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TRANSFER PRICING: DATA DUMPS AND COMPARABILITY – US, UK, CANADIAN, AND AUSTRALIAN CASE STUDIES

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TRANSFER PRICING: DATA DUMPS AND COMPARABILITY –
US, UK, Canadian, and Australian case studies

Richard T. Ainsworth & Andrew B. Shact[1]

Comparability is the heart of transfer pricing. The OECD,[2] U.K.,[3] Canadian,[4] Australian[5] and U.S.[6] transfer pricing rules all echo one another on how critically

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[1] Biographical info.

[2] Organization of Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Review of Comparability and of Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines) ¶1.33 (July 22, 2010)

> To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (*e.g.* price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

available at: http://www.oecd.org/dataoecd/23/12/45763692.pdf

[3] The United Kingdom closely follows the OECD. The U.K.'s transfer pricing rules are found in Schedule 28AA of the Income and Corporate Tax Act, 1988. Paragraph 2 indicates that Sch. 28AA is to be construed in a manner consistent with:

> the expression of the arm's length principle in Article 9 of the OECD Model Tax Convention on Income and on Capital and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

As a result, where transfer pricing rule interpretations conflict or appear ambiguous, the statute itself states that the OECD materials take precedence to resolve them.

[4] Canadian transfer pricing rules are found in the INCOME TAX ACT, R.S.C. 1985, §247 (Can.), with interpretive guidance in Information Circular 87-2R (September 27, 1999). The Information Circular expressly follows the 1995 OECD *Guidelines*. The Tax Court of Canada adopted the 1995 OECD *Guidelines* in *GlaxoSmithKline Inc., v. The Queen*, 2008 TCC 324, ¶¶59-65 (May 30, 2008). It is not clear if Canada will follow the 2010 revisions to the OECD *Guidelines*, even though that is the assumption of tax advisors based in part on Canada's past practices and the placement of a CRA official as the chair of the OECD Working Party 9. [Ernst & Young, *Tax Alert*, 2010 Issue No. 28 (August 23, 2010) at 3.]

[5] INCOME TAX ASSESSMENT ACT 1936, §136AD (Aust.); TR 97/20 ¶¶ 2.1 & 2.2 (emphasis added):

> Conceptually, the arm's length principle requires a calculation of the taxable income that might reasonably be expected if the parties were dealing at arm's length with one another. It does this by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from the interaction of the forces of supply and demand in a *comparable open market*, or from negotiating among *comparable independent parties* in more complex settings. In effect, this uses the open market results or the behavior of the independent parties dealing at arm's length with each other as a benchmark.
>
> The *concept of comparability* is therefore central to the application of the arm's length principle.

[6] United States, Treas. Reg. §1.482-1(b)(1) (emphasis added)

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of *comparable transactions under comparable circumstances*.

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important the comparability analysis is. Performing this analysis and *proving* comparability, however, is a demanding exercise.

What makes the proving comparability so difficult is that the analysis is two sided. Both controlled and uncontrolled transactions must be thoroughly analyzed. Just as much effort needs to be applied to determine the functions, contract terms, risks and the economic conditions for the unrelated party comparables as is spent on analyzing the related parties (taxpayers).

But there is more to this equation. On the "comparables side", there are not one but two steps. First a comparables search is needed. Then the search result differences must be carefully scrutinized and adjust for differences if they are material.[7] As the OECD's *Guidelines* (2010) indicate:

> By definition, a comparison implies examining two terms: the controlled transaction under review and the uncontrolled transactions that are regarded as potentially comparable. The *search* for comparables is only part of the comparability analysis. It should be neither confused with nor separated from the comparability analysis. The search for information on potentially comparable uncontrolled transactions and the process of *identifying* comparables is dependent upon prior analysis of the taxpayer's controlled transaction and of the relevant comparability factors (see paragraphs 1.38-1.63).[8]

Case law has always demanded this balanced or dual comparability analysis. While this requirement has been implicit in the Internal Revenue Service regulations, it recently it has become more explicit. The 2010 revisions to the OECD *Guidelines* contain similar language reflecting this change.

The OECD has become critical of *database dumps*, extensive automated financial database searches for *potential comparables* that are then *dumped on* (or presented to) tax authorities as-they-are. This is problematic because the search is being offered as a substitute for meaningful analysis. There is also anecdotal evidence that this *data dumping* has become a common practice.[9]

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[7] Adjustments are normally made to the unrelated (independent or referent) parties rather than related parties. Under OECD rules making related party adjustments implicates OECD Model Treaty Article 9(1). Doing so means the transfer pricing analysis is not performed on the *real transactions* but rather on *hypothetical ones*. *See also*: Treas. Reg. §1.482-1(d)(2) which states the same general rule. This is different from isolating (separating) a transaction from a related parties' other transactions. Separation is appropriate, provided this process does not remove from consideration elements that have a material effect on prices. In such case, aggregating transactions is required. *See: infra* note 112 and related text. This was a problem in the *Roche Products Pty. Ltd v. Commissioner (Australia)* and the *GlaxoSmithKline v. The Queen* cases considered herein.

[8] OECD *Guidelines* (2010) *supra* note 2, at ¶3.1 (emphasis added).

[9] For example, Dr. Deloris Wright, an economist and frequent expert witness in transfer pricing cases 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

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Some jurisdictions, like New Zealand, have challenged this practice[10] while other jurisdictions, like the US, appear more accepting. Thus, what may pass for comparability in the US may not be acceptable in N.Z. or other jurisdictions. This creates difficulties for firms relying on the same transfer pricing study for both US and foreign filings.

The *database dump* itself, no matter how well the screens or how carefully crafted the filters, never provides solid *proof* that comparables have been found. At best, the screens and filters provide rough-hewn results. Solid proof requires an entity level analysis that:

(a) Identifies differences between the controlled and uncontrolled parties
(b) Assesses the materiality for each difference and if the differences are material, then
(c) Specifies the adjustments needed to bring the uncontrolled parties into alignment with the controlled parties

Case law requires this process because Judges demand proof as to comparability. The place where jurisdictions differ is in how they answer the next question: What happens when adjustment are not or cannot be made after material differences have been identified? If one jurisdiction accepts search results as comparable (albeit with reduced reliability)[11] while another rejects them as incomparable[12], then it becomes important for an enterprise to further support its pricing study with a profit split. The only workable method that does not require comparables is a profit split and this is where an audit will likely go if all proposed comparables are rejected.

> 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.

Deloris R. Wright, *Certain Issues in the Use of Profit-based Methods*, 10 Geo. Mason L. Rev. 895, 905 (2002).

[10] New Zealand Inland Revenue, TRANSFER PRICING PRACTICE ISSUES, *Comparables* (December 1, 2010) *available at*: http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-comparables.html

> **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.

[11] This is the US position. *See:* Treas. Reg. §1.481-1(d)(2).

[12] This is the OECD position. *See*: Organization of Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 1995) ¶¶1.15 & 1.16.

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This paper considers a sequence in US and Australian tax cases where arguments based heavily on *database search* results were involved. Observations are then extended to Canada and the UK that have not yet heard precisely similar cases. Because, however, Canada and the UK follow the OECD *Guidelines* they would more likely than not follow the Australian rather than the American lead when faced with determining what value if any to accord a *database dump.*

Six cases are considered: *E.I. DuPont de Nemours and Company v. United States*,[13] *Seagate Technology, Inc. v. Commissioner*,[14] *Westreco, Inc. v. Commissioner,*[15] *Roche Products Pty. Ltd v. Commissioner (Australia)*,[16] *GlaxoSmithKline v. The Queen,*[17] and *DSG Retail v. HMRC*.[18]

(1) *DuPont (1978)*

DuPont is both an early and an unusual *database dump* case. The comprehensive financial database searches in *DuPont* pre-date modern search engines and digitized financial databases. The *DuPont* search was a time consuming manual search. In addition, *DuPont* is probably the only case where a one party's *search* (the IRS) results in the other party's *dump* (DuPont).

Background

DuPont was the world's largest chemical company when the case arose. The Company was seeing a decrease in US sales <u>and</u> a significant increase in both volume and margins on exports. As a result, the European Common Market[19] presented both an opportunity for greater sales and margins and a threat that DuPont might be locked out.[20]

DuPont decided to establish Swiss based subsidiary operations that would be both integral to the US company and complement its existing independent distributor network. Therefore, this Swiss subsidiary was to be more than a mere sales entity. DuPont's success had always been its technical sales service and its indirect sales support. These services and wholesaling product was what the newly formed Swiss subsidiary would provide in Europe.[21]

DuPont intentionally located its subsidiary in a low tax jurisdiction.[22] The long term plan was to use low taxed profits generated in Switzerland, sheltered from US income tax, to finance its European expansion.[23] As a result, DuPont de Nemours International S. A. (DISA) was established in 1959 and intercompany pricing was set to

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[13] *DuPont*, 1978 WL 3449 (Ct. Cl. Trial Div.); 608 F.2d 445 (1979).
[14] 102 T.C. 149 (1994).
[15] *Westreco*, T.C. Memo 1992-561.
[16] [2008] ATA 639
[17] 2008 TCC 324 (2008); 2010 FCA 201 (2010)
[18] [2009] SC 3056; TC 00001 (March 31, 2009).
[19] Established under the Treaty of Rome in 1957
[20] *DuPont*, 1978 WL 3449 (Ct. Cl. Trial Div.) at *4 - *5.
[21] *Id.*, at *2.
[22] *Id.*, at *9.
[23] *Id.*, at *6.

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split US and Swiss profits on a 25:75 ratio.[24] In addition, the pricing formula guaranteed the Swiss company profits so that it would never incur losses on any transaction.[25]

DuPont's Deficiency

In the statutory notice, the IRS determined deficiencies for tax years 1959 and 1960. In the notice DISA was treated as a distributor and applied a modified resale price method[26], even though the results were calculated differently in 1959[27] and 1960.[28] When trial started, the IRS had also completed additional audits through 1967. Similar adjustments were proposed for those years and the same calculation method applied as in the 1960 determination.[29]

DuPont's Pricing Defense

DuPont relied on three experts to defend the pricing used on its return[30]. Each expert attributing 50 percent of net profits on sales flowing through DISA as appropriate based on DISA's marketing function's efforts.

Under cross-examination, however, all three DuPont experts admitted that their opinions assumed that DISA took on normal entrepreneurial risks. Each expert was then made aware that DuPont guaranteed that DISA would be (a) shielded from operational risk of loss and (b) protected from contract termination risk. Each expert then revised his opinion and their net profit allocation estimates fell from 50 percent to 10 – 20 percent.

The trial judge subsequently rejected each DuPont experts' opinion because they provided no analysis as to how they adjusted for this material difference in risk, despite their agreement that the difference in risk was material. It had a definite and significant effect on price.[31]

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[24] *Id.*, at *13.
[25] *Id.*, at *13.
[26] The Court recognizes this as a "fourth method" *DuPont*, 608 F.2d 445, 456, n. 28.
[27] The margin in 1959 is based on a discount to DISA on its purchases from DuPont.

> The discount resulted from the application to DISA of ratios of DuPont's total selling expenses (exclusive of advertising) and total administrative expenses to DuPont's total sales on a departmental basis. This discount of 5.65 percent was then applied to DISA's actual 1959 net sales less commissions to sales representatives …

Id., at *25, at ¶15.
[28] The margin in 1960 is based on a statistical compilation of US wholesalers.

> This calculation was made by computing the average ratio of net profits to sales for all United States wholesalers of drugs, chemicals and allied products … that had reportable taxable income on their United States corporation income tax returns … as compiled by the Statistics Division of the Internal Revenue Service and recorded in the Source Book of Statistics of Income.

Id., at *25, at ¶16.
[29] *Id.*, at *25, at ¶16.
[30] The experts were Professor Robert B. Stobaugh, Jr. (Harvard Business School), Dr. Stanley Miller (former professor at Harvard Business School and currently a business consultant in London), and Mr. Martin Bower (director at McKinsey & Company). Stobaugh's opinion was based on his academic experience; Miller's opinion was based on a joint venture between Haloid (Xerox) and J. Arthur Rank that he worked with; Bower's opinion was based on his consulting practice at McKinsey. *Id.*, at *78 - *82.
[31] *Id.*, at *25, at ¶19.

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The Database Search

Neither DuPont nor its experts conducted a financial database search while the IRS did. Their search results became a critical element in both party's argument before the Court.

The IRS started their review with all publicly traded companies required to register and file their financial statements with the SEC. Three filters were then applied to narrow the results. The Court agreed that the 32 firms selected had "general functional similarity"[32] with DISA. The trial court noted:

> Independent of Dr. Berry [the IRS expert], defendant [IRS] caused a random compilation to be made of publicly-held firms believed to fall in any of the three categories mentioned [by Dr. Berry, i.e., management consulting firms, advertising agencies, and distributors operating in the US]. Reference was then made to the public files of the Securities and Exchange Commission in an attempt to obtain pertinent financial and operational data relative to these companies. … Some firms were discarded because their 10K filings disclosed that in fact their business did not fall predominantly within one of the three categories. Most were eliminated because they had not been subject to Form 10K filing requirements for a sufficient period of time to constitute a representative period. With exclusions made only for these reasons, the roster was reduced to 32 companies[33].

DuPont's Use - IRS database search

The 32 companies selected included 6 management consulting firms, 5 advertising agencies and 21 distributors. The *distributors* were considered the "most functionally comparable to DISA."[34]

DuPont selected all 21 distributors and further refined the IRS search. Fifteen companies were removed, leaving it with the 6 distributors that "most closely" resembled DISA. DuPont then argued that these companies were *comparables* and that their markup percentages verified the appropriate DuPont / DISA pricing under a resale price methodology.[35]

Dr. Berry's Use - IRS database search

The IRS expert, Professor Charles Berry, also used the 32 firms the IRS identified in their database search. Rather than using them to determine an arm's length price for the DuPont / DISA transactions, Professor Berry used them to support the original Statutory Notice of Determination's validity. Dr. Berry did not consider the 32 firms to

[32] *DuPont*, 608 F.2d 445, 452, n. 16 (1979).
[33] *DuPont*, 1978 WL 3449 (Ct. Cl. Trial Div.) at *98, at ¶118.
[34] *Id.*, at *101, at ¶123.
[35] The markup percentages were 38%, 33%, 26%, 23%, 20.5% and 19.5%. DISA's markup was at the mid-point (26%). *DuPont*, 608 F.2d 445, 452, n. 16.

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be *comparables* in the sense employed in the regulations[36] nor did he use them to advance a specific transfer pricing methodology.[37]

Applying an average gross income / total cost ratio to the 6 management consulting firms (108.3%), 5 advertising firms (123.9%), and 21 distributors (129.3%), Dr. Berry demonstrated that the original IRS allocation brought DISA's extraordinary 336% and 397.1% ratios much closer to the results expected from a company like DISA (108.6% and 179.3%).

Both the trial judge and the full Court of Claims strongly embraced Professor Berry's core analytical point. If a service provider like DISA also functions as a distributor, its gross profit level cannot be compared with other service provider / distributors if significant service based selling expenses are reportable as operational expenses. This is true because DuPont rather than DISA is bearing the cost for those operational expenses.

> [W]e agree with the trial judge and defendant's expert that, in general, what a business spends to provide services is a reasonable indication of the magnitude of those services, and because plaintiff has not rebutted that normal presumption in this case, we cannot view these six companies as having made resales similar to DISA's. They may have made gross profits comparable to DISA's but their selling costs, reflecting the greater scale of their services or efforts, were much higher in each instance.[38]

This point is driven home when the court applied Professor Berry's ratios to the six DuPont selected distributors from the IRS database search. When considered from the "markup percentages" perspective, DISA was squarely at the range mid-point for these companies.[39] Under Professor Berry's analysis, however, DISA is a remote outlier and the reason for this difference is clear. DuPont, rather than DISA bears the cost for most DISA's service based selling expenses.[40]

Database Searches Provide Results, Not Comparables

DuPont assumed that the IRS search found *comparables*, but it did not.[41] Neither the IRS during its search or through its expert Dr. Berry nor DuPont itself provided the Court with any comparability analysis. The 32 firms were *not* comparables.

> Beyond the most general showing that this group [of distributors], like DISA, distributed manufactured goods, there is nothing in the record showing the degree of similarity called for by the regulation. No data

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[36] *Id.*
[37] *DuPont*, 1978 WL 3449 (Ct. Cl. Trial Div.) at *97.
[38] *Id.*, at 452.
[39] *Supra*, note 35.
[40] *Id*. at 452. When operating expenses are taken as a percent of net sales, the six distributors report 27.5%, 20.5%, 20.5%, 20.0%, 16.0% and 11.5%. DISA reports 6.7% (or 7.1%). The trial court calculated DISA's ratio at 6.7%; the full Court of Claims calculated it at 7.1%. The differences are not explained.
[41] DuPont argued that by performing the search and offering it in evidence, the IRS conceded that the 32 selected firms were *comparables*. The IRS objected, and the court agreed with the IRS. *DuPont*, 608 F.2d 445, 452, n. 16.

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exist to establish similarity of products (with associated marketing costs), comparability of functions, or parallel geographic (and economic) market conditions.[42]

Without performing a comparability analysis on the IRS search results, DuPont's presentation to the Court was a classic *database dump*. This dump occurred before modern technology existed where on-line databases could use powerful engines to search and filter significant data in just a few moments. Despite this limitation, the results were the same as they would be today. The courts rejected *database dumps* masquerading as comparables.

In addition, the US Treasury Regulations in place at the time compelled rejection. Adjustments were mandated, rather than optional[43], whenever material differences between controlled and uncontrolled parties have a definite and reasonably ascertainable effect on price. DuPont made no adjustments for operating expenses or risks. The need for adjustment was very clear with respect to risk. As the trial court noted:

> Evidence offered by plaintiff's own experts in this case specifically identified exposure to such entrepreneurial risks as the risk of operating loss as a circumstance that has a definite and reasonably ascertainable effect on price. Findings 102, & 103.
>
> It is not suggested and it does not appear that any of the 32 entities evaluated by Dr. Berry bore any less than all of the risks of loss or failure normally associated with the conduct of an independent, profit-making enterprise. By virtue of its pricing and other arrangements with plaintiff, DISA was not subject to those risks. Findings 78-80, 82, & 84.[44]

DuPont was decided on the presumptive correctness in the statutory notice.[45] The taxpayer could not prevail with its resale price method because the *potential comparables* identified in the IRS database search differed materially from the controlled parties. The differences affected price, adjustments were required, and no adjustments were made.

(2) *Seagate (1994)*

Seagate presents a classic fact pattern where the comparable uncontrolled price (CUP) studies[46] should have been used to resolve the transfer pricing questions. Here,

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[42] *Id.*, at 451.

[43] Treas. Reg. §1.482-2(e)(3)(ix) (1968) (available among other places as an appendix in *DuPont*, 608 F.2d 445, 460) (emphasis added).

> In determining an arm's length price appropriate adjustment *must be made* to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price.

[44] *DuPont*, 1978 WL 3449 (Ct. Cl. Trial Div.) at *101, at ¶124.

[45] *DuPont*, 608 F.2d 445, 461 (Judge Nichols, concurring).

[46] *Seagate*, 102 T.C. 149, 239 (1994). The court notes:

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both the government and taxpayer representatives sought “simpler” solutions for reasons having to do with adequate taxpayer records and difficulties in reconstructing records after the fact. Unfortunately, however, these solutions did not work. On most issues, the court was left with a record where its decision was based on its “best estimate.”[47]

The IRS used a database search in part of its case.[48] The search was designed to find a gross margin that would determine an arms length price under a resale price method for completed disk drives Seagate Singapore sold to Seagate Scotts Valley. The IRS's method was rejected because it only offered the court a *database search*. It did not *prove* that the search results had uncovered comparable companies. The court believed that numerous adjustments were needed to arrive at what were considered comparables. The IRS did not make them and the court did not have the record to make them on its own.

Background

Seagate Scotts Valley was a leading US computer hard disk drives and component parts manufacturer. Seagate sold 15 disk drive models to a wide ranging OEMs and distributors.

Prior to establishing Seagate Singapore, all disk drive manufacturing occurred in California. On July 30, 1982 a wholly owned subsidiary was established in Singapore to manufacturing high volume, low-end commodity disk drives. Market prices were falling rapidly and market competition was intense. Seagate was searching for a way to further reduce costs by utilizing a 10-year tax holiday in Singapore.

Once established, the Singapore subsidiary grew rapidly. Volumes increased from 125,919 units in 1984 to 3,413,463 in 1987. Beginning with 50 employees, Seagate became Singapore's second largest employer in 1987 with 8,067 workers. Beginning with component manufacturing in 1982, Seagate Singapore only one year later was also engaged in complete disk drive manufacture. Seagate Singapore sold either to Scotts Valley or to independent parties that placed orders through Scotts Valley. Internal CUPs were therefore potentially available in all product lines for all years.

Initially, Seagate set intercompany prices at the standard cost to manufacture in the US. Transfer prices were later set at the standard cost to manufacture in Singapore plus a 25% markup.[49]

> Third 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 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.

[47] *Id.*, at 195 and 230.

[48] There are nine separate transfer pricing issues in *Seagate*. Only the IRS argument involving intercompany sales for completed disk drives involves a database search.

[49] *Id.*, at 196.

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Seagate's Deficiencies

In the statutory notice, the price for *completed disk drives*[50] Seagate Singapore sold to Seagate Scotts Valley were set at a 20% discount from Seagate Scotts Valley's resale price to independent parties.[51]

The IRS had significant difficulty supporting this adjustment in their statutory notice. Given how the taxpayer's accounting records were kept, it was not possible for auditors to isolate the costs for Singapore manufactured drives sold to Seagate Scotts Valley from identical US manufactured ones sold directly into the market[52]. As a result rather than being able to cleanly determine the deficiency for completed disk drives, the IRS "backed into" it by aggregating this adjustment with a related adjustment for marketing services.[53] In the statutory notice, the "marketing services" adjustment was set at 20% of Seagate Singapore's "total adjusted sales".[54]

Seagate's pricing defense

Two expert witnesses defended Seagate's completed disk drive pricing. Dr. Gary E. Holdren prepared a CUP based pricing study in which he compared the prices and sale terms by disk drive model for disk drives Seagate Singapore sold to unrelated third parties and those sold to Seagate Scotts Valley[55].

The court rejected Dr. Holdren's study because he did "… not establish that the circumstances involved in the uncontrolled sales are identical to the circumstances involved in the controlled sales."[56] Adjustments were needed but not made for differences in sales volume, market size and competitive landscape, geographic market, and timing for sales.[57] In addition, weighted average rather than actual sales prices were used in the analysis.[58]

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[50] All totaled, there were nine transfer pricing issues in this case.
[51] *Id.*, at 201 (the *component parts* adjustment was determined to be the cost of manufacture (in Singapore) plus 15%). *Id.*, at 176.
[52] Disk drives are commodity products. Disk drives manufactured at Seagate Scotts Valley are indistinguishable from the same disk drive model manufactured at Seagate Singapore. Internal records did not track manufacturing origin for disk drives. It was not possible to follow a specific Singapore manufactured disk drive sold from Singapore to Scotts Valley then on to an identified third party.
[53] A marketing services adjustment was due because Seagate Scotts Valley provided marketing services for all Seagate disk drives. Seagate Scotts Valley facilitated Seagate Singapore's substantial direct third party sales. These direct sales frequently exceeded 50% of all Seagate Singapore sales. *Id.*, at 202.
[54] Total adjusted sales included: (a) Singapore sales to third parties, (b) amounts Singapore actually received from intercompany disk drive sales, and (c) a price adjustment applied to the figure at (b). *Id.*, at 203.
[55] *Id.*, at 203 – 213.
[56] *Id.*, at 229.
[57] *Id.*, at 229 (in a falling, highly competitive commodity market the circumstances of the sale greatly determine the price, and neither a transaction at a specific point in time, nor an average of all transactions will provide comparability).
[58] *Id.*, at 230 (indicating a wide variation in prices and listing one example from each year: the ST412 in 1984 [$440 to $343.83]; ST212 in 1985 [$450 to 219.43]; ST 225 in 1986 [$1,334.67 to $246]; ST225 in 1987 [$341.50 to $211.00])

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A second expert, Dr. Daniel P. Broadhurst, used average costs and prices from Dr. Holdren's report to support Seagate's pricing under a resale price method.[59] Once again, the court rejected this conclusion. Because Broadhurst based his report on Holdren's data, it now suffered from Holdren's failings. That is, no required adjustments were made for material differences and average rather than actual sales prices were used.[60]

The IRS's Argument – RSP with a Database Dump

The IRS used a resale price method and two expert witnesses Dr. Grant M. Clowery and Dr. Daniel J. Frisch to support the proposed deficiency.

Dr. Clowery performed an accounting analysis for Seagate Scotts Valley that sets out the gross profit earned on complete disk drive sales.[61] The key calculation involved determining the cost of sales. Gross profit is segmented between disk drives Seagate Scotts Valley manufactured and those Seagate Singapore manufactured.[62] Direct and indirect costs[63] were allocated based on relative sales values[64].

The second expert, Dr. Daniel J. Frisch, looked at just the *complete disk drive* distribution function at Seagate Scotts Valley. This is an operation that includes both disk drives manufactured in Scotts Valley and those manufactured in Singapore. Frisch's report compared Dr. Clowery's calculated gross profit margin for Seagate Scotts Valley with gross profit margins for ten independent distributors he deems to be comparable.

Database search

Because, "Dr. Frisch could not locate any independent distributor that performed precisely the same functions under the same circumstances as Seagate Scotts Valley, …"[65] he searched for comparable companies in databases and hoped to extract from the search an analytically sound gross margin that could be used in a resale price calculation.

> Dr. Frisch concluded that, taken as a whole, for the fiscal years ended 1984 through 1987, Seagate Scotts Valley earned a negative gross profit margin from reselling the Seagate Singapore-produced disk drives. In contrast, the 10 companies experienced average gross profit margins ranging between 10 and 25 percent of sales over the same 4-year period. Consequently, Dr. Frisch concluded that Seagate Singapore's transfer

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[59] *Id.*, at 213 – 217.
[60] *Id.*, at 239.
[61] Seagate did not segregate income on its balance sheets in a manner that easily allowed completed disk drive sales to be segmented from other income streams (notable component sales).
[62] *Id.*, at 217 (Clowery used Seagate Scotts Valley's monthly cost of sales journals that distinguished various costs incurred locally from "Singapore materials" costs).
[63] The indirect costs of sales were Seagate Scotts Valley costs incurred attributable to disk drives sold that were manufactured at both the Scotts Valley and at the Singapore facility.

> Next, also on the basis of relative sales value, Dr. Clowery allocated to the disk drives manufactured by Seagate Scotts Valley and Seagate Singapore, Seagate Scotts Valley's indirect costs of sales, after certain adjustments including adjustments to conform the total indirect costs with the indirect costs of sales reflected on Seagate Scotts Valley's consolidated income statement. (*Id.*, at 219).

[64] *Id.*, at 218.
[65] *Id.*, at 221.

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> prices to Seagate Scotts Valley for disk drives should be adjusted so that Seagate Scotts Valley's gross profit margin for each year is at least equal to the gross margin earned by Micro D, which for each such year recorded the lowest gross margin of the companies he identified as comparable to Seagate Scotts Valley.[66]

Dr. Frisch's database search was more high-tech than the IRS's search conducted in *DuPont.* It had more digital filters but that did not make it any more analytical. Dr. Frisch searched under the Standard Industrial Classification (SIC) codes 5045 (computers and computer peripheral equipment and software wholesalers) and 5065 (electronic parts and equipment wholesalers). Within this group[67] he applied the following filters to select companies that:

(a) should be a significant disk drive distributor
(b) does not engage in manufacturing as a significant activity
(c) engages in no (or a trivial amount of) retail level activity
(d) was an going concern during Seagate's fiscal years 1984 through 1987
(e) neither started up nor ceased operations during those years that
(f) issued public SEC statements with financial data for at least part of this period

Dr. Frisch's search identified ten potential comparables. He admitted to the court that there were at least seven significant differences between this group and Seagate Scotts Valley. He deemed only two differences, inventory levels and accounts receivable, to be material and made adjustments for them. The court, however, was not convinced and pointed to search assumptions that covered over fundamental differences it felt even a casual analysis would notice.

Assumption – Clowery's accounting matched that of the comparables

Central to Dr. Frisch's report is the assumption that gross margin percentages Dr. Clowery calculated for Seagate Scotts Valley were the same as or used the same accounting rules as gross margin calculations made for the ten potential comparables. The court notes that Dr. Frisch assumes: (1) that the Form 10-K SEC reports conform to Dr. Clowery's calculations for Seagate Scotts Valley; (2) that all ten firms follow a full absorption costing method for determining cost of goods sold including inventoriable and non-inventoriable expenses in cost of goods sold; and (3) that the ten potential comparables allocate to cost of goods sold the same costs that Dr. Clowery allocates when he determined cost of goods sold for Seagate Scotts Valley.

Assumption – Distribution Can be Segmented from Manufacturing

More damaging still is the problem that both Drs. Clowery and Frisch have with segmenting the distribution and manufacturing functions within Seagate Scotts Valley. Dr. Frisch conceded that:

> … if the costs of sales Dr. Clowery allocated to the Seagate Singapore-produced disk drives includes an extensive amount of manufacturing

[66] *Id.*, at 224.
[67] The court notes that the group was "… generally [comprised of] Seagate Scotts Valley's customers." *Id.*, at 221.

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> costs, then Dr. Frisch's selected companies would no longer be comparable since he would be comparing a manufacturer and reseller to a resellers only. [And] Dr. Clowery conceded that he possibly allocated some manufacturing expenses to the cost of sales for the disk drives Seagate Scotts Valley purchased from Seagate Singapore. … [And the Court] conclude[s] that, in all probability, Dr. Clowery allocated a significant portion of Seagate Scotts Valley's manufacturing costs to the cost of sales for the Seagate Singapore-produced disk drives.[68]

In short, the Tax Court considered the Frisch report to be a *database dump*. There were too many assumptions and comparability adjustments were simply not made. The *search* itself was being offered as a substitute for meaningful comparability *analysis.* Thus, the court held that there were no comparables because there was no analysis.

> …we are not convinced that the gross profit percentages Dr, Frisch calculated for the 10 companies he selected as comparables constitute a comparable markup percentage for Seagate Scotts Valley's distribution functions relating to the Seagate Singapore-produced disk drives. … respondent has failed to convince us that the transfer prices propounded by Dr. Frisch for the completed disk drives are reasonable.[69]

(3) *Westreco (1992)*

Westreco[70] presents a much simpler transfer pricing fact pattern than either *DuPont* or *Seagate*. This case is important because it contrasts what happens when comparability analysis developed from a good *database search* is set against a *database search that simply dumps its results* on the court without analysis.

The Westreco business plan is based mostly on providing contract research services for its foreign parent Nestec. Minimal technical services were, however, provided to ultimate parent company Nestlé Foods Corp., Inc. In this case, only the Westreco / Nestec service agreement was under scrutiny.[71] The question is simple. What is the appropriate fee for the services Westreco provided to Nestec?

Background

Nestlé, S.A. is a publicly owned Swiss company engaged in worldwide research, development, manufacturing, and marketing for processed food products. R&D is critical to its success, and Nestec is Nestlé's dedicated R&D subsidiary.

Nestec operated through six divisions and seventeen technological development centers located in more than ten countries, most using the suffix "reco" in their name to

[68] *Id.*, at 236.
[69] *Id.*, at 236.
[70] *Westreco*, T.C. Memo 1992-561
[71] Because there are two lines of service and the IRS decides to only adjust the major line (services to Nestec) some unnecessary complexity is brought into the case. The Westreco/Nestec services need to be segmented from the Westreco / Nestle Foods Corp. services. Although the statutory notice is drafted as if this segmentation has been performed, neither the salary multiplier method the audit team used nor the analysis the IRS experts performed at trial make this distinction.

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denote themselves as a "research company."[72] Westreco, Inc. is Nestec's U.S. subsidiary engaged in contract research at Nestec's direction.

Westreco had two facilities: (1) a pilot plant and laboratory in Marysville, Ohio that focused on research issues related to instant coffee and instant tea, and (2) a technology facility in Milford, Connecticut engaged in technological development and provided technology assistance to related parties[73]. Westreco's fee for services was determined on a sliding scale cost-plus basis:

> Nestec compensated petitioner for its R and D services on a cost-plus basis. Nestec was contractually obligated to reimburse petitioner for certain expenses plus a profit equal to 7.5 percent on the first $350,000 of such expenses, 5 percent on the next $1,500,000 of expenses, and 3.5 percent of petitioner's expenses there- after. The reimbursable expenses included all salaries, rent, consulting fees, raw materials, equipment, and administrative expenses, but not taxes. The contract could be terminated by either party on a year-by-year basis, subject to 3 months' written notice.[74]

Westreco's deficiency

The IRS determined deficiencies for 1978 through 1982 based on a "salary multiplier", a measure commonly used to determine compensation in large construction and engineering firms.[75] This unconventional method was shown to be defective[76] and was therefore not relied upon at trial.

Westreco's CUP pricing defense

Westreco's expert, Dr. Clark Chandler, compared Westreco to four companies that each provided contract research and engineering consulting services as their core business function.[77] We are not told about the search process other than it identified these four firms. The search probably was conducted through an online database search. One is left with the impression that we are not told much about the search itself because the search is not what is important. What we are told about in considerable detail is how Chandler sets out his *proof* that these companies are comparable to Westreco.

The Treasury regulations identify five comparability factors: functions, risks, contractual terms, economic conditions, and property or service[78]. The OECD *Guidelines*

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[72] *Id.*, at *1.
[73] *Id.*, at *2.
[74] *Id.*, at *9.
[75] *Id.*, at *11.
[76] Not only was Westreco not functionally comparable to a traditional engineering firm (*Id*., at *18), but if the multiplier is used against a correct wage base for hours actually billed (without administrative costs, fringe benefits, sick leave, vacation, holiday and incentive pay), then the salary multiplier method indicates that Westreco was over-paid rather than underpaid. (*Id*., at *17). In addition, the statutory notice used an un-segmented base that included the salaries for researchers working on Nestle Foods projects, even though the adjustment was made only on the fees for Nestec projects (*Id.*, at *17).
[77] The companies are Arthur D. Little, Inc.; Artisan Industries, Inc.; Gulf Machinery Company, Inc.; and Knechtel Research Sciences, Inc. (*Id.*, at *18).
[78] Treas. Reg. §1.481-1(d).

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also specify the same factors. While there is a slight difference in how Treasury and the OECD express these factors, for all practical purposes the same factors are involved[79].

Rigorous analysis is needed whenever a comparability factor or circumstances involving a controlled transaction may affect the arm's length result under a transfer pricing method[80]. Three comparability factors are critical for Dr. Chandler who analyses (1) business relations with clients, (2) financial comparability, and (3) economic and business risks (client, general business, research, and downstream market risks).[81] In each category, Dr. Chandler contrasts Westreco with all four firms selected and explains why Westreco is comfortably positioned within this group[82].

After Dr. Chandler is convinced that Westreco "fits" in this group, he confirms his assessment with four financial ratios: (1) operating income as a percent of net sales; (2) operating income as a percent of operating assets; (3) pretax income as a percent of net sales; and (4) pretax income as a percent of total assets.[83] Once again Westreco "fits" in this group and Dr. Chandler concluded:

> …from the data analyzed, that Westreco's profits were likely to be somewhat lower than those of the four comparable corporations because two of them (Artisan and Gulf) developed commercially viable technology on their own account and owned the rights to that technology. Westreco's profits were relatively more consistent from year to year than other comparables because it faced lower risks. The comparable corporations would be expected to realize higher average profits to compensate for their higher risks. Accordingly, Dr. Chandler opined that the fees received by petitioner from Nestec were comparable to such income from services performed for unrelated corporations.[84]

IRS's Cost-Plus Argument – a Database Dump

The IRS abandons its salary multiplier argument at trial and uses Dr. Dennis Carlton and Dr. Richard Leftwich as expert witnesses to support a cost-plus methodology. A *database dump* used to determine the "plus".

Drs. Carlton and Leftwich consulted the Standard & Poor's Computstat Services, Inc. database for publicly traded companies, indexed according to SIC codes. While SIC code number 8711 (engineering services) and 8731 (commercial physical and biological research) were selected, Drs. Carlton and Leftwich did not filter the resulting SIC code

[79] The OCED Guidelines consider functions and risks together, listing business strategies as a fifth factor. Under US regulations, business and market share strategies are a "special circumstance." Thus the five factors are not set down identically but for all practical purposed they are the same. Treas. Reg. §1.481-1(d)(1) and OECD Guidelines (2010) ¶1.36; (1995) ¶1.17.
[80] Treas. Reg. §1.481-1(d) and OECD Guidelines (2010) ¶1.33; (1995) ¶1.15.
[81] The two other factors (functions and property or service) are handled in the general description of the companies Chandler selects.
[82] *Id.*, at *19.
[83] *Id.*, at *20.
[84] *Id.*, at *20.

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data. The experts' testimony under cross-examination showed their failure to take into account certain attributes for these comparables including:

- (a) merging during the relevant years
  - i. operating the same or similar line of business
  - ii. facing unique risk
  - iii. owning particular intangible assets
  - iv. owning particular assets
- (b) relevant trade level
  - i. exact functions performed
- (c) individual customers
  - i. involvement in technological development

The court concludes that "the most important fallacy in the report of Drs. Carlton and Leftwich is the lack of comparability between the petitioner and the 15 enumerated corporations."[85] The court was particularly concerned about the proposed comparables' patent and trademark ownership, high number of government contractors, Westreco's guaranteed profitability, and using Compustat data *before* interest and taxes. Westreco's profitability, on the other hand, was considered *after* these amounts were deducted.

The IRS's cost-plus approach was based entirely on a *database dump*. No comparability analysis was performed and the court rejected the IRS's cost-plus results.

> Drs. Carlton and Leftwich did nothing to ensure that the functions of the corporations *in reality* approximated petitioner's business operations. Dr. Carlton, at trial, emphatically stated that comparability is assured when relying solely upon SIC codes because the codes "naturally group firms that do similar things together."[86]

(4) *Roche (2008)*

Australia's first substantive transfer pricing case, *Roche Products Pty. Ltd v. Commissioner (Australia),*[87] was a dispute about a deficiency derived entirely from *database dumps*. The court rejected these search results because the studies lacked any analysis that would *prove* comparability.

Roche is important because Australia still follows the 1995 OECD *Guidelines.*[88] The court arrives at the same conclusion about *database dumps* as the US courts came to

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[85] *Id.*, at *24.
[86] *Id.*, at *24 (emphasis in original).
[87] [2008] ATA 639.
[88] Australia follows the OECD *Guidelines* more closely in cases involving a double tax treaty modeled on the OECD. Unlike the UK where the *Guidelines* are expressly adopted in the statutes, Australia follows the *Guidelines* because it is the "best evidence of international practice." The Federal Court of Australia recently observed (comparing the Australian and UK adherence to the *Guidelines*):

> [T]he Sch 28AA regime [in the UK], by virtue of para 2 requires effect to be given to the Transfer Pricing Guidelines as they apply to treaties following the OECD model. The incorporation is not wholesale: it merely requires the schedule as a whole to be interpreted in such a way as secures consistency between para 1 of the schedule and the OECD model in accordance with the Transfer Pricing Guidelines. There is no incorporation of the OECD model in s 770 [in Australia]. But it seems to us that in

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under the 1968 regulations. The searches were *completely rejected* because they do not *prove* comparability. While the 1994 regulations relaxed US comparability standards, a jurisdiction following the 1995 OECD *Guidelines* would more likely follow the courts footsteps in *DuPont*, *Seagate*, and *Westreco* than would a US court applying the 1994 regulations. The current US rules do not reject bad comparables, they just reduce their reliability.

The rules on comparability adjustments were clear in the 1968 regulations. If there were material differences between controlled and uncontrolled transactions, then adjustments *must be made* to the referenced uncontrolled parties or the proposed comparables are rejected. This alignment with controlled parties[89] was the regulatory linchpin in the *DuPont, Seagate,* and *Westreco* decisions. The 1995 OECD *Guidelines* adopt the same rule that these adjustments *must be made*[90].

The 1994 regulations changed this rule. Now if adjustments cannot be made, the proposed comparables need not be rejected. Instead, the *analysis' reliability is reduced*.[91]

> determining the arm's length price, the approach of 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.

SNF (Australia) Pty. Ltd. v. Commissioner of Taxation, [2010] ATC 20-190; [2010] FCA 635.

[89] Treas. Reg. §1.482-2(e)(3)(ix) (1968) (available among other places as an appendix in *DuPont*, 608 F.2d 445, 460) (emphasis added).

> In determining an arm's length price appropriate adjustment *must be made* to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price.

[90] OECD, *Guidelines* (1995) at ¶¶1.15 & 1.16 (emphasis added).

> To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. … *In all cases adjustments must be made* to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or return required by independent enterprises. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions.

[91] Treas. Reg. §1.481-1(d)(2) (emphasis added).

> In order to be considered comparable to a controlled transaction, an uncontrolled transaction *need not be identical* to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, *adjustments must be made* if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied. *If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced*. Generally, such adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis. See §1.482-1(c)(1) (Best

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The 2010 OECD *Guidelines* half-way responded to this change. While the 2010 OECD *Guidelines* are not in full agreement with the US rule, an adjustment is only required *where possible to improve the comparison's reliability*.[92]

Background

Roche Holdings Limited is the Basel, Switzerland based multinational pharmaceutical company that sells and manufactures pharmaceuticals globally. Roche Products Pty. Ltd. (Roche Australia) is the Australian subsidiary that develops marketing outlets in Australia operating through Prescription, Consumer, and Diagnostic divisions.

The Prescription Division is the most substantial division, marketing Roche prescription pharmaceuticals and performing limited research and development. The Consumer Division sells over-the-counter pharmaceuticals and the Diagnostic Division sells equipment and preparations used in hospitals and medical laboratories. The Diagnostic division had never been successful.

Most pharmaceutical products were obtained from Roche Holdings Limited in Basel, although some were obtained from the Roche Singapore subsidiary. Both tax treaties follow the OECD model. Article 9 in the Australian / Swiss and Article 6 in the Australian / Singapore double tax treaties are implicated in the case. The transfer pricing adjustments were also supported under applicable tax statute, specifically Division 13 of the ITAA 1936.

The Commissioner determined that the intercompany prices Roche Australia paid were not at arm's length. The prices were deemed excessive and that profits were being transferred from Australia through the pricing.

Decision

The court was persuaded that a reasonable gross margin for prescription pharmaceutical would be 40% and applied a resale price method with the same markup for all years in issue (1993 – 2003). The court reduced the assessment from approximately A$110 million to A$45 million. Only the Prescription Division was implicated in the appeal. The Commissioner's deficiency related to the Consumer and Diagnostic Divisions was not upheld.

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method rule). In any event, unadjusted industry average re- turns themselves cannot establish arm's length results.

[92] OECD, *Guidelines* at ¶¶1.33 & 1.35 (2010) (emphasis added)

> To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (*e.g.* price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. … Where there are differences between the situations being compared that could materially affect the comparison, comparability *adjustments must be made, where possible*, to improve the reliability of the comparison. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions.

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The court rejected both parties transfer pricing arguments, although it found the Roche Australia economist, Dr. Daniel Frisch's submitted data while limited in scope to be persuasive. Dr. Frisch's report presented a CUP analysis based on internal comparable data he had access to for several pharmaceutical companies. The government was unaware on audit about this information. The ATO supported their assessment with experts Dr. Deloris Wright and Dr. Brian Becker. This paper focuses on the deficiency determination and the Roche *database dumps* defense, passing on other issues addressed in the case.

The Roche Deficiency – Multiple Database Dumps

The ATO engaged Dr. Wright as their expert witness to assist in developing the deficiency notice and defend their deficiency at trial. Altogether Dr. Wright conducted seven fairly comprehensive searches, in no case does the court indicate that she has presented it with anything more analytical than the search results themselves.

For the Prescription Division, Dr. Wright determined that a resale price method was most appropriate for the distribution and marketing functions while a cost-plus method was best for the clinical trial management and secondary manufacturing functions. A resale price method was also applied to the Consumer and Diagnostic Divisions.

It is important to put into context the *database dumps* involved in this case because the quantity of data involved has a role to play in the suggestion that the search itself can be substituted for comparability analysis. Roche Australia may well represent substituting "quantity for quality" that the OECD warns about.[93] Roughly speaking, the seven searches are summarized as follows:

(1) Prescription Division

(a) *Clinical trials* - Three commercial databases are consulted yielding 591 companies from which 580 are discarded.[94] Eleven companies met Dr. Wright's criteria and five were added from other searches.[95] Fourteen of the remaining sixteen companies were UK firms. Markups for these firms ranged from 24.8% to (20.0%) with a 3.7% to 11.3% interquartile range and a 7.9% median.

(b) *Secondary manufacturing* - In this search 1,440 companies were identified as potential comparables. From this potential pool, unspecified filters were applied to eliminate all but one remaining French firm and one Canadian firm. Because only the French firm had markup figures for the whole period, it became the exclusive referent to determine the interquartile range. Markups for these firms ranged

[93] OECD *Guidelines* (2010) *supra* note 2, at ¶¶1.51 & 3.33.

[94] The court notes, "She gave very few details of this process." *Roche*, [2008] ATA 639, at ¶65.

[95] There is no indication as to what the criteria was that narrowed the search, other than these firms are "contract research organizations which specialize in the management of clinical trials, [which] … is not, of course, what Roche Australia did." There is also no indication what the "other searches" are that provide the additional comparables. *Roche*, [2008] ATA 639, at ¶¶65 & 67.

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from 2.6% to 30.2% with a 10.4% to 17.9% interquartile range and a 12.6% median. The court notes that, "Dr. Wright accepts [the single French company] as a comparable"[96].

(c) *Distribution and marketing* - A search for Australia companies was fruitless so Dr. Wright went to seventeen other countries that she felt were comparable to Australia and again she found no companies.[97] As a consequence, Dr. Wright segmented this function into its component parts: distribution, marketing, and selling:

i. *Distribution*. Finding no independent pharmaceutical distributors in Australia, Dr. Wright went to the seventeen comparable countries and identified 1,080 companies. All but twenty-five were rejected for unspecified reasons and to this amount twenty-four were added from an unspecified prior search. An interquartile gross margin range was identified which after adjustments[98] yielded a gross margin range that was converted to operating margins (because a total cost plus method was being applied). The gross margin for these firms ranged from 14.3% to 6.8% with a 1.0% to 2.6% interquartile range with a 1.6% median[99].

ii. *Marketing*. This search involved eighteen countries including Australia. Dr. Wright found 265 companies, rejecting 258 leaving seven – six from the US and one from Canada. The search revealed a 2.9% to 23% markup range with a 9.0% to 15.9% interquartile range and a 13.1%.median

iii. *Selling*. Dr. Wright's initial search this time found 1,069 companies, all located in the US. These companies provided various services to the pharmaceutical industry including outsourced sales services. There was apparently no further filtering for this group. The markup range was from (1.7%) to 16.5% with a 3.3% to 10.3% interquartile range and a 6.6% median. In this case Dr. Wright selected a markup at the top of the range "because I believe it to be the appropriate markup" without further analysis.[100]

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[96] *Roche*, [2008] ATA 639, at ¶69 (if so, the court observes, "… a very large markup can be found in a company operating at arm's length.")

[97] The court notes that what Dr. Wright was looking for:

> she could not find companies which carried out functions sufficiently comparable to the activities of Roche Australia, partly because they did not carry out the detailing or direct marketing through medical practitioners.

Roche, [2008] ATA 639, at ¶70.

[98] Dr. Wright indicated that adjustments for: (a) carrying costs of inventory, (b) net accounts receivable, and (c) functional intensity were needed yet only the last adjustment (c) was made. For adjustments (a) and (b), Dr. Wright had no data to make them and did not do so. Dr. Wright indicated that these adjustments were "usually small" but in this case "could be quite large." *Roche*, [2008] ATA 639, at ¶73.

[99] The gross margin range was 7.7% to 13.4% with a 7.2% to 9.2% interquartile range a 8.3% median. *Roche*, [2008] ATA 639, at ¶74.

[100] *Roche*, [2008] ATA 639, at ¶77.

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Dr. Wright aggregated these Prescription Division search results to find a 43.2% to 45.8% arm's length gross margin range with a 44.4%.median.

(2) *Consumer Division*. Limited to only a division segment (Category 1 products) Dr. Wright searched for independent distributors involving fully finished unpatented products in Australia. She found none and for unspecified reasons resorted to the database search spanning seventeen comparable countries used in the *distribution* function under the Prescription Division. Unspecified adjustments were made to the search yielding 3.9% to 6.9% operating margins with a 5.6% median[101].

(3) Diagnostics Division. Dr. Wright confronted similar problems with the Diagnostic Division as she did with the Consumer Division. Finding no comparables in Australia and nor in the seventeen other countries, she resorted to searching under the distribution function within the Prescription Division where Dr. Wright found 10 of the 49 pharmaceutical product distributors to be diagnostic product distributors. Once again, unspecified adjustments were made to the search yielding 4.5% to 9.0% operating margins with a 6.7% median[102].

The court's response to database dumps

The court was clearly frustrated with Dr. Wright's *database dumps*, confused by the methods Dr. Wright used and concerned that Dr. Wright's experience with American (as opposed to Australian) transfer pricing biases her conclusions. While Dr. Wright indicated that traditional methods were used, the court felt that fact profit methods were used. Also, Australian rules under the 1995 OECD *Guidelines* were not the same as the American rules in effect.

(1) *Confusion in methods employed*. The Court notes that Dr. Wright stated that she used traditional resale price or a cost-plus method[103]. The court declares that this is not what Dr. Wright does. "The method used by Dr. Wright is not really a transaction method but rather a profit method, with all their disadvantages"[104].

The real concern should not be with the methods used[105] but whether or not Dr. Wright was dealing with comparables. There was no evidence as to Dr Wright's efforts to *prove* comparability with anything more analytical than the raw search data. In the end, no method can withstand scrutiny if it is not based on comparables and comparability must be demonstrated not simply asserted.

Some shifting among methods is acceptable as data is analyzed. As the OECD *Guidelines* state, "a transactional net margin method operates in a manner similar to the

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[101] The gross margins were 60.9% to 62.7% with a median of 61.7%. *Roche*, [2008] ATA 639, at ¶80.
[102] The gross margins were 59.2% to 63.7% with a median of 61.4%. *Roche*, [2008] ATA 639, at ¶82.
[103] *Roche*, [2008] ATA 639, at ¶75.
[104] *Roche*, [2008] ATA 639, at ¶75.
[105] Under the 1995 OECD *Guidelines* profit-based methods, like the transactional net margin method, were methods of "last resort." In this sense then the method does matter.

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cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied"[106]. What does not shift among methods, however, is the requirement that analysis must be based in *proven* comparables.

> A comparability analysis *must be performed in all cases* in order to select and apply the most appropriate transfer pricing method, and the process for selecting and applying a transactional net margin method should not be less reliable than for other methods. … As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons. … When the comparable uncontrolled transactions being used are those of an independent enterprise, a high degree of similarity is required in a number of aspects of the associated enterprise and the independent enterprise involved in the transactions in order for the controlled transactions to be comparable; there are various factors other than products and functions that can significantly influence net profit indicators[107].

An example should make the *Roche* court problem much clearer. When Dr. Wright searched the Prescription Division's *secondary manufacturing* function for the markup percentage, Dr. Wright began her search with 1,440 *potential comparables.* Through an unspecified filtering process Dr. Wright eventually narrowed the pool to a single French company and concluded this is *the comparable.*

If this is true, then we expect considerable firm-level analysis demonstrating comparability. We are looking for something like Dr. Chandler's four comparable companies analysis in the *Westreco* case. We are looking for analysis that looks carefully and comparatively at the five comparability factors: functions, risks, contractual terms, economic conditions, and property or service.

Dr. Wright, however, did not appear to compare Roche Australia's secondary manufacturing function with the French company as Dr. Chandler did. Instead, Dr. Wright simply holds up this single French company as the lone standard for determining the markup. The French firm became the standard because it was the "last man standing" after Dr. Wright applied her unspecified screens to the 1,440 potential comparables.

Responding to an American Bias

The court is well aware that *Roche* is the first Australian transfer pricing case, and that there is not a lot of litigation-tested transfer pricing economists in Australia. The court is also aware that the Australian statute[108] and the relevant double tax treaties[109] are

[106] OECD *Guidelines* (2010) *supra* note 2, at ¶2.58.
[107] OECD *Guidelines* (2010) *supra* note 2, at ¶¶2.68 & 2.69.
[108] Division 13 of the Income Tax Assessment Act 1936.
[109] Article 9 of the *Agreement Between Australian and Switzerland for the Avoidance of Double Taxation with Respect to Taxes on Income* [1981] ATS 5; Article 6 of the *Agreement Between the Government of*

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not the same as §482 and regulations. It laments the lack of argument on these points. All of the experts in this case are Americans:

> Transfer pricing issues relating to taxation are apparently highly sophisticated and highly complex in the United States. Each of the experts is an economist specializing in the field. *Their approach to the issues before me must have been colored by their United States experience*. At times I wondered why Australian experts could not have approached this matter with just as much skill as the experts from the United States but *without some of the presumptions* which their work must have led to. Unfortunately, none of the experts were either asked to, or did, directly address the provisions of either the double tax treaties or the Assessment Act. Had they done so my task might have been easier[110].

One of the points the court needed to hear arguments on was whether or not Dr. Wright's segmentation of Roche Australia's related party transactions was appropriate. Did the seven pricing studies represent distinct transactions or were these transactions so closely linked that they could not be examined separately?[111] Was this segmentation a prohibited adjustment to the controlled transaction under the Australia / Swiss and Australia / Singapore double tax agreements?[112]

Adjustments are normally made to the referent, aligning it with the controlled party. In this instance, however, Dr. Wright reversed the process, and made adjustments to the controlled party to align it with the referents. In determining whether this is this allowable, the court observes:

> Although Dr Wright attempted to find companies whose activities were comparable to those of Roche Australia it must have been difficult to know precisely how much was outsourced in each case she selected and whether it was comparable to the work Roche Australia carried out. *It also occurs to me that different arm's length results may be obtained in a company providing only one of a group of services such as clinical trials,*

Australian and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income [1969] ATS 14.

110 *Roche*, [2008] ATA 639, at ¶33.

111 OECD, *Guidelines* (1995) at ¶1.42.

112 Article 9(1) indicates that the provision should be applied on the basis of "their [the two enterprises'] commercial or financial r1elations" (emphasis added). This means that the fixed point for the arm's length test is the actual transaction. Adjustments should not be made to the transaction itself but to the referent transaction (the transaction between the uncontrolled parties). Properly applying Article 9(1) would mean that all price-sensitive conditions for the independent transactions are adjusted to match the controlled transaction conditions (and not the other way around). The US rule is similar, but more loosely drawn: "*Generally*, such adjustments [of material differences between controlled and uncontrolled transactions] must be made to the results of the uncontrolled comparable." (emphasis added). Treas. Reg. §1.482-1(d)(2). This issue was a topic of concern in the 2008 discussion draft *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment* at ¶198. *Report on the Transfer Pricing Aspects of Business Restructurings: Chapter IX of the Transfer Pricing Guidelines* (July 22, 2010) at ¶9.165. Adjusting the price-sensitive conditions for the controlled relationship re-characterizes the relationship resulting in establishing the price for a purely hypothetical relationship, not determining the actual transaction's price.

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> *secondary manufacturing and distribution and marketing, compared with a company providing all of those services*. The one service company may make a greater markup because it is a specialist while the multi service company may make a greater markup because of the comprehensive service it supplies. The important matter is not which one of these, or some other alternative, is true, but simply that the availability of such considerations damages the comparability of the figures.[113]

Segregation – the other aspect of adjusting comparables

What the *Roche* court is concerned about could be seen as the converse of a comparability adjustment. Comparability adjustments are made to *uncontrolled parties* to align them with controlled parties. Segmentation is just the reverse. Segmentation is the process whereby certain transactions of *controlled parties* are isolated so that they can be compared more precisely with transactions that have been identified between uncontrolled parties.

Under both US and OECD rules it is appropriate to conduct separate and aggregate arm's length price tests. Aggregation is appropriate if taken as a whole, the transactions are so interrelated that the transactions together are the most reliable means to determine the arm's length price.[114] It is not appropriate to pull discrete transactions from a group of interdependent transactions if the separation removes business elements that have a definite and material effect on prices.

Dr. Wright segments Roche Australia into at least seven parts. She does this to align discrete parts of Roche Australia with results from her database searches. What she does not do is justify the segmentation. Because the court does not know why she performs this segmentation, it rejects her database searches outright. Even though the segmentation may indeed be appropriate, the court needs to be told "why" this is the case. The court is not told. In particular, the court needs to know that the segmentation does *not* remove from the comparison critical elements of the Roche Australia business processes that have a material impact on prices. The court is *not* assured that this has *not* happened. The court has been presented with a *database dump*, no more, no less.

The *Roche* court's concern is echoed in a recent Canadian transfer pricing case, *GlaxoSmithKline v. The Queen.*[115] Once again in *Glaxo* we are concerned with a global pharmaceutical company that has a controlled subsidiary marketing prescription pharmaceuticals locally. The *Roche* / *Glaxo* comparison is very apt because Canada, like Australia, is following the 1995 OECD *Guidelines*[116]. The concern in *Glaxo* is that the government appears to be inappropriately segmenting the purchase of prescription medication ingredients from the related license that allows the company to manufacture and sell the finished product.

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113 *Roche*, [2008] ATA 639, at ¶67.
114 Treas. Reg. §1.482-1(f)(2)(i)(A); OECD, *Guidelines* (1995) at ¶1.42.
115 *GlaxoSmithKline v. The Queen*, 2008 TCC 324 (2008); 2010 FCA 201 (2010)
116 CRA, Information Circular 87-2R at ¶¶2-3.

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(5) *GlaxoSmithKline (2008 & 2010)*

Glaxo Group Ltd., a UK based multinational pharmaceutical company that also sells and manufactures pharmaceuticals globally. Glaxo Canada is the Canadian subsidiary that secured the Canadian rights to manufacture and sell Zantac, an ulcer medication in a license agreement with its UK parent. In a separate agreement Glaxo Canada purchased ranitidine, the active ingredient in Zantac, from another related Swiss based company (Adechsa S.A.).

Glaxo Canada paid a 6% royalty for the Canadian manufacturing and selling rights. It paid between CAD 1,512 and CAD 1,635 per kilogram for ranitidine. The Canadian Revenue Authority (CRA) adjusted the price Glaxo Canada paid for ranitidine, ignoring the royalty arrangement.

The Deficiency

The CRA presented evidence that generic drug manufacturers in Canada purchased chemically identical ranitidine for market prices between CAD 194 and CAD 304 per kilogram throughout the assessment period. These independent firms were able to manufacture and sell a generic drug that was medically identical to Zantac. The CRA argued that the prices these companies paid for ranitidine were comparable uncontrolled prices.

The Tax Court upheld the CRA assessment based on a CUP methodology. The court applied the highest per-kilogram price GlaxoSmithKline's competitors paid for ranitidine to the volumes Glaxo Canada Purchased. The difference (less a $25 per kilogram adjustment for the finer GlaxoSmithKline ranitidine granulation) was allocated to Glaxo Canada as unreported profits. The Tax Court followed the CRA's lead and disregarded the license agreement.

On appeal, the Federal Court of Appeal found that the Tax Court had erred in its arm's length price determination for ranitidine, because the license agreement had a material effect on the price paid for ranitidine. The Appeals Court indicated that the Tax Court failed to consider a crucial business circumstance. The question is not: "What is the fair market value of ranitidine?"[117] The question is: "What would a reasonable person in the same business circumstances as Glaxo Canada be willing to pay for ranitidine?"

It would be pointless for Glaxo Canada to purchase ranitidine from Adechsa without a license to manufacture and sell Zantac. A third party buyer, however, might be willing to pay a premium for Adechsa ranitidine if doing so would allow it to manufacture and sell a trademarked pharmaceutical drug (Zantac) that commands a significant price premium over competing generic drugs.[118] This is what the Tax Court should have considered and the Appeals Court remanded the case back to the Tax Court to make such a determination based on these facts. This is an instance where two

[117] *GlaxoSmithKline*, 2008 TCC 324 at ¶161; 2010 FCA 201 at ¶75.
[118] *GlaxoSmithKline*, 2010 FCA 201 at ¶ 44.

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transactions must be considered in the aggregate. The license cannot be segregated from the ranitidine purchase.

In reaching its decision, the Canadian Federal Appeals Court found support in the Australian Appeals Tribunal reasoning within the *Roche* decision. In the Appeals Court decision, an internal comparable was identified that was applied to the prescription pharmaceuticals Roche Australia imported. The Australian Tax Commissioner objected that the prices Roche Australia paid were too high. The court, however, pointed out that the foreign parent needed to be compensated not only for the tangible product but also for the related intellectual property. These two transactions needed to be aggregated.[119]

Conclusion

If searches for comparables in commercial databases are becoming the norm in transfer pricing[120] and there is a growing tendency to substitute the search itself for sound comparability analysis (the *database dump*),[121] then what is the likely result if on audit or through litigation all of a taxpayer's proposed comparables are rejected? *DSG Retail v. HMRC*, the final case considered in this paper, indicates that we will probably end up with a profit split in an OECD jurisdiction.

(6) *DSG Retail (2009)*

DSG is the first decision of the Special Commission of Income Tax (now the First-Tier Tax Tribunal) and the UK's first substantive transfer pricing case. *DSG* looks in detail at how to find "the most appropriate method"[122]. It is particularly concerned

[119] The Federal Appeals Court indicates:

> The appellant [Glaxo Canada] submits, and I agree entirely with that view, that these circumstances do not arise from the non-arm's length relationship between the appellant and Adechsa or between the appellant and Glaxo Group. To the contrary, these circumstances, and I quote the appellant, "arose from the market power attaching to Glaxo Group's ownership of the intellectual property associated with ranitidine, the Zantac trademark and the other products covered by its License Agreement with Glaxo Canada". As the Administrative Appeals Tribunal of Australia stated in *Roche Product Pty Limited and Commissioner of Taxation*, [2008] AATA 639 (July 22, 2008) at paragraph 153:
>
>> It is the intellectual property which is really the product, not the pill or capsule by which it is dispensed. The intellectual property included patent rights. The intellectual property came from very substantial expenditure on research and development, much of which would have produced no result. The profits from the exploitation of the intellectual property rights was something to which [the parent company which invented the product] had a special claim even though the profit would be collected for Australian sales by the Australian subsidiary.

GlaxoSmithKline, 2010 FCA 201 at ¶ 80.

[120] Ernst & Young, Ernst & Young Responds to OECD Transfer Pricing Consultation, Tax Analysts 2006 WTD 242-14; Doc 2006-25051 indicating,

> As a practical matter, commercial electronic databases are therefore very widely used and this is one of the most important reasons for the almost pervasive adoption of TNMM or CPM.

[121] *See*: Dr. Deloris Wright, *supra* note 9 (and accompanying text).

[122] OECD, *Guidelines*, *supra* note 2, at ¶ 2.2 (2010).

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with what should be done when all proposed comparables fail because adequate adjustments cannot be (or are not) made.

Background

The DSG group constitutes the largest electronics retail chain in the UK. Outlets include Dixons, Currys, and PC World. DSG offers customers extended warranties at check-out and for a fee consumers can purchase an extension to the manufacturer's warranty.

In-store DSG personnel function as agents for a third-party insurer, Cornhill Insurance plc (Cornhill), that is based in the Isle of Man[123]. Cornhill was not, however, prepared to hold more than 5% of the risk on an insurance contract[124] so Cornhill purchased reinsurance for the other 95%. In all cases the reinsurer was another DSG company, Dixons Insurance Services Limited (DISL), a wholly owned DSG subsidiary resident in the Isle of Man[125].

Thus, Cornhill effectively ceded 95% of the proceeds from extended warranty contracts back to the DSG group through DISL. DISL and Cornhill were both exempt from income tax in the Isle of Man.

Assessing comparables

DISL's non-existent bargaining power continually troubled the Special Commission, especially when it only had three real employees.[126] Any potential comparable that could not explain how DISL achieved exceptional returns with three employees performing routine activities and minimal bargaining power was rejected.

DSG offered the court six CUPs and a TNMM. All seven proposals were rejected because adjustments could not be made to the uncontrolled parties to account for material differences. Bargaining power was the critical difference. HMRC argued and the court agreed that because all the comparables were inadequate, a profit split must be used. The Special Commission did not *reduce the proposed comparables reliability* as would be suggested under the US regulations. Instead it *rejected the comparables* as suggested under the OECD *Guidelines*. The court aggregated all profits and then distributed among the parties (DSG, Cornhill, and DISL) in accordance with their relative capital contributions.

"[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." The

[123] 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.
[124] 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.
[125] DISL was not authorized to write insurance in the UK.
[126] DSG International Insurance Services Ltd (2007) IPT 0013; [2007] UKSPC (25 October 2007) at ¶10.

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Special Commission underscores that by moving to a profit split. The Special Commission is therefore, in fact and in substance, following the OECD *Guidelines*.[127]

> 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.[128]

Other DSG-type outcomes are likely

One of the key differences in the approach to comparability between the current US regulations[129] and 1995 and 2010 OECD *Guidelines*[130] is what happens if adjustments are not made for material differences. This difference is important, and it is likely to be encountered by MNEs.

The likely situation is where one jurisdiction (an OECD jurisdiction) rejects a transfer pricing study based on a *database dump*, and another jurisdiction (a jurisdiction agreeing with the US approach) finds the comparables proposed in the *database dump* to be acceptable, but with reduced reliability.

While all situations are unique, a rough road map for where this scenario might arise can be inferred from comparative studies involving global APA programs. Most APA programs release data on the transfer pricing methods used in successful agreements. Because commercial databases are used most heavily with the CPM and TNMM methods, it would stand to reason that a jurisdiction that resisted CPMs and TNMMs in the APA process would be a jurisdiction that was inclined to reject rather than work with *database dumps*.

For example, a recent comparative APA study indicated that the TNMM comprised 93% of the South Korean,[131] 59% of the Australian,[132] 53% of the Italian,[133] but only 39% of the Canadian APAs.[134] In the US, the Cost Plus and Profit Split methods taken in aggregate represent 65% of the APAs dealing with tangible and intangible

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[127] DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶143.
[128] DSG Retail v. HMRC, TC 00001 (March 31, 2009) at ¶153.
[129] Treas. Reg. §1.481-1(d)(2) ("… the reliability of the analysis will be reduced …")
[130] OECD, *Guidelines* (1995) at ¶1.16 ("In all cases adjustments must be made …"); OECD, *Guidelines* at ¶1.35 (2010) ("… adjustments must be made, where possible, …).
[131] *Id.*, at 12 (based on just 2008 and covering 30 APAs).
[132] Joel Cooper & Rachit Agarwal, *The Transactional Profit Methods in Practice: A Survey of APA Reports*, INT. TRANSFER PRICING JOURNAL (Jan/Feb 2011) 10 (based on years 1999 – 2009 and covering 260 APAs).
[133] *Id.*, at 12 (based on years 2004 – 2009 and covering 19 APAs).
[134] *Id.*, at 11 (based on years 1993 – 2010 and covering 142 APAs).

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property and 45% of the APAs dealing with services[135]. The Japanese data considered in this study was not as robust because the TNMM was not accepted in Japan until March 2004. However, since 2004, the TNMM has grown in popularity in Japan and has accounted for 35% of the APAs in 2005, 63% in 2007, and 72% in 2008[136].

These statistics suggest that supporting a pricing decision with a CPM / TNMM that relied on a *database dump* would be considerably more risky in a US / Canadian context than in a US / South Korean context. Canada still follows the 1995 OED *Guidelines* and retains a preference for the traditional over the profit-based methods. Canada also *requires* adjustments for all material differences.[137] South Korea, on the other hand has adopted the 2010 OECD *Guidelines.* Korea has abandoned the methods hierarchy in favor of the "most appropriate method."[138] Korea also requires adjustments for material differences "… where possible, to improve the reliability of the comparison"[139].

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[135] *Id.*, at 11-12.
[136] *Id.*, at 11.
[137] CRA, Information Circular 87-2R at ¶¶2-3 & 50 (on mandating adjustments) and ¶¶48-49 (on the "natural hierarchy of methods" that preferences traditional over profit methods).
[138] OECD, *Guidelines*, *supra* note 2, at ¶ 2.2 (2010).
[139] Hwang Su Hyun, Ha Dong Hoon, Warren Chung & Ahn Sang Min, *South Korea: Taxpayers Rush for Protection from Transfer Pricing Audits*, INTERNATIONAL TAX REVIEW (March 23, 2011) indicating that:

> Korea's transfer pricing regulation, the Law for the Coordination of International Tax Affairs (LCITA), has been revised recently to reflect the changes in the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and to provide more reasonable grounds for transfer pricing implementation in Korea.

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