Tax authorities using CUPs for pricing transactions

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Matthew Wall and David Jarczyk explain the new trend where tax authorities use third party agreements to test, and adjust if needed, the arm's length price of related party transactions.

Joseph Andrus, head of the transfer pricing unit at the OECD, asked this question last autumn during the OECD public consultation on intangibles:

"If a tax authority conducts a special project to search for third party terms and conditions in, for example, the biotech industry, is it okay for the tax authority to use this information during the audit of a biotech company?"

We recognise this is a new trend, not an academic discussion.

Background

Many companies use the transactional net margin method (TNMM) or comparable profits method (CPM) for their transfer pricing documentation. This shows the tested party earned an arm's length profit on the sum of related party transactions, which suggests but does not prove individual transactions are priced on an arm's length basis. While the TNMM / CPM is an accepted method in most countries, it might not be enough to satisfy the tax authority in all circumstances.

Many tax authorities now use a risk based approach, focusing on some, but not all, of the related party transactions. This might explain why a tax authority searches for third party data for pricing selected transactions. If the tax authority finds third party transactions, which they consider to be reliable as a comparable uncontrolled price (CUP), the taxpayer should not be surprised when the tax authority uses this information as support for a proposed transfer pricing adjustment for the years in dispute.

The tax authorities are being strategic in using a CUP, which is preferred to another transfer pricing method when both can be applied in an equally reliable manner, for the reasons explained in paragraph 2.2 and 2.3 of the OECD transfer pricing guidelines (2010). The tax courts agree, consistently relying on CUPs in their decisions to the detriment of the TNMM / CPM and other methods. More on this later.

Tax authorities searching for CUPs

Tax authorities have been quick to learn databases for third party agreements have come a long way. For example, ktMINE has more than 50,000 royalty rates and 80,000 license agreements, 15 million US patents and patent assignments, 10 million US trademarks and trademark assignments. Further, the interface was designed with the transfer pricing professional in mind, allowing them to search using specific criteria, view results in a summary format, refine the search using other criteria, document all of the search steps taken, export data, and view selected agreements to assess their comparability.

Jarczyk has been training tax authorities in Canada, the US, UK, Australia and other countries on how to search ktMINE for third party transactions to price related party transactions. This may be news for taxpayers, and suggests they might need to do their own search at some stage of an audit.

Wall says using these databases have increased the probability of finding potential CUPs when, not too long ago, this was often a frustrating and time consuming exercise with poor results.

What will the tax authority find?

Getting back to Andrus' question, this article shows a tax authority would find 2,828 agreements for the biotech industry if they searched the ktMINE database. Below are further details that dispel old notions.

We sorted the agreements by territory for each of the five continents, finding 38 in Africa, 204 in Asia, 141 in Europe, 485 in North America, 57 in South America, 61 in Oceania, 1,292 worldwide and 550 in countries not yet assigned to one of these territories. This shows the database covers more than just the US and there are agreements in substantial numbers across all five continents for the biotech industry.

We also sorted the biotech agreements by type and found 123 for asset purchase, 31 for cross license, 249 for distribution, 493 for joint development, 2,474 for manufacturing/process intangibles, and 685 marketing intangibles. Note there are 1,227 agreements that overlap other types of transactions. This shows there are agreements for the types of transactions that are often audited by the tax authority.

We also checked the aging of these agreements and confirm that the number of agreements in three year intervals were 176 from 2012 to 2010, 276 from 2009 to 2007, 444 from 2006 to 2004. This shows agreements are being replaced in significant numbers on a rolling basis.

These are just a few of the criteria used to narrow the search. At some point, you will review the results summary to assess (accept / reject) which of the agreements might be comparable to the related party transaction. There is a summary for each agreement that includes a short synopsis, name of the parties, effective date, term, type of agreement, industry, SIC code, territory, exclusivity.

Click a button for a copy of the actual agreement including its terms and conditions.

Jarczyk says this shows ktMINE and other databases like it will help the tax authorities find relevant agreements in the biotech industry and, knowing they are already using them, suggests taxpayers and their advisers should also consider this information, particularly if it helps resolve their differences.

Must be comparable

Wall recognises these databases are now useful in ways they once were not, but cautions successfully using these databases will depend on an effective search strategy in order to find relevant third party transactions, plus additional analysis to show the transaction is comparable in accordance with the OECD guidelines, before it will be considered reliable for pricing related party transactions.

In brief, the comparability, as explained by the OECD guidelines, requires the "economically relevant characteristics of the situations being compared must be sufficiently comparable" which refers to the five comparability factors of: Characteristics of property or services; functional analysis, assets used and risks assumed; contractual terms; economic circumstances; and, business strategies.

Differences between transactions do not exclude a third party transaction from being a CUP for pricing the related party transaction provided, according to paragraph 2.14 the OECD guidelines:

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.

If a third party transaction is found to be relevant, but not entirely reliable (that is comparable), the information might still be used as support for other transfer pricing methods and analysis.

Is it okay for the tax authority to do this?

To answer Andrus' question, the issue should no longer be is it okay to use these databases, since it is welcome news to find credible sources of third party agreements that might be used as CUPs. The issue becomes when is it okay to use these databases, and how should they be used.

Wall responded to "when is it okay" last autumn during the OECD public consultation on intangibles. He stressed the tax authority has an obligation to first consider the legal form of the agreement between related parties and economic substance of the transaction including the transfer pricing documentation provided by the taxpayer. Paragraph 1.64 of the OECD guidelines suggests a tax authority can use this information only in "exceptional cases" because in doing so the "... tax authority disregard the actual transactions or substitute other transactions for them" which risks "restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which would be compounded by double taxation created where the other tax administration does not share the same views".

Respectfully, it would be inappropriate for a tax authority to begin an audit with the intent of using this information, which might prejudice their request for, and interpretation of, the taxpayer's information. However, in light of this article, it is understood that the tax authority might use this information at a later stage of the audit under specific circumstances, which requires more guidance from the OECD.

Jarczyk explains the second part of "how should they be used", saying anyone can find good benchmark agreements given the size of this database. However, experience counts, the more the better, which helps in the search strategy and comparability analysis to show relevant transactions are reliable as CUPs for pricing related party transactions. This explains why tax authorities ask for training on how to use ktMINE effectively.

Advice for taxpayers

Wall says, at some stage of the audit, taxpayers might need to request and review the third party transactions that the tax authority found, conduct their own search for third party transactions, or both. Be careful though, while the taxpayer should use this information to supplement their existing documentation for a selected transaction, the tax authority might use this information to dispute the arm's length price including the taxpayer's documentation for this same transaction.

Jarczyk adds that tax authorities are also using ktMINE to search for third party agreements to answer the question "would a third party actually agree to these terms and conditions?" Wall explains this might lead the tax authority to dispute the characterisation of the taxpayer's transaction, which is much more serious than disputing the arm's

length price of a transaction between related parties.

Finally, third party agreements can also be used for tax planning, transfer pricing documentation, advanced pricing agreements, requests for competent authority, and expert reports for the tax court.

Case law

Wall was the transfer pricing expert in *Alberta Printed Circuits v. Her Majesty the Queen* and says this is a good example where CUPs prevailed over the TNMM in the decision by the Tax Court of Canada. Another example is *SNF (Australia) Pty. Ltd. V. Commissioner of Taxation*. These cases are precedent setting.

Richard Ainsworth and Andrew Shact, from the Boston University School of Law, studied these and other cases before concluding "CUPS are the judicial gold standard" and "all transfer pricing regimes give priority to the comparable uncontrolled price (CUP) method" in their article *Transfer Pricing: The CUP – Case Studies: Australia, US, UK, Norway and Canada*. This is an excellent article, worth reading.

In brief, Ainsworth and Shact discuss the tax court's decision in five different cases, each case from a different country, including examples for exact CUPs, adjusted CUPs, and phantom CUPs. They also explain why each CUP succeeded or failed given the facts and circumstances of the case.

Freedom to choose

Taxpayers and their advisers have the freedom to choose the most appropriate and reliable method for pricing related party transactions. However, if the taxpayer chooses the TNMM / CPM to show the tested party earned an arm's length profit, the tax authority might claim this does not prove that one of the transactions selected for audit, from the list of transactions, is at an arm's length price.

The tax authorities are now using third party agreements to test, and adjust if needed, the arm's length price of related party transactions. This is a new trend, not an academic discussion, and one that taxpayers and their advisors must face.

The key concern, perhaps for the next OECD public consultation, is not that the tax authorities use these databases, but when is it okay for tax authorities to use these databases, and how should they be used.

Matthew Wall is the founder of MDW Consulting Inc., an independent firm that specialises in transfer pricing, and member of the Altus Alliance, an international network of transfer pricing professionals. Matthew was the transfer pricing expert in the *Alberta Printed Circuits Ltd. case*, which the Tax Court of Canada decided based on his expert report and testimony.

David Jarczyk is the founder and President of ktMINE, an intellectual property (IP) information services firm focused on delivering IP protection and competitive advantage to analysts and IP owners across the globe. Before this, David was a transfer pricing economist for many years, assisting multinational companies price their related party transactions.