TRANSFER PRICING, BUSINESS RESTRUCTURINGS AND INTANGIBLES—
CASE STUDIES
UPS v. COMMISSIONER; DSG RETAIL LTD. v. HMRC

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United Parcel Service of America, the largest motor carrier in the US, and DSG Retail the largest retailer of electrical goods in the UK, restructured operations and established captive insurance companies in offshore tax havens. In both instances, these restructurings removed sizeable amounts of income from the domestic tax base.

The IRS and HMRC opened transfer pricing audits. The UPS case involved tax year 1984 and was settled in 2003, DSG Retail involved 1997 through 2005 and was settled in 2009. Both settlements came on the heels of government-favorable court decisions, and prior to the addition of Chapter IX to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines).

The Organization of Economic Cooperation and Development’s (OECD) Committee on Fiscal Affairs (CFA) added Chapter IX on Transfer Pricing Aspects of Business Restructurings to the Guidelines on July 22, 2010. The rules in this chapter deal (partially) with the UPS and DSG fact pattern, but they are weak when transfers of intangible assets are involved. The core transfer pricing issue in a captive insurance case (in OECD terms) is the measure of compensation that should be returned to a domestic company by its captive on the transfer to it of (a) the business opportunity, or (b) the right to provide re-insurance on policies that underwrite risks of retail customers.

In a small way, UPS and DSG demonstrate why twenty days prior to announcing that Chapter IX would be added to the Guidelines, the OECD initiated a new project on transfer pricing and intangibles. The stated reason for the project was that the OECD had experienced considerable difficulty with the treatment of intangibles in the business restructuring meetings. In short order, the OECD received forty-five sets of external commentary on this project. All submissions agreed that a project on intangibles was necessary.

Intangibles are one of the most challenging topics in the transfer pricing area, both from a theoretical perspective and because of the number and

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3 DSG Retail v. HMRC, TC 00001 (March 31, 2009); UPS v. Commissioner, T.C. Memo 1999-268 (August 9, 1999) reversed 254 F.3d 1014 (June 20, 2001).
5 OECD, OECD invites comments on the scoping of its future project on the Transfer Pricing Aspects of Intangibles, available at: http://www.oecd.org/document/55/0,3343,en_2649_33753_45565303_1.1.1.1.100.htm
6 OECD, Public comments received on the scoping of a new project on the Transfer Pricing Aspects of Intangibles (Sept. 23, 2010) available at: http://www.oecd.org/document/5/0,3343,en_2649_45675105_46030661_1.1.1.1.100.html
size of the disputes that arise in relation to their recognition and valuation. This became obvious in the OECD project on the transfer pricing aspects of business restructuring. The OECD Committee on Fiscal Affairs decided to commence a new project examining the transfer pricing aspects of intangibles, to be carried out by Working Party No. 6 (WP 6) on the Taxation of Multinational Enterprises.7

UPS and DSG therefore are case studies for the application of transfer pricing rules in a business restructuring context where a critical element involves the transfer of an intangible. This paper considers how the arguments and outcomes in these cases inform the present discussion on transfer pricing and intangibles.

UPS

Facts. UPS was a major US-based multinational engaged in the domestic and international package delivery business. At the time, UPS was an employee-owned company with about 14,000 current and former employees, their families, and their successors in interest as shareholders.8

As a regulated carrier under the control of the Interstate Commerce Commission (for motor carriers) and the Civil Aeronautics Board (for air carriers) UPS was able to charge its shippers a fee for each package based on weight, distance, value, and accessorial services provided. One of these services was to assume/insure damage that occurred to shipments.

The regulatory liability of UPS was limited to the declared value, but not more than $100 per package.9 In the event that values exceeded $100 per package, UPS was authorized to charge a shipper desiring additional protection an amount not to exceed $0.25 for each increment of $100.10 This was the Excess Value Charge (EVC). The EVC was an exceptionally rich income stream. In generated in excess of $100 million per year for UPS.11

In 1982 UPS began considering the benefits of establishing a separate subsidiary to handle the EVC. UPS received a proposal from a commercial insurance broker indicating that the potential benefit to UPS (after tax earnings) would be $31,001,618 (after all losses are closed).12 This amount was simply the income UPS would earn by

7 OECD, Transfer Pricing Aspects of Intangibles, available at: http://www.oecd.org/department/0,3355,en_2649_45675105_1_1_1_1_1,00.html
8 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 15 (indicating the employee ownership of UPS as well as the distribution of OPL shares to those shareholders in 1984).
9 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 4 (discussing the liability limitation).
10 UPS v. Commissioner, T.C. Memo 1999-268, at ¶¶ 2 & 3 (discussing the Excess Value Charge arrangement).
11 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 28 (indicating that not only was the income stream substantial, but it was exceptionally stable “decades-old system for setting shipping rates” that had received regulatory approval).
12 UPS v. Commissioner, T.C. Memo 1999-268, at ¶¶ 8 & 22 (discussing the proposals by American International Group’s Risk Management subsidiary – AIGRM – another subsidiary the National Union Fire
establishing a foreign re-insurance entity multiplied by UPS’s effective US tax rate. The commercial insurer would provide a no risk, no exposure “fronting service” that would then pass the insurance coverage on to the re-insurance subsidiary.

In 1983 a wholly owned Bermuda subsidiary was formed (UPSINCO, Ltd., with a later name change to Overseas Partners, Ltd [OPL]). UPS made a capital contribution of $41 million, and OPL entered into a re-insurance agreement with an unrelated commercial insurance carrier (the Fronting Company). Pursuant to the agreement the EVC collected by UPS from its customers was transferred to the Fronting Company. The Fronting Company in turn ceded 100% of the liability and net premiums to OPL.

A unique aspect of the UPS fact development occurred on December 31, 1983. On that date UPS distributed a very significant portion of the OPL stock to its shareholders. Thus, the shareholders of UPS and OPL were essentially the same (from a proportional standpoint). UPS did retain ownership of a portion of the OPL stock. The UPS group was restructured, changing UPS-OPL relationship from parent and 100% owned subsidiary to brother/sister.

Functionally, no changes occurred in the UPS business model with the establishment of OPL. UPS handled the EVC in the same manner it always had with its shippers. Claims were processed in the same manner as they had been before the creation of OPL. UPS did not charge either the Fronting Company or OPL for costs related to non-payment of charges by shippers, or any related collection costs.

Finally, at the time of these transactions an unrelated, major commercial insurance carrier offered coverage to UPS (under the same excess coverage arrangement) for approximately half of the $0.25 charge.

Tax Court decision. Judge Ruwe in the Tax Court considered the EVC transactions (UPS – Fronting Company – OPL) to be shams. He ruled that they lacked economic substance and should be ignored for tax purposes. The entire premium income and expenses should be recognized directly by UPS. Although the decision formally

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13 UPS v. Commissioner, T.C. Memo 1999-268, at ¶¶ 13 & 14 (discussing the formation of UPSINCO in Bermuda, the capital contribution and the name change to OPL).
14 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 22 (listing the 17 discrete functions performed by UPS with respect to the Excess Value Charge both before and after the establishment of OPL).
15 UPS v. Commissioner, T.C. Memo 1999-268, at ¶¶ 22 & 23 (indicating that no charges were made for collection services provided, sales, marketing, interest charges, reductions for uncollectable amounts, legal defense raised against shippers’ claims denied, or the costs of the loss prevention department and audit control activities).
16 UPS v. Commissioner, T.C. Memo 1999-268, at ¶¶ 17 & 35, n. 55 (indicating that Fireman’s Fund Insurance Company [FFIC] through a policy sold by Parcel Insurance Plan Inc. [PIP] offered excess value protection identical to that provided by UPS at fifty-percent of the rate charged by UPS and tried to secure the UPS business, and further indicating that UPS rejected this proposal knowing that it would have cut its excess value charge related revenues in half).
rests under §61, a critical element of Judge Ruwe’s sham analysis is that the prices were not at arm’s-length.\textsuperscript{17} Thus, both §61 and §482 are both invoked.

Making the determination that prices were not at arm’s length did not seem that difficult for Judge Ruwe. The IRS presented insurance experts (Kelley and Cohen), a finance professor (Shapiro), an insurance economist (Nye), and an actuary (Kilbourne) who all agreed that prices were not at arm’s length. Even one of the UPS experts (Doherty), an expert in the economics of insurance, agreed.

In Judge Ruwe’s mind, the IRS presented the court with a very good internal comparable (a “comparable uncontrolled transaction,” or CUT) and with supporting financial analysis that placed the arm’s length charge for EVC insurance within a range of $0.08\textsuperscript{18} to $0.09.\textsuperscript{19} This would be less than half the $0.25 collected by UPS and remitted to OPL through the Fronting Company.

But the court went further. It was apparent to Judge Ruwe that even at these rates, these were amounts paid for non-existent, theoretical, improbable and unrealistic assumption of risk by the Fronting Company and OPL. There were two reasons for this. First, UPS had an additional “umbrella policy” that provided coverage for losses between $25,000 and $10 million. The court determined that losses in excess of $10 million (per shipment) were only a “theoretical exposure.” Secondly, based on eleven years of data it was clear to the court that EVC claims (for the amounts under $25,000) never exceeded 40\% of the gross EVC amounts collected directly from customers. Essentially, the remaining 60\% of the gross EVC amounts were pure profit, and this was being remitted to OPL through the Fronting Company.

For these reasons, the court found that this arrangement provided “… no significant nontax benefit to either [UPS] or its shippers.”\textsuperscript{20} The transactions were considered economic shams.

After carefully considering the entire record, including the expert reports offered by both petitioner and respondent, we are persuaded that the price of 25 cents per $100 of excess value liability paid [by shippers to UPS, then on to the Fronting Company and finally to OPL] was not a result of arm's-length negotiations and that the price of 25 cents per $100 was far in excess of the price that could have been negotiated by [UPS]. This is another indication to us that petitioner's arrangement … was a sham.

\textsuperscript{17} UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 34 (observing that, “another factor in determining whether a particular transaction was a sham is the presence or absence of arm’s-length price negotiations and the relationship between price and fair market value”).

\textsuperscript{18} $0.08 is the rate that Fireman's Fund Insurance Company would charge for “very similar” coverage. UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 35, n. 52.

\textsuperscript{19} $0.092 is the rate that Professor Alan Shapiro determined would be arm’s length based on an analysis of OPL’s return on equity for reinsuring EVC activity in 22 comparable property/casualty insurers and diversified insurance companies. UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 35.

\textsuperscript{20} UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 34.
The 11th Circuit decision. The Tax Court decision was reversed on appeal. The 11th Circuit agreed with UPS that the captive insurance arrangement was not a sham. There was a genuine and enforceable insurance contract with a bone fide third party insurer, and even though the chances of the insurer suffering a loss were remote, they were nevertheless real.

Thus, the 11th Circuit finds that UPS’s restructuring had a business purpose. There is nothing wrong with tax planning. To have a business purpose does not mean that a taxpayer must show that its transactions are free from any tax considerations.

The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive. True, UPS's restructuring was more sophisticated and complex than the usual tax-influenced form-of-business election or a choice of debt over equity financing. But its sophistication does not change the fact that there was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure.21

disposing of the sham transaction argument however, did not dispose of the case. The 11th Circuit understood that both §61 and §482 had been invoked. As a result, the case was remanded.

The tax court did not, however, reach the IRS's alternative arguments in support of its determination of deficiency, the reallocation provisions of IRC §§482 and 845(a). The holding here does not dispose of those arguments, and we therefore must remand for the tax court to address them in the first instance.22

UPS Settlement. It is easy to see why UPS would want to settle with the government. They did so in February 2003. Judge Ruwe’s Tax Court decision had lined up many of the necessary §482 elements. An internal comparable (CUT) and an arm’s length range (a price between $0.08 to $0.09) was determined. To be sure, there would be room to argue about whether or not there was common control. UPS and OPL were brother-sister corporations. UPS did not directly control OPL, however proving indirect control or a concert of action would seem easier.23 There was no hint in UPS of the arguments raised in DSG that question the validity of comparables in a captive insurance case based on the unequal bargaining power of the parent company.

DSG

21 UPS v. Commissioner, 254 F.3d 1014, 1020 (11th Cir. 2001).
22 UPS v. Commissioner, 254 F.3d 1014, 1020 (11th Cir. 2001).
23 Treas. Reg. §1.482-1A(a)(3) defines control as:
   Any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.
   See also: Grenada Industries v. Commissioner, 202 F.2d 873 (1953).
Facts. The DSG group of companies is the largest electronics retailer in the UK. Retail outlets include the Dixons, Currys and PC World chains. DSG offers customers extended warranties at check-out. For a fee (sometimes approaching the cost of the goods) consumers are offered a one-year (or more) warranty contract that will commence following the usual 12-month manufacturer’s warranty. Prior to April 1997 the extended warranty was an insurance-based contract. Due to a change in the Insurance Premium Tax, DSG restructured its warranty program a second time so that the customer’s contract became a non-insurance services contract. To the customer there was no functional difference in these warranties.

Prior to April 1997 the DSG extended warranty program was a carbon copy of the EVC arrangement at UPS. In-store personnel at DSG functioned as agents for a third-party insurer (Cornhill) and arranged warranty insurance policies for DSG customers on goods purchased at DSG retail stores. When acting as agents for Cornhill the DSG employees were technically performing services on behalf of Coverplan Insurance Services (CIS), another DSG entity. Cornhill Insurance plc is an Isle of Man company.24

Cornhill was not prepared to hold the full risk on the insurance contract. It held no more than 5% of the risk.25 Cornhill purchased reinsurance for the other 95%. In all cases the reinsurer was another DSG company, Dixons Insurance Services Limited (DISL). DISL is a wholly owned subsidiary of DSG, and a resident of the Isle of Man.26 In addition, Cornhill purchased separate administration and repair contracts with other DSG companies to take care of all paperwork and make necessary repairs and replacements related to claims.

Thus, Cornhill effectively ceded 95% of the proceeds from extended warranty contracts back to the DSG group (through DISL). Cornhill received a “ceding commission” from DISL of 4% (for premiums up to £25 million in a 12 month period) or 3% (for premiums between £25 million and £50 million) or 2% (for premiums above £50 million). These fees did not remain fixed. A series of one-year contract modifications (beginning on May 1 in 1987, 1988, 1989, 1990) were negotiated between 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 required to be kept in trust by DISL for covering claims.

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, and (b) Cornhill did not attempt to pass on these “costs” to the DSG group.27

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24 Cornhill Insurance plc in the DSG fact pattern performs the same role as the Fronting Company set up by Fireman’s Fund Insurance Company in the UPS fact pattern.
25 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, other evidence point to the fact that 5% is the minimum standard fee for a “fronting insurer” to take. DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶11.
26 DISL was not authorized to write insurance in the UK.
27 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶16.
DISL and Cornhill were both exempt from income tax in the Isle of Man. 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. Insurance transactions are also exempt from VAT (although this made the VAT paid by DSG on related expenses non-deductible).

As a consequence, the only UK tax directly imposed on DSG’s extended warranty program was the Insurance Premium Tax (IPT). Prior to April 1997 the IPT rate was 2.5%. However, as of April 1, 1997 the IPT rate was raised to 17.5%. This higher rate was equal to the standard rate for UK VAT, and in effect made premiums under the IPT subject to the same rate of tax as services under the VAT. This rate change prompted DSG to restructure in 1997.

By changing the extended warranty program from an insurance product to a service the extended warranties were brought within the scope of the VAT. This in turn allowed DSG to deduct VAT it paid on related expenses. To accomplish this DSG terminated the Cornhill relationship and opened up a new relationship with Appliance Service Plan Limited (ASL), a newly incorporated Isle of Man company. ASL, like Cornhill, was an independent third-party unrelated to DSG. Other than changing the characterization of the warranty contract from insurance to services, there was no other substantial change in the warranty program.

ASL entered into an administration and repair arrangement with DSG Mastercare, the same company that Cornhill contracted with to provide warranty repairs and replacements. ASL then insured 100% of its risk with DISL. DISL needed to change its registration with the Isle of Man so that it could offer insurance (to ASL) rather than reinsurance (to Cornhill). When this change was in place DISL requested (and received) a ruling from the Isle of Man tax authorities to confirm that this change did not alter its tax-exempt status. The 17.5% IPT did not apply to the payments made by consumers to ASL (because the contract was for services, not insurance), and the IPT did not apply to the premiums paid from ASL to DISL (because the insurable risk was located in the Isle of Man, not the UK).

The net effect of these transactions (whether through Cornhill or ASL) was to leave a substantial portion of the re-insurance (Cornhill) or insurance premium (ASL) income in DISL as profit. These amounts were tax-free in the Isle of Man and immune from UK tax.

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28 This is not an insignificant deduction for DSG. The Special Commission indicates that, “[m]oving to service contracts saved [DSG] many millions of pound per annum compared with continuing with insured warranties …” DSG International Insurance Services Ltd (2007) IPT 0013; [2007] UKSPC (25 October 2007) at ¶145.


30 DSG International Insurance Services Ltd (2007) IPT 0013; [2007] UKSPC (25 October 2007) (in this case the HMRC lost its argument that the insurable risk was in the UK rather than the Isle of Man, and that there was a single insurance contract between the customer and DISL).
Special Commission of Income Tax decision. The DSG decision is an exceptionally important UK tax case. Not only is it the first decision of the Special Commission of Income Tax (now the First-Tier Tax Tribunal), it is the UK’s first substantive transfer pricing case.

The case looks in detail at how to determine the appropriate methodology for a transfer pricing adjustment. It is particularly concerned with the comparability threshold for data, and will be very relevant for determining comparable uncontrolled prices (CUPs), as well as the resale price and cost plus methods. But more than this, the DSG case applies transfer pricing rules to non-contractual arrangements between related parties, or (in UK terminology) to the indirect “provision” by a UK company of a business facility to a related party.

Sham transaction. Although factually very similar to UPS, the Special Commission did not adopt Judge Ruwe’s sham transaction approach. It would not be difficult to conclude that the Cornhill-DISL or the ASL-DISL relationship provided “no significant non-tax benefit” to DSG or the final consumers who purchased electronic goods at DSG’s retail outlets. In fact, for all practical purposes (except for the text of the extended warranty contract itself) the consumer only dealt with DSG employees. However, the Special Commission did not consider this approach.

Sham transaction arguments were not raised by the HMRC. The reason for this may have been very pragmatic. Not only had the essential facts of the case been litigated before the VAT and Duties Tribunal in 2007 where the HMRC tried to demonstrate that the insurable risk was within the UK, but

The practical experience of transfer pricing disputes has, for many years (as evidenced by the lack of reported litigation), been one of negotiation and settlement with HMRC. Indeed, for the early years of the DSG extended warranty arrangements the taxpayer had reached settlement with HMRC and closed its computations. Thus for the period of the Cornhill-insured warranties, the only open year was 1996/97. Agreement had also been reached with HMRC regarding DISL’s CFC status.31 If sham transaction arguments had been raised, DSG would most likely have argued that the time for that had long since passed.

Comparable Uncontrolled Prices (CUP). Judge Ruwe’s and the IRS’s alternate argument, and the basis for the 11th Circuit remand to the Tax Court was the evidence supporting an internal comparable (CUT) from Fireman’s Fund,32 reinforced with Professor Alan Shapiro’s “return of equity” profit split.33

31 Murray Clayson, HMRC Transfer Pricing Victory, THE TAX JOURNAL 6 (May 4, 2009)
32 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 35.
33 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 35 (additional support included the actuary Fredrick Kilbourne who performed a arm’s length premium coverage analysis using customary industry rates, and Doctor Blaine Nye’s capital asset pricing model based on underwriting profit margins).
However, unlike UPS, where the IRS’s CUT was looked on favorably by both the Tax Court and the 11th Circuit, in DSG the Special Commission rejected each of the six CUPs that DSG offered, as well as a transactional net margin (TNMM) approach that used a return on capital as a profit level indicator.

Throughout the assessment of comparables, the Special Commission was continually troubled by DISL’s lack of bargaining power. In a sense, and without expressly stating it, the Special Commission seemed to have determined that DISL should be treated as the “tested party.” It is easy to see why. Although DISL had three directors, and held annual board meetings in the Isle of Man, it only had three real employees. As a result, any comparable that could not explain how DISL achieved exceptional returns with three employees performing routine activities was rejected.

[1] Currys-Orion. The first CUP presented was an internal comparable dating from the 1980’s. The Special Commission rejected it because it represented conditions in an entirely different market. Although the goods sold at retail were similar, and the point of sale advantage of Currys was similar to that of DSG, there was limited information about the Curry-Orion relationship. In addition, there was very limited information about the insurance claims that were made.

The Special Commission believed that “the bargaining position of retailers improved with the consistently low loss ratios shown as more data became available [on extended warranty business].” For example, the Cornhill-DISL agreement included “retrospective profit commissions,” and Cornhill (the insurer) was not able to resist efforts by DSG to reduce its commissions substantially year-after-year (which increased DISL’s profits). The Currys-Orion CUP was rejected.

… retailer[s] by [1990 were] in a much stronger position, and [DSG] Group’s position was improved again in 1993. But most importantly 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 equals. This is a factor for which we have no evidence enabling us to make adjustments.

[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 the sale of warranty contracts (primarily of satellite dishes). Cornhill provided the insurance.

35 DSG Retail v. HMRC, TC 00001 (March 31, 2009) 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).
36 For example, there was no copy of the Curry-Orion agreement available for the Special Commission to consider. DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶100.
37 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶104.
38 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶104.
39 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶104.
In this case Cornhill did not re-insure the risk with an off-shore subsidiary of NSS, thus the comparable is offered to indicate an arm’s length price (or Cornhill’s appropriate profit margin).

The Special Commission rejected the CIS-NSS comparable because warranties were not sold in stores (point of sale), but rather at installation. In addition the agreement related mostly to satellite equipment, not a range of electronic goods sold through DSG.

In addition, 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, and both parties may have wanted to gather data before making a decision on entering a longer-term relationship. In fact, the CIS-NSS contract was terminated in one year. The court could not adjust for the lack of data, the short-term nature of the contract, and the limited range of goods involved. This CUP too was rejected.

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

[4] The Link. A fourth comparable offered by DSG involved Link Stores, a mobile phone retailer. Link Stores was an internal comparable. BT Cellnet (40%) and the DSG group (60%) formed Link Stores as a joint venture. Insurance-based extended warranties were offered to mobile phone customers. Cornhill was the insurance provider and DISL re-insured the risk.

The Special Commission rejected Link Stores as a comparable because not only was the insurable risk limited to mobile phones, the risk itself (loss or damage of a cell phone) was clearly higher than the risk associated with the range of electronic goods sold by DSG. There was no way to adjust for these differences. As with DSG however, The Link was considered to be in a stronger bargaining position than DISL, but this was not sufficient to make The Link comparable to DSG.

[5] DSG Ireland Limited. DSG Ireland was also offered as a comparable. Although smaller in size than that the UK operations, the Irish stores offered extended warranties on the same range of goods as DSG UK. Cornhill provided insurance for the risk, and DISL re-insured.

Cornhill however, was able to negotiated (prospectively) for an 80% loss ratio with DSG Ireland. The Special Commission rejected DSG Ireland as a comparable, because this loss ratio was more than double that experienced by DSG over the previous eleven years. The court was not offered a mechanism to adjust for difference.

[6] Cornhill. Cornhill itself was offered as a potential comparable for DISL. Cornhill holds 5% of the same risk that passes to DISL. The Special Commission noted
however, that Cornhill was in a better bargaining position than DISL, and as with the other potential comparables there was no basis on which to make adjustments. As a result, “… the conditions for applying the CUP Method are not met.”

However, the Cornhill data is useful in two other ways: (1) it sets a ceiling on DISL’s profits (“Our conclusion is that the only assistance that can be obtained from Cornhill’s position is that it puts a ceiling on what DISL could expect to make, …” and (2) focuses the Special Commission on the central question that a correct transfer pricing method must resolve – it must explain why “… DISL earned a return on capital 10.64 times that of Cornhill.” If DISL’s return on capital cannot be explained, then the correct method must provide the adjustment.

*Transactional Net Margin Method (TNMM).* The seventh comparable, Domestic & General Group plc, is used in a TNMM methodology.

[7] Domestic & General Group, plc. Domestic & General Group plc (D&G) was the largest independent provider of off-the-shelf extended warranty products in the UK. It provided domestic appliance breakdown insurance directly to customers of manufacturers and also to customers of smaller retailers at the point of sale.

In this case DSG offered D&G’s return on capital as a profit level indicator with which to benchmark the market rate of return on capital for DSG. This is a transactional net margin approach. The Special Commission agreed that calculating the return on capital is a widely used measure of performance in the insurance industry, but it consider D&G a poor comparable for DSG because: (a) the functional profile of the companies were different and (b) the bargaining power dynamics were inverted – D&G provided insurance to many small retailers, whereas DISL was a wholly owned subsidiary of DSG with no capacity to engage in serious bargaining.

D&G was a better comparable to DSG than the general insurance industry (OFT Report), its brand, reputation, experience and organizational capabilities made it appropriate for D&G to earn returns in excess of a routine level. DISL had no similar capabilities, and should be due a routine return on capital. Once again, the Special Commission was not able to adjust for differences (other than differences in capital), and D&G was rejected as a comparable.

*Profit Split.* HMRC argued that all the comparables offered by DSG 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, DISL) in accordance with their relative contributions.

Relative contributions were measured by capital. “… [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

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40 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶135.
41 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶132.
takes more relevant factors into account.” The Special Commission believes that this approach is in conformity with the OECD Transfer Pricing Guidelines.\textsuperscript{42}

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{43}

The Special Commission was fashioning a profit split analytically very similar to that employed in Grenada Industries v. Commissioner.\textsuperscript{44} In Grenada Industries the taxpayer had allocated significant sums to a related partnership (Grenada Hosiery) that reportedly provided valuable services (ideas for designing products, merchandising plans, and directly securing several large purchasers for the company’s hosiery), but had no employees, engaged in no selling activities, had no machinery, plant or other tangible assets. The court held that Grenada Hosiery was entitled to “fair value” for the services provided, and noted that “… we think that, in essence, the [Commissioner] did substantially that here (after making an allowance of a 10% return on partners’ capital).”\textsuperscript{45}

\textit{Grenada Industries} is noted in the US as the first case to segregate functions performed by controlled parties, and then endeavor to allocate an appropriate return based on these functions. In the years that followed \textit{Grenada Industries} this approach became the core of the “fourth-method methodology” and was often described as a profit-split or functional methodology. DSG and \textit{Grenada Industries} are a transfer pricing pair.

\textbf{THE CAPTIVE INSURANCE COMPANY PROBLEM}

Captive insurance companies present unique analytical problems for tax authorities. The core difficulty is that two independent parties are embedded in a constellation related parties in a manner that short-circuits traditional transfer pricing analysis. There is an alternate way of analyzing this problem.

\textit{Traditional analysis.} The following diagram illustrates the problem. If we use simplified UPS facts to describe the pattern we have a Consumer (unrelated to any of the other parties) purchasing excess value coverage (EVC) from an Insurer (that is also unrelated to any of the other parties). The related parties in the pattern are the Retailer and the Re-insurer. The Retailer is a selling agent for the Insurer, but there are no \textit{direct} related party transactions (Retailer/ Re-insurer). All relevant transactions involve unrelated parties.

\textsuperscript{42} DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶143.
\textsuperscript{43} DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶153.
\textsuperscript{44} Grenada Industries v. Commissioner, 17 T.C. 231 (1951)
\textsuperscript{45} Grenada Industries v. Commissioner, 17 T.C. 231, 260 (1951)
The Retailer has exceptional market power and uses this power to control most of the transactions in the fact pattern. The Retailer functions as an insurance broker locating Customers willing to purchase EVC. The Retailer compels the Insurer to purchase re-insurance only from the related Re-insurer. The Retailer controls all pricing formulas – the price the Consumer pays for the EVC, and the profit of the Insurer.

If we assume that the insurance purchased by the Consumer is over-priced (a charge of $0.25 per additional $100 in value exceeding the $0.08 that a third parties would charge for the same coverage); and if we assume that the Retailer’s market power allows it pass this excess profit to the Re-insurer; then what we really have is a Retailer that can indirectly confers a benefit on the Re-insurer. The Insurer is relegated to the function of being a conduit.

Transactional methods have a difficult time solving this puzzle. Related party transactions are not being analyzed. A CUP demonstrating that the Customer is paying above market for insurance simply quantifies the market power of the Retailer. It does not capture the amount of profit that is being improperly shifted to the Re-insurer.

The amount that is being improperly shifted should be more than the difference between the price charged for the insurance ($0.25 per $100) and the CUP offered in cases like UPS ($0.08 per $100). The Retailer’s market power lets it demand more. The transfer pricing problem then, is to quantify the income that should be part of the Retailer’s tax base. To do this with the CUPs that are offered in UPS and DSG requires that an adjustment should be made.

What makes conduit analysis so unsatisfying is that we are essentially looking at a contract between two unrelated parties (Customer/ Insurer), and using comparable of this relationship to reallocate income between two different related parties (Retailer/ Re-insurer).

This analysis is unsatisfying. Not only is it exceptionally difficult to locate good Customer/ Insurer comparables, the most critical factor in determining insurance rates is data. We need actuarial knowledge of the long-term claims rates. Only the Retailer has this knowledge. Third parties can only guess at it. With insufficient data third-party insurers will always over-estimate the risk, and thus overstate the arm’s length price. This results either in (a) an adjustment that is insufficient – if the UPS settlement followed the CUTs that were proposed in the Tax Court, then this settlement was too low, or (b) an adjustment that cannot be supported – in DSG the court rejected each CUP because no mechanism for adjusting the comparable is available.
Alternate analysis. A different way of looking at this same fact pattern is to ignore the transaction between the two independent parties (Customer/Insurer) and focus instead on the direct transfer of a going concern (the transfer of the business opportunity of re-insuring/holding the warranty risk of the Retailer’s customers) or the direct transfer of an intangible asset (the right to re-insure/hold the warranty risk of the Customer). This is more clearly what a captive insurance arrangement is doing. A Re-insurer can achieve extraordinary profits because it uses the Retailer’s competitive advantage in the marketplace.

Transfer of a Business (Alternate Analysis #1). It seems apparent that Michael Cohen, an expert witness for the IRS in UPS, saw the re-insurance arrangement as a business transfer (although the question he was being asked was more traditionally about a CUP for the Customer/Insurer transaction). Judge Ruwe states in the decision:

Similarly, respondent’s [IRS] expert Mr. Michael Cohen, an insurance expert with extensive brokerage experience, agreed that the 25 cents per $100 of excess value was too high. Referring to petitioner’s loss ratios and declared revenues for 1981 through 1983, Mr. Cohen stated in his report:

In my experience spanning more than thirty years I cannot recall a single case where the broker would offer the insurer on behalf of his client a piece of business at such an advantageous rate.⁴⁶

In both DSG and UPS the *business* of insuring extended warranties or EVC was developed domestically (at the head office) and then transferred overseas through a restructuring. In both cases the transfer occurred even though significant aspects of the business continued to be performed as before. DSG continued to perform necessary functions through subsidiaries; UPS did the same, but performed them through the parent. UPS received no compensation for these services; DSG may have paid for this benefit, but the record is not clear.

In *DSG* full claims administration and product repair/ replacement functions were provided through Mastercare Service and Distribution Ltd. In *UPS* the list of “free” services provided OPL was extensive – UPS:

- provided sales, and marketing services,
- became the point of contact for shippers,

47 In the case of UPS the EVC insurance business began in 1983 as a direct result of regulatory changes by the ICC (various state regulatory agencies followed the ICC lead). The regulations became effective July 1983. The rate allowed by regulation was $0.25 per $100 in excess value. UPS billed and collected EVC during 1983. Amounts were “… included in [UPS’s] reported income for tax, financial, accounting, ICC, State regulatory, and Security and Exchange (SEC) reporting purposes.” In 1982 UPS had begun discussions with Hall (one of the largest insurance brokerage firms in the world), and the possibility of UPS setting up its own insurance subsidiary was discussed. During 1983 Hall worked with the American International Group (AIG) to submit proposals for handling the EVC coverage. In November 1983 UPS set up UPSINCO (later to be OPL) in Bermuda. In December, 1983 National Union Fire Company (NUF) a wholly owned subsidiary of AIG entered into agreements with OPL for the exclusive re-insurance of 100% of the EVC risk. Commission amounts (payable to NUF) were specified as a percent of coverage. The agreement was effective January 1, 1984. As a result, for the year ending December 31, 1984 UPS did not include EVC amounts in income for tax, financial, accounting, ICC, State regulatory, and Security and Exchange (SEC) reporting purposes. The EVC business opportunity had now been effectively transferred. UPS v. Commissioner, T.C. Memo 1999-268, at ¶¶ 4 – 10 & 15.

48 DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶¶ 7 – 16.

7 & 143.
- provided all billing related services with shippers,
- collected all overdue amounts,
- made all necessary account adjustments,
- paid all claims in cases where there was proven losses or damaged shipments,
- defended against shippers when claims are denied,
- established controlled parcel handling procedures for
  - bagging,
  - tagging, and
  - tracking of high value packages
- maintained a full loss prevention department.49

Thus, UPS and DSG can be seen as transferors of a business unit – a fully functional business – to a related party. The business unit is complete with customers (the Insurer’s demand for re-insurance), agents for securing more business, agents for performing necessary services, and mechanisms/agents that collect amounts due under the contract. The re-insurer (OPL or DISL) in both cases does not compensate the transferor for the exclusive right to this business.

Transfer of an Intangible Asset – the Right to Re-insure (Alternate Analysis #2). Alternately DSG and UPS could be analyzed as cases where intangibles are transferred between related parties. The key to making captive insurance arrangements work is the requirement (imposed on the Insurer by the Retailer) or the right (granted to the Re-insurer as a third-party beneficiary of a contract between the Retailer and the Insurer) that the re-insurance of the Customer’s risk will only occur with the captive Re-insurer.50

The following, Figure 2, illustrates the transfer of a complete business (Alternate Analysis #1), and the transfer of an intangible right to exclusive re-insurance (Alternate Analysis #2) perspective.

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49 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 23; DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶¶ 15 – 16.

50 UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 8 – 11 (indicating that Kenneth Johnson [head of UPS insurance department] consulted with UPS’s CFO in 1982, and then with insurance brokers at Hall, which set out the terms for the AIG proposal to utilize NUF to insure, an the for NUF to re-insure 100% of the EVC risk through OPL. The NUF/OPL contract reflected this understanding.).
Figure 2: Alternate Analytical Framework for Captive Insurance

OECD DEVELOPMENTS

The July 22, 2010 revisions to the OECD Guidelines include guidance specifically directed at the transfer of a business relationship (an ongoing concern) among related parties in a restructuring. The Guidelines also discuss the transfer of intangibles in a restructuring context, and suggest the direction that the next transfer pricing project will take – Transfer Pricing Aspects of Intangibles. Although the specific case of a restructuring that establishes a captive insurance company is not presented in the Guidelines, the fact pattern presented by the UPS and DSG cases are clearly applicable.

Transfer of an Ongoing Concern. In a relatively short section of three paragraphs the Guidelines considers the transfer of a going concern in a restructuring. The first paragraph defines an ongoing concern, the second considers how to find an arm’s length value, and the third provides an example.

The example is drawn from manufacturing where an enterprise transfers machinery, equipment, inventories, patents, manufacturing processes, know-how and key contracts with suppliers and clients to a related entity in another jurisdiction. The second paragraph’s concern with valuation of the transferred business unit emphasizes that the
value is “… not necessarily [equal] to the sum of the separate valuations of each separate element that comprises the aggregate transfer.”  

Transferring an ongoing concern is a topic that is much broader than the OECD’s example. The definitional statement in the first paragraph makes this clear, and it is easy to see captive insurance companies included within the language.

Business restructurings sometimes involve the transfer of an ongoing concern, i.e. a functioning, economically integrated business unit. The transfer of an ongoing concern in this context means the transfer of assets, bundled with the ability to perform certain functions and bear certain risks. Such functions, assets and risks may include, among other things: tangible and intangible property; liabilities associated with holding certain assets and performing certain functions, …

Both UPS and DSG had a fully functional business unit dedicated to insuring excess value charges (UPS) or extended warranties (DSG) before captive insurance companies were set up. In both cases these highly profitable business units were transferred to related parties in jurisdictions where their income would escape taxation. These high profit units had high (potential) risk, but in both cases the risks were deemed manageable primarily because each of the parent companies had collected long and deep claims-history databases. Risk was manageable, because the risk was know and predictable.

Determining the arm’s length value (the compensatory amount) due to the parent entity (Retailer) from the Re-insurance entity can be accomplished by following the OECD’s recommendations. The value would appear to be greater than the value of the insurable risk on the open market, as was demonstrated in DSG.

Transfer of an intangible asset. The Guidelines devote much more time to the transfer of intangible assets, and the topic is immediately recognized as a complex and difficult one.

Transfers of intangible assets raise difficult questions both as to the identification of the assets transferred and as to their valuation. Identification can be difficult because not all valuable intangible assets are legally protected and registered and not all valuable intangible assets are recorded in the accounts. … The determination of the arm’s length price for a transfer of intangible property right … will be affected by a number of factors among which are the amount, duration and riskiness of the expected benefits from the exploitation of the intangible property, the nature of the property right and the restrictions that may be attached to it (restrictions in the way it can be used or exploited, geographical restrictions, time limitations), the extent and remaining duration of its

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51 OECD, Guidelines, supra note 4, ¶ 9.94.
52 OECD, Guidelines, supra note 4, ¶ 9.93.
legal protection (if any), and any exclusivity clause that might be attached to the right. Valuation of intangibles can be complex and uncertain.\(^{53}\)

However, with captive insurance companies neither difficulty factors (the identification and the valuation) is problematical. The intangible asset that both UPS and DSG transfer (to OPL and DISL) is the exclusive right to re-insure contracts that they arrange with their own retail customers. In addition, determining the arm’s length value of the re-insurance business is very measurable, particularly when actuaries are allowed access to detailed claims histories, such as those kept by UPS and DSG.

Judge Ruwe, for example, rebuffed UPS’s contention that the amount of risk assumed by OPL justified its exceptionally high profits as follows: Petitioner's excess value claims payments over 11 years never exceeded 40 percent of the total excess value income. Considering the consistency of the ratio of loss claims payments to EVC revenue from year to year, we find that the possibility that total cumulative annual payments for shipping losses from single occurrences involving less than $25,000 might exceed EVC revenue was so remote, that for all practical purposes, it was nonexistent. As a result, the level of risk, if any, that was shifted from petitioners to NUF and OPL was insignificant.\(^{54}\)

Judge Ruwe favorably referenced the IRS expert witness report of Edward T. Kelley, who concluded: Since … [petitioner], by the nature of its operations, generates a very large number of relatively homogeneous units of exposure, the predictability of expected losses related to shippers' property in its custody is very high and year to year variability is relatively limited. Its self-insurance program for handling claims for loss of or damage to shippers' property produced consistently profitable results during the years 1979 through 1982 ...\(^{55}\)

The Special Commissioners reached the same conclusion by pointing to the Report on Extended Warranties on Domestic Electric Goods issued by the Competition Commission that deemed the marketplace to be a near monopoly controlled by retailers at point of sale,\(^{56}\) and the fact that DSG had comprehensive long-term data about claims.\(^{57}\)

But the OECD \textit{Guidelines} have even more relevant details. They specifically address contract rights as intangibles transferred in a restructuring in two dedicated paragraphs. The discussion closely fits the captive insurance fact pattern. The first paragraph indicates:

\(^{54}\) UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 34.
\(^{55}\) UPS v. Commissioner, T.C. Memo 1999-268, at ¶ 34, n. 49.
\(^{56}\) DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶ 9.
\(^{57}\) DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶¶ 143 - 144.
Contractual rights can be valuable intangible assets. Where valuable contractual rights are transferred (or surrendered) between associated enterprises, they should be remunerated at arm’s length ...  

The second paragraph contains an example that closely replicates the fact pattern in UPS and DSG. It states:

Tax administrations have expressed concerns about cases they have observed in practice where an entity voluntarily terminates a contract that provided benefits to it, in order to allow a foreign associated enterprise to enter into a similar contract and benefit from the profit potential attached to it. For instance, assume that company A has valuable long-term contracts with independent customers that carry significant profit potential for A. Assume that at a certain point in time, A voluntarily terminates its contracts with its customers under circumstances where the latter are legally or commercially obligated to enter into similar arrangements with company B, a foreign entity that belongs to the same MNE group as A. As a consequence, the contractual rights and attached profit potential that used to lie with A now lie with B. If the factual situation is that B could only enter into the contracts with the customers subject to A’s surrendering its own contractual rights to its benefit, and that A only terminated its contracts with its customers knowing that the latter were legally or commercially obligated to conclude similar arrangements with B, this in substance would consist in a tri-partite transaction and it may amount to a transfer of valuable contractual rights from A to B that may have to be remunerated at arm’s length, depending on the value of the rights surrendered by A from the perspectives of both A and B.  

It is very clear that UPS and DSG had valuable “… contracts with independent customers that carry significant profit potential …” [both UPS and DSG self-insured directly before they established captives]. In both cases these customer relationships were “… voluntarily terminate[d] … under circumstances where the [customers] are legally or commercially obligated to enter into similar arrangements with company B … ” [both UPS and DSG did not change the point of sale solicitation of insurance from customers]. In both cases “… the contractual rights and attached profit potential that used to lie with A now lie with B… ” [UPS moved profits to Bermuda, and DSG moved profits to the Isle of Man through this device].

The captive insurance fact pattern is an ideal example of the tri-partite transaction that the OECD is concerned with, and which a number of tax administrations have “… expressed concerns about…”

CONCLUSION

58 OECD, Guidelines, supra note 4, ¶ 9.91.
59 OECD, Guidelines, supra note 4, ¶ 9.92 (emphasis added).
UPS and DSG, when read in conjunction with the new OECD Guidelines on business restructurings, present tax administrations with the full range of analytical approaches to transfer pricing and captive insurance companies. There is Judge Ruwe’s sham transaction approach – which brings all the captive income back to the domestic company; there is the profit split approach followed in DSG that has been used in transfer pricing cases as far back as Grenada Industries; there is the possibility of CUPs applied to the Customer/Insurer transaction (and also TNMMs), but these approaches will all need adjustments to comparables to compensate for the unusual market powers of the Retailer; then there are the more recent approaches suggested by the OECD – transferring a going concern, and transferring an intangible asset.

But more than this, they offer useful fact patterns through which the transfer of intangibles in a business restructuring can be considered. The advantage of the captive insurance pattern is that it is a real-word example stripped down to basics. There is not much more going on in a captive insurance case than the contractual movement of a stream of business income overseas.

The most interesting aspect of this comparative look at transfer pricing in a captive insurance context is that CUPs may be harder to find than first appears to be the case. Six CUPs and a TNMM were all rejected in DSG because comparability issues could not be resolved. The critical issue was the Retailer’s bargaining power, reinforced with proprietary data on historical claims patterns.

The 11th Circuit appears to have urged further consideration of CUPs in UPS when it referred the case back to the Tax Court. In light of the DSG analysis, it may have been that the IRS and UPS settled on a profit split fashioned along the lines of DSG, and employed earlier in Granada Industries. We will never know.

The OECD’s business restructuring analysis dealing with the transfer of a going concern, or intangible assets among related parties is right on point with the dynamics in a captive insurance fact pattern. Then again, both of the OECD approaches are vulnerable to a sustained attack on comparability grounds. DSG makes it very clear that market power taints what would normally be considered good comparables, and when this occurs the older profit split methodologies have a lot to offer.

It will be interesting to see how the new OECD project on the Transfer Pricing Aspects of Intangibles will deal with question like this. It may well be that the answer to an intangible transfers may bring us back full circle to the return on capital profit splits from Grenada Industries and DSG.