acquire their stock. The Australian operations of multinational companies are not necessarily excluded from this.

As indicated above,\(^{180}\) this theme in *Roche* was picked up and further emphasized in the *SNF* decision.

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standardized approaches and is valid both for database searches made by taxpayers/practitioners and for those made by tax administrations.

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Dr. Deloris Wright, the economist who performed the TNMM in *Alberta Printed Circuits* and a frequent expert witness in transfer pricing cases globally observes:

> Many of the [CPM] studies that cross the author's desk take a “database dump” approach to the selection of comparables. In these cases, no reasonable person could argue that the companies selected are comparable to the tested party, unless the sole search criterion is that the comparable companies operate a business. Proper selection of comparables is a time-consuming, difficult challenge, but a necessary one, if the results are to be useful in planning, audit defense, or/and APA negotiation.

> Often, the database dump approach also results in a transfer pricing range from negative infinity to positive infinity. Even when this is narrowed to the inter-quartile range, it is virtually meaningless and does not assist the lawyers and accountants who must use the information.


**Industry data dumps don't work**

The best comparables are those that exhibit key economic characteristics closest to the targeted company or transaction. Our policy guidelines require the consistent use of one or more reliable comparables. "Industry data dumps" are not acceptable, even if additional statistical analysis is provided using various measures of central tendency (such as inter-quartile ranges, medians and averages). Statistical tools may to some extent enhance the reliability of data carefully selected, but cannot enhance inappropriately selected comparables. Regression analysis too, is only as good as the robustness of the model employed, the underlying assumptions and the data input.

*See also:* Canadian Revenue Authority, Information Circular 87-2R (September 27, 1999) at ¶111.

Supra note 125.


Supra note 33, referencing *SNF* [2011] FCAFC 74 at ¶130.
In *Alberta* the taxpayer went one step further. To fully extinguish the government’s TNMM, the taxpayer’s expert took the government’s data and constructed his own TNMM to demonstrate how subjective biases can turn a TNMM completely around. Instead of supporting the government this CUP reinforced the taxpayer’s position.\(^{181}\) Is it any wonder that the courts in these situations seek shelter in the comfort of a CUP?

Courts give just as much authority to constructed CUPs (*Compaq*, and *SNF*) as are given exact CUPs (*Alberta*). The only requirement is that when adjustments are needed, the party that proposes the constructed CUP must spend the considerable time and effort needed to prove comparability (*DSG*).

CUPs do not answer all transfer pricing questions. There are clearly cases where exact CUPs are impossible (*ConocoPhillips*) because independent firms do not enter into similar arrangements. CUPs may appear to be present but careful analysis will find a mirage. Analysts need to be cautious, as some CUPs are phantoms.

There is a companion danger. When attempting to capture amounts from a business restructuring, it is dangerous to apply a TNMM (*Alberta*). In these cases, if the taxpayer produces an exact CUP or is able to construct one (*Compaq*), then the court may see only the clear pricing issue before it. There is very little about the TNMM that draws a court to accept its analysis. Because of all the subjective elements involved, a TNMM it can quickly be rejected.

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\(^{181}\) Supra note 171, referencing *Alberta Printed Circuits*, 2011 TCC 232 at ¶228