# Kluwer International Tax Blog

## Global Experts debate Landmark Transfer Pricing Cases in IFA Webinar

Seema Kejriwal, Mukesh Butani (BMR Legal) · Tuesday, August 31st, 2021

On 20 May, 2021 the first Webinar of IFA's online series "A conversation on International Tax Practice" was held. Chaired by Robert Danon (Chair IFA Permanent Scientific Committee), global experts shared their perspectives on India's software royalty case and on landmark transfer pricing rulings delivered by Courts in various jurisdictions thereby suggesting alignment and divergence of principles.

Mr Mukesh Butani discussed India's software royalty case together with expert panelists Peter Barnes, Sophie Chatel, Johann Hattingh, Adolfo Martín Jiménez and Jonathan Schwarz. The presentation and panel discussion on this case will be covered in a separate blog to follow shortly.

In an eminent panel moderated by Professor Robert Danon, and comprising Clark Armitage (who presented the Coca-Cola case), Dr Niv Tadmore & Benjamin Lancaster (both of who presented the Glencore case), Al Megji (who presented the Cameco case), Matt Andrew (who presented a global perspective in light of these rulings), together with Guglielmo Maisto, Luis Schoueri, Isabel Verlinden, Vikram Chand, Jonathan Schwarz, the panelists discussed the three landmark rulings of Coca-Cola in the US, Glencore in Australia and Cameco in Canada. The rulings were discussed by the panelists in light of domestic law, OECD Guidelines and interplay of the Courts' observations in a global landscape.

**Glencore Australia**

Ruling – In November 2020, the Full Federal Court of Australia had reviewed and upheld a September 2019 ruling of the Federal Court of Australia in the case of Glencore, in favour of the taxpayer. On May 21, 2021, the High Court of Australia refused to hear an appeal challenging the decision of the Full Federal Court. The Glencore ruling thus stands accepted in Australia. In Glencore's case, in 2007, Glencore changed its basis of pricing. The Commissioner's argument was that third parties acting at arm's length would not have agreed to those amendments. The Court after a very detailed observation on price setting in the copper business, the state of the copper industry in 2006 and 2007, and the evidence set forth by the taxpayer in support of its prices, set aside the addition by the tax office.

Expert Panel Discussion:

The Panel discussed the ATO's approach in large disputes, of attacking not just the price of a related party transaction but the transaction itself. The Panel also discussed the ATO's approach of looking at using a combination of GAAR with TP to restructure or recharacterize a transaction. The Panel discussed the Court's reference to OECD Guidelines as "very highly generalized", "frustratingly opaque", and "lacking the much greater discipline and rigour in drafting that is usually found in domestic legislation". While the Court did not give a lot of weight to the OECD Guidelines, ironically Australia's TP guidance which has changed since, incorporates the OECD Guidance by way of legislation, hence it will be interesting to see how the Court's observations pan out in future cases. One of the panelists commented that while the Court critiqued the OECD Guidelines, what transpired in the case was actually in accordance with the Guidelines and referred the OECD Guidelines[1] regarding independent entities behaving in a commercially rationally manner. The court opened a wide spectrum for transfer pricing by looking into commercial rationale beyond just the concepts of price/margin/profits. The OECD's shift from the substance over form approach in the 1995 & 2010 Guidelines to an accurate delineation of transaction approach – and the significance of concepts such as factoring 'control over risk' and 'financial capacity to assume risk' was another topic of discussion. The Panelists appreciated the Court's approach of a two-step analysis; that of arm's length conditions, and then of arm's length prices. The Panelists discussed the implication of commercially rationally behaviour accepted by the Court in the context of implications in the current pandemic, and how the views could be extrapolated in current renegotiations. One of the Panelists referred to the "viral spread" of CFC and anti-abuse rules as "scary and frightening".

Author's views:

One of the important findings of the Court was that there is arm's length range of pricing structures and not just of prices. The Court also observed it is commercially rational to agree to a pricing structure that reduces risks, rather than to maximise profits at all costs. The important principle emanating out of the Glencore ruling is that mere drop in profits due to change in pricing terms should not be a cause for addition, as long as it can be demonstrated that the change in terms was an arm's length arrangement. Transfer pricing envisages an analysis where, in most cases, both parties will constantly seek to better terms of arrangements to achieve closer to market results in the long run. Additionally, the decision to take or offload risks, lies with parties to a contract. As an instance, Indian Courts have time and again emphasized that tax office should not question the commercial wisdom of a taxpayer.

**Coca-Cola – USA[2]:**

Ruling[3] – In an October 2020 ruling , the U.S. Tax Court affirmed an IRS adjustment of nearly USD 9.5 billion to the income of The Coca-Cola Company (Coke). The Tax Court ruled that Coke's group entities had not compensated Coke adequately for use of trademark intangibles.. Coke in-turn had argued that its trademarks were in the nature of wasting assets and need to be regularly supported with intensive advertising and marketing support. Since the group companies and independent bottlers bore a share of advertising and marketing expenses, a portion of the returns towards such intangibles were attributable to them. The Court laying emphasis on legal ownership of intangibles ( which belonged to the Parent holding IP rights of the Coke brand) did not accept the arguments , inter alia on the grounds there were no marketing functions were performed by the group companies, and they were mere passive recipients of expense allocations, budgets for which were entirely discretionary and prerogative of Coke.

Expert Panel Discussion:

Clearly, a big win for the IRS where non-routine profits were brought to tax, ostensibly on what seemed like a routine marketing activity yielding a 6-7% return. This development in light of Coke's past audits (between 1987 & 1995) wherein a 10:50:50 split was accepted with Coke supply points (with no rationale), comes as a rude shock. The Experts debated the context of the OECD DEMPE position developed by the Court without making a specific reference. Though, the OECD guidance is in the nature of "soft law" to interpret Article 9. 'Depending on the nature of the DEMPE guidance, they can be considered as clarificatory or substantive. Clarificatory guidelines can be used as an aid to interpret laws prior to the period of issuance . Whereas the concept of risk, controls etc. are enshrined in Chapter 1 of the guidance, Chapter 6 dealing with DEMPE could be viewed as clarificatory. A mapping[4] of OECD Guidelines from 1998 with TP Regs issued by IRS reveal the extent of clarificatory and substantive nature. However, its debatable in the context of DEMPE functions whether significance of financial control over risks is a substantial or clarificatory – in the context of Coke while the group companies in question (the supply points), did not have personnel, it did have the financial capacity to bear DEMPE risks. Jonathan Schwarz argued that while DEMPE functions were not invented in 2017 Guidelines, what changed in 2017 were the consequences. He observed that legal ownership of intangibles is no longer the basis for profit attribution. The 2017 Guidelines mandate an "economic substance" whereby intangible related profit is attributed by reference to DEMPE functions performed and risks allocated on the basis of the steps in the Guidelines and not by reference to the legal relationships between the parties. Taxpayers must apply this – it is not just for tax authorities to disregard legal transactions. The OECD Guidelines recognize a return for legal ownership, however they do not provide adequate clarity on what such returns could be. The panel strongly felt that there is inadequate guidance on return for financial risks borne in DEMPE situations. The Panelists debated the impact of the pre-closing agreement in terms on audit procedures as opposed to actual transfer prices, noting that the challenges on this basis, are not necessarily under TP law, but under administrative & constitutional law.

Author's views:

The concept of a FAR (Functions, Assets and Risks) analysis is ingrained in an arm's length analysis and guidance, in domestic law supported or supplemented by the OECD soft law. Whether the returns need to be an implicit return or a specific return, would depend on the facts and circumstances of each case. The key is comparability analysis. If adequate diligence is exercised on choice of comparables whilst performing a FAR analysis, and the tested party is at arm's length under such benchmarking, no further returns need to be attributed. An observation[5] by the Delhi High Court in India on choice of comparables for determination the ALP in the context of a distributor assumes significance. – In Coke's case, the choice of comparables by the IRS is highly debatable; even in broad comparability terms, bottlers who operate in a different space in the industry value chain, could not be comparable to the supply points for benchmarking returns. Notwithstanding, the uncontrolled nature of the transactions with the bottlers is questionable.

**Cameco Canada:**

In June 2020, Canada's Federal Court of Appeal upheld a 2018 ruling from the Tax Court of Canada that centered on Cameco's use of a subsidiary in Switzerland to sell and trade its uranium. In February, 2021, the Supreme Court of Canada refused an application from the Canadian Revenue Authorities to further appeal in the matter. Cameco, a Canada based company incorporated a subsidiary in Switzerland, which eventually became the aggregator of most of Cameco's purchase and sale business. The Canadian Revenue Authorities contended the arrangement was a sham, and as all the decision making lay in Canada, Switzerland was a "rubber stamping" entity. The CRA urged the courts to recharacterize the transaction and disregard the Swiss entity, as well as the sale transactions between the Canadian and the Swiss entity. The Court ruled that the transaction was not a sham. For recharacterization, it ruled the question is not if the transaction should have been done, the question is if the transaction is commercially normal – companies do give up commercial opportunities for the right price, and with respect to the sale by Canada were also at arm's length. In appeal, the CRA did not pursue the sham agreement.

Expert Panel Discussion:

Canadian courts have been almost fundamentalistic in insisting on commercial certainty when it comes to tax. Canadian Courts are reluctant to place emphasis on vague notions such as substance, residence, sham, which American courts tend to do quite liberally, and hence provide more certainty. Canada is a more "form" based jurisdiction – Courts are careful about drawing distinction between legislative and judicial functions. The importance of legislation vs OECD Guidelines was also discussed – the legislation prevails. However, it cannot be ignored that OECD Guidelines are soft law and courts do consider them. The Panelists debated that in European countries, courts would have probably approached the sham argument differently. The obligation was on the government to demonstrate sham under the precise definition of sham in tax laws. The Panelists were appreciative of the Court's approach of not letting sham become a soft GAAR. Cameco was the first case in Canada which tested recharacterization provisions, and it was appreciated that the Courts were stringent in applying the provisions.

Author's views:

The courts did not let transfer pricing become about tax avoidance. The Court would have also probably considered that GAAR provisions of Canada were not invoked, and it would have been bad precedent to test GAAR in the garb of transfer pricing.

**Conclusion:**

Court rulings have a posturing on MAP and APA discussions as well, as was well observed by one of the Panelists during this IFA webinar. It is important to keep abreast of Court thinking across jurisdictions. Commercial rationality is a very subjective test – options realistically available to taxpayers has a very broad connotation. It is important for Courts to set high bars for recharacterization and re-emphasize that commercial rationality has to be the call of the taxpayer not the tax administrator. Indian Courts have consistently ruled the tax office should not question the commercial wisdom of the taxpayer, including the Indian Supreme Court[6]. Another important concept that should be taken cognizance of is the importance of range of arm's length conditions – tax administrators should not seek to establish ALP under conditions other than condition adopted by the taxpayer. Importance of accepting the conditions cannot be emphasized enough. It was also heartening to note that attempts to adjust pricing structures, rather than pricing were negated by courts. The Coca-Cola case was an outlier and will be of interest to tax administrators of developing countries such as India, as the Court's view on returns on intangibles was different from the view of developing countries which seek excessive transfer pricing adjustments for advertising. marketing and promotion expenses incurred by taxpayers.

[1] Para 9.35 of the OECD Guidelines

[2] https://www.lexology.com/library/detail.aspx?g=f74d1d32-afc3-402d-b56e-4f49ba354da6

[3] http://kluwertaxblog.com/2020/12/18/the-coca-cola-company-ruling-analysing-the-us-tax-courts-observations/

[4] https://core.ac.uk/download/pdf/224838774.pdf

[5] Para 137 of the Delhi High Court ruling in the case of Sony Ericsson Mobile Communications India Private Limited v CIT (2015 – 374 ITR 118) – Aggregation of transactions is desirable and not merely permissible if the nature of transactions taken as a whole is so inter-related that it will be the more reliable means for determining the arm's length consideration for the controlled transaction.

[6] [2015] 378 ITR 640 (SC) – Mangalore Ganesh Beedi Works.

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