

# Transfer Pricing Guidelines

## A guide to the application of section GD 13 of New Zealand's Income Tax Act 1994

This appendix contains guidelines on the application of New Zealand's transfer pricing rules. They provide a general overview of the framework within which transfer pricing operates, discuss documentation taxpayers should be looking to prepare if they are to evidence compliance with the arm's length principle, and consider the more specific areas of intangible property, intra-group services, and cost contribution arrangements. The introduction also discusses briefly the Competent Authority procedure and advance pricing agreements (APAs).

The material in these guidelines was released for consultation in draft form in two parts. Part 1, released in October 1997, provided a general overview of the framework within which transfer pricing operates, including a discussion on documentation. Part 2, released in January 2000, dealt with intangible property, intra-group services, and CCAs. No changes have been made to Part 2 following consultation, other than to update cross-references. Some changes have been made to Part 1, but these do not affect substantive issues.

Transfer pricing is not an exact science. For this reason, the guidelines have been drafted as a practical guide, rather than as prescriptive rules. These guidelines are not issued as a binding public ruling.

Inland Revenue fully endorses the positions set out in chapters 1 to 8 of the OECD guidelines and proposes to follow those positions in administering New Zealand's transfer pricing rules. Consequently, these guidelines should be read as supplementing the OECD guidelines, rather than superseding them. This applies for the domestic application of New Zealand's rules, as well as in relation to issues raised under New Zealand's double taxation agreements.

These guidelines apply only to the application of section GD 13 to transactions between separate entities. They do not apply to transactions within a single entity, such as between a parent company and its branch operation. Those transactions are subject instead to the apportionment rules in section FB 2.

This document is also available on the Internet. Visit Inland Revenue's website at [www.ird.govt.nz](http://www.ird.govt.nz) and choose the *Tax Information Bulletin* section.

The document is listed as an appendix to *TIB* Volume 12, No 10 (October 2000)

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*All section references in these guidelines are to the Income Tax Act 1994*

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# Introduction

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## Coverage of guidelines

1. These guidelines on New Zealand's transfer pricing rules aim to provide taxpayers with an appreciation of what they will need to do if they are to demonstrate to the Commissioner of Inland Revenue that they have complied with the arm's length principle in section GD 13.
2. Specifically, the guidelines consider:
  - the rationale behind New Zealand's adoption of the arm's length principle
  - the conceptual framework on which application of the acceptable transfer pricing methods is based
  - the general principles of comparability (including a discussion on functional analysis) which forms the foundation of transfer pricing analysis
  - the factors taxpayers should consider in determining the extent to which documentation should be prepared and maintained in support of their determination of the arm's length price
  - the treatment of intangible property
  - the treatment of intra-group services, such as management fees, and
  - cost contribution arrangements (CCAs).
3. The material in these guidelines was released for consultation in draft form in two parts. Part 1, released in October 1997, provided a general overview of the framework within which transfer pricing operates, including a discussion on documentation. Part 2, released in January 2000, dealt with intangible property, intra-group services, and CCAs.
4. No changes have been made to Part 2 following consultation, other than to update cross-references. Some changes have been made to Part 1, but these do not affect substantive issues. A summary of the changes is set out in a short chapter at the end of these guidelines.

## Relationship to OECD guidelines

5. *Tax Information Bulletin* Vol 7, No 11 (March 1996) described New Zealand's transfer pricing legislation enacted in December 1995. On page 1 of that publication, it was stated that until New Zealand's transfer pricing guidelines are issued, Inland Revenue will be following the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (referred to in these guidelines as the "OECD guidelines") in applying the transfer pricing rules.
6. There is, however, no valid reason why Inland Revenue should not follow the OECD guidelines entirely in administering New Zealand's transfer pricing rules. The consensus established between OECD member countries means that the OECD guidelines will, for example, be the relevant guidelines to consider if a transfer pricing issue is raised under New Zealand's double tax agreements. Inland Revenue also does not differ substantively from the OECD's view on any point.
7. Inland Revenue, therefore, fully endorses the positions set out in chapters 1 to 8 of the OECD guidelines and proposes to follow those positions in administering New Zealand's transfer pricing rules. Consequently, New Zealand's guidelines should be read as supplementing the OECD guidelines, rather than superseding them. This applies for the domestic application of New Zealand's rules, as well as in relation to issues raised under New Zealand's double taxation agreements.

8. The question might be asked, therefore, of why New Zealand has drafted its own guidelines. The answer is that by issuing guidelines with a practical focus, Inland Revenue hopes to explain transfer pricing in a way that is perhaps more accessible to taxpayers confronted by the issue than are the OECD guidelines. Further, it is expected that New Zealand guidelines will be able to offer pragmatic solutions to issues that are better suited to the New Zealand business environment. Finally, the OECD leaves issues such as documentation to the discretion of individual jurisdictions, so it is necessary for Inland Revenue to develop an appropriate view on the issue.

9. These guidelines are cross-referenced to paragraphs in the OECD guidelines, when relevant. If more detail is required than is provided in these guidelines, reference should be made to the OECD guidelines.

## **Inland Revenue's approach to New Zealand guidelines**

10. There are two possible approaches that might be taken in drafting transfer pricing guidelines. The first is to draft prescriptive guidelines that attempt to deal with every transfer pricing issue that may arise. In Inland Revenue's view, such an approach is ineffective. Establishing appropriate transfer prices for tax purposes involves the application of judgement, which will often depend on taxpayers' individual circumstances. Prescriptive guidelines are, therefore, not considered to be a practicable option.

11. The second approach is to provide guidance on the factors that should be considered in determining whether an amount constitutes an arm's length price and how these factors might affect a transfer pricing analysis. This is the approach adopted in these guidelines, and it is hoped that the result will achieve the aim of providing a practical guide to transfer pricing issues and the application of the arm's length principle.

12. Inland Revenue acknowledges that the guidelines cannot provide an exhaustive discussion of transfer pricing issues. Taxpayers may therefore wish to look to additional sources for advice on how to apply the arm's length principle. The OECD guidelines should obviously be the first point of reference, particularly as they will form the basis for resolving transfer pricing disputes under the mutual agreement articles of New Zealand's double tax agreements. However, on issues concerning the administration of New Zealand's transfer pricing rules on which New Zealand has discretion to establish an independent position, such as documentation, the New Zealand guidelines should be read as paramount.

13. Two other significant references are the guidelines issued by the Australian Tax Office (ATO) and the United States' section 482 regulations. Both of these sources provide valuable background information on the application of the arm's length principle. Obviously aspects in those guidelines that have been drafted with only Australia or the United States in mind, such as the point within a range to which the relevant jurisdiction will seek to adjust taxpayers' transfer prices, will not be relevant in the New Zealand context. However, on issues such as the application of pricing methods and the principles of comparability and functional analysis, for which both jurisdictions follow the established international norm, there should be no inconsistency between the Australian and United States approaches, and that of New Zealand.

## **Key messages**

14. A number of important messages are reiterated throughout these guidelines.

15. Perhaps first and foremost, transfer pricing is not an exact science. These guidelines continually emphasise that transfer pricing is a matter of judgement. ("Judgement" is used here in the sense of establishing the extent to which a factor is significant in determining an arm's length price, as opposed to an intuitive feeling that a price is correct). This is the reason for preparing these guidelines as a practical guide, rather than as prescriptive rules for determining transfer prices.

16. Second, the transfer pricing rules will be administered most efficiently if taxpayers and Inland Revenue co-operate in resolving transfer pricing issues. Taxpayers are encouraged to discuss concerns about their transfer pricing practices with their account manager in Inland Revenue. Alternatively, they could contact either Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340, or John Nash, the Chief Advisor (International Audit), on (04) 802-7290.

17. The final key message is that taxpayers know their business best, and this should influence how they respond to the transfer pricing rules. Taxpayers know how their prices are set and what the economic and commercial justifications are for the actions they take, and this knowledge can be used to develop a strong transfer pricing analysis. If taxpayers make conscientious efforts to establish transfer prices that comply with the arm's length principle, and prepare documentation to evidence that compliance, Inland Revenue is likely to determine *prima facie* that those transfer pricing practices represent a low tax risk, and the review of those practices is likely to be diminished accordingly. By contrast, taxpayers who give inadequate consideration to their transfer pricing practices are likely to receive closer attention from Inland Revenue. Documentation to evidence consistency, therefore, plays a key role in determining whether Inland Revenue is likely to review taxpayers' transfer pricing in greater detail. Inland Revenue considers it to be in taxpayers' best interests to prepare and maintain adequate documentation.

## **Scope of guidelines and application of section FB 2 to branches**

18. These guidelines apply only to the application of section GD 13 (as modified by section GC 1 where relevant). They therefore apply only to transactions between separate entities.

19. The guidelines do not apply to transactions within a single entity, such as between a parent company and its branch operation. Those transactions are subject instead to the apportionment rules in section FB 2.

20. Inland Revenue has received several comments expressing concern that no guidance has been issued to date on the application of section FB 2 to branches.

21. Section FB 2 was intentionally drafted to parallel the wording contained in Article 7 of the OECD Model Tax Convention, and in particular that part of Article 7(2) that attributes to a permanent establishment:

... the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

22. The drafting of section FB 2(1) follows closely that of the OECD, because of New Zealand's policy of following, in relation to branches, the position established by the OECD for permanent establishments.

23. The OECD's current published position on the issue, which Inland Revenue follows, is set out in the loose-leaf version of the OECD's *Model Tax Convention on Income and on Capital* (November 1997), specifically, the:

- commentary on Article 7 (Business Profits) in volume 1, and
- report on the Attribution of Income to Permanent Establishments in volume 2.

24. The OECD is continuing to work on developing guidelines on the application of the arm's length principle to permanent establishments. It is not clear when this work might be expected to be completed, or whether it might entail a change of interpretation of how Article 7 applies. Whatever the outcome, Inland Revenue expects to continue following the position established by the OECD, once it is finalised and published.

## **Mechanisms to reduce transfer pricing disputes**

25. Two mechanisms that can reduce the incidence of transfer pricing disputes and about which Inland Revenue considers brief comment should be made are those of the Competent Authority procedure and advance pricing agreements (APAs).

### ***Competent Authority procedures***

26. New Zealand has a number of bilateral income tax treaties with other countries. One reason for signing such treaties is to eliminate the double taxation that often results from the allocation of tax revenues from international transactions.

27. When a foreign tax administration has initiated or proposed a transfer pricing adjustment, taxpayers can be expected to seek assistance from the New Zealand Competent Authority, either to obtain corresponding adjustments or deductions in New Zealand, or to obtain assistance in presenting its case to the foreign tax administration. The appropriate person to contact in this regard is John Nash, the Chief Advisor (International Audit), on (04) 802-7290.

28. If a transfer pricing adjustment has been made by a foreign tax administration that results in double taxation, a taxpayer may request competent authority consideration under the Mutual Agreement Procedure Article in New Zealand's tax treaties. This could result in a corresponding adjustment being allowed in New Zealand, or the New Zealand Competent Authority taking the issue of appropriate arm's length pricing up with the foreign administration.

29. Taxpayers should not, however, seek to make corresponding adjustments or deductions directly to their tax returns. Such an approach is inconsistent with New Zealand's tax law, which effectively requires the actual transaction price to be used for tax purposes unless the transfer pricing rules substitute an alternative price. The fact that a foreign tax administration has substituted an alternative price for their tax purposes does not change the transaction price to which New Zealand's rules apply.

30. Under the Mutual Agreement Article, an onus is placed on the Competent Authorities of the two countries to attempt to resolve the matter in a way that avoids double taxation.

### ***Advance pricing agreements (APAs)***

31. APAs are another mechanism that can help reduce transfer pricing disputes. An APA is defined, at paragraph 4.124 of the OECD Guidelines, to be:

“an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for that transaction over a given period of time.”

32. The main benefit of an APA from a taxpayer's perspective will be that it can provide certainty of treatment—the taxpayer is provided with the assurance that the transfer prices they determine will be acceptable to Inland Revenue. Once an APA is in place, any Inland Revenue transfer pricing audit activity will, provided the taxpayer continues to comply with the terms and conditions of the APA, extend only to confirming that compliance.

33. Inland Revenue has not established any formal processes for obtaining an APA, as each case may be different, depending on a taxpayer's specific facts and circumstances. If a taxpayer does want to pursue an APA, or wishes to discuss Inland Revenue's likely requirements in the APA process, they should contact either Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340, or John Nash, the Chief Advisor (International Audit), on (04) 802-7290, for further information.

## **Terminology**

34. In the guidelines, the term “multinational” is used to refer to any commonly owned group with members in more than one country. The term “members” refers to constituent parts of that multinational, each having a separate legal existence.

35. The guidelines also frequently refer to “controlled transactions” and “uncontrolled transactions”. A “controlled transaction” is one in which the ownership relationship between the parties is able to influence the transfer price set. In relation to section GD 13, a controlled transaction will be any transaction between associated persons. However, it is possible that the term could have a wider meaning to the extent that section GC 1 applies.

36. An “uncontrolled transaction” is one that is conducted at arm’s length between enterprises that are independent of each other. This could include, for example, transactions between two independent firms, or transactions at arm’s length between a multinational and an independent firm. Uncontrolled transactions form the benchmark against which a multinational’s transfer pricing is appraised in determining whether its prices are arm’s length.

37. Notice should also be taken of the term “related parties”. Section GD 13 applies only to transactions between associated persons. However, because section GC 1 can extend the application of section GD 13 to non-associated parties in certain circumstances, the guidelines use the term “related parties” in preference to “associated persons” to encompass the potential application of both section GD 13 and section GC 1.

## **Future work**

38. The OECD is continuing to undertake work on specialist transfer pricing areas such as global trading and insurance. At this stage, Inland Revenue does not propose to issue its own guidelines in these areas. Instead, Inland Revenue is likely to endorse the OECD guidelines, once issued, in the administration of these areas in the form in which the OECD releases them.

39. It is also unlikely that Inland Revenue will issue separate guidance on attributing income to branches. Although the draft guidelines suggested Inland Revenue would seek to issue guidance in this area also, there would seem little to be gained by replicating the analysis of the OECD once published, given that Inland Revenue is likely to endorse fully any position established by the OECD in this area.

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# Arm's length principle

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## Key points

- The transfer prices adopted by a multinational directly affect the amount of profit derived by that multinational in each country in which it operates. If a multinational adopts non-market values in its transactions, the income calculated for each of its members will be inconsistent with their relative economic contributions.
- The focus of New Zealand's transfer pricing rules is to ensure that the proper amount of income derived by a multinational is attributed to its New Zealand operations.
- New Zealand's transfer pricing rules are based on the arm's length principle stated in paragraph 1 of Article 9 of the OECD Model Tax Convention.
- New Zealand has adopted the arm's length principle because it is considered the most reliable way to determine the amount of income properly attributable to a multinational's New Zealand operations and, because it represents the international norm, it should minimise the potential for double taxation.

## Introduction

40. When independent enterprises deal with each other, market forces ordinarily determine the conditions of their commercial and financial relations. By contrast, when members of a multinational deal with each other, external market forces may not directly affect their commercial and financial relations in the same way.

41. For example, a multinational may be more concerned with its overall profitability than it is with the allocation of those profits between its members. On the other hand, the multinational may well have set its transfer prices with a view to determining accurately the profit attributable to a local operation, perhaps for the purpose of measuring accurately the relative performance of its managers.

42. The upshot is that there are many factors that might drive a multinational's transfer pricing policies. However, these factors can conflict with the objectives of a host government. For this reason special rules have been adopted to determine transfer prices for tax purposes.

43. New Zealand taxes all persons on their income sourced in New Zealand, which means exercising its jurisdiction to tax foreign-based multinationals on profits attributable to their New Zealand operations. These profits, in theory, are expected to be commensurate with the economic contribution made (including commercial risk borne) by those New Zealand operations.

44. New Zealand's transfer pricing rules are intended to measure the amount of income and expenditure of a multinational properly attributable to its New Zealand operation.

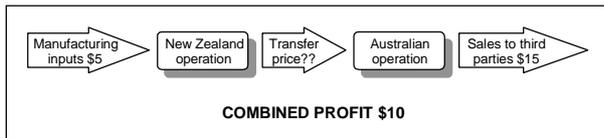
## Importance of transfer prices to determination of tax base

45. The transfer prices adopted by a multinational have a direct bearing on the proportional profit it derives in each country in which it operates. If a non-market value (inadequate or excessive consideration) is paid for the transfer of goods, services, intangible property or loans between those members, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will flow through to the tax revenues of their host countries.

46. For example, if a multinational sells to a controlled entity in a country at a high price (one that exceeds the market selling price), the profit it earns in that country is reduced. Similarly, if the multinational sells into a country at a low price, the profit it earns in that country is increased.

47. The following example illustrates the effect of transfer prices on the profit allocation between firms in two countries. For simplicity, it is assumed that neither firm incurs any distribution costs or other expenses (other than the cost of purchasing the product).

48. Consider a multinational that has a manufacturing operation in New Zealand and a distribution operation in Australia. The cost of producing one unit of a product in New Zealand is NZ\$5.00. The finished product is then sold in Australia for NZ\$15.00. The combined profit for each unit sold is, therefore, NZ\$10.00.



49. The allocation of the \$10.00 per unit profit is determined by the price at which the product is transferred from the New Zealand manufacturing operation to the Australian distributing operation. This inter-operation price is referred to as the transfer price.

50. At one extreme, the transfer price might be set equal to the cost to the New Zealand operation (\$5.00). The entire profit from each unit sold will then accrue to the Australian operation:

	<b>New Zealand Operation</b>	<b>Australian Operation</b>
Transfer price \$5.00		
Sales	\$5.00	\$15.00
Costs	(\$5.00)	(\$ 5.00)
Profit	\$0.00	\$10.00

51. At the other extreme, the transfer price might be set equal to the ultimate selling price of the Australian operation (\$15.00). The entire profit from each unit sold will then accrue to the New Zealand operation instead:

	<b>New Zealand Operation</b>	<b>Australian Operation</b>
Transfer price \$5.00		
Sales	\$15.00	\$15.00
Costs	(\$ 5.00)	(\$15.00)
Profit	\$10.00	\$ 0.00

52. The transfer price adopted by a multinational determines where the profits of that multinational are sourced. Consequently, it also determines whether tax is imposed on the amount of income truly attributable to each jurisdiction in which the multinational operates. From a host government's perspective, therefore, the focus of transfer pricing rules is to ensure that the proper amount of income is attributed to its jurisdiction.

### **Arm's length principle in New Zealand law**

53. New transfer pricing rules was enacted by the Income Tax Act 1994 Amendment Act (No. 3) 1995. The rules replaced the ones formerly found in section GC 1 (section 22, Income Tax Act 1976). The new rules apply from the start of the 1996/97 income year.

54. Tax Information Bulletin Vol 7, No 11 (March 1996) provides a detailed description of how the legislation works. What follows is a discussion of the arm's length principle, the concept on which the legislative mechanics have been built.

55. New Zealand's transfer pricing rules are based on the arm's length principle. The arm's length principle is stated in paragraph 1 of Article 9 of the OECD Model Tax Convention:

“[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

56. Fundamentally, the arm's length principle is based on the notion that the operation of market forces results in a true return to the economic contribution of participants in a transaction. By seeking to remove the effect of the common ownership, the arm's length principle seeks to reduce a transaction within a multinational to one that reflects the conditions that would have existed had the pricing of the transaction been governed by market forces. In this way, the true return to economic contribution for each member of the multinational is determined.<sup>1</sup>

57. The arm's length principle has been enacted into New Zealand legislation in section GD 13(6):

“[The] arm's length amount of consideration must be determined by applying whichever ... method ... will produce the most reliable measure of the amount completely independent parties would have agreed upon after real and fully adequate bargaining.”

58. This rule does not say that an arm's length price will result if a multinational sets its prices based on real and full internal bargaining. Rather, it recognises that real and fully adequate bargaining between unrelated parties is a feature of the operation of market forces in a transaction. Section GD 13(6) therefore requires a multinational to adopt the price that may have arisen had its controlled transaction been governed by normal market forces.

59. The problem to be resolved is how a multinational should determine what price would have arisen if its transactions were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an “uncontrolled transaction”) should be used as a benchmark against which to appraise the multinational's prices (the “controlled transaction”). Any differences between the two transactions can then be identified and adjusted for. By adjusting the price adopted in the uncontrolled transaction to reflect these differences, an arm's length price can be determined for the multinational's transaction.

60. This, in simple form, is what applying the arm's length principle is about. This theme is developed in subsequent chapters of these guidelines.

## **Reasons for adopting arm's length principle**

61. New Zealand has adopted the arm's length principle for two main reasons:

- The arm's length approach is considered the most reliable way to determine the amount of income properly attributable to a multinational's New Zealand operations.
- Because the arm's length approach represents the international norm, the potential for double taxation is minimised.

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<sup>1</sup> It is accepted that the conclusion that market forces lead to the true return to economic contribution is, strictly speaking, debatable. However, it is not the purpose of these guidelines to argue the merits of the arm's length principle over alternative approaches to resolving the transfer pricing problem. The arm's length principle represents the developed international consensus on transfer pricing, which the New Zealand Government has chosen to follow.

### ***Merit of arm's length approach for determining net income***

62. A significant reason for adopting the arm's length principle is that it is considered to provide the most accurate measurement of the fair market value of the true economic contribution of members of a multinational.

63. Parties transacting at arm's length would be expected to endeavour to make efficient use of their resources. In doing this, firms seek to earn the full return to their economic activities. The arm's length principle uses the behaviour of an independent firm as the benchmark for what would be expected of a firm seeking to earn the true return from its economic contribution. By applying this benchmark to a multinational, the arm's length principle seeks to remove the effect of any ownership relationship between members of the multinational from the transfer price it adopts. It is anticipated that this will result in each member of the multinational earning a return that is commensurate with its economic contribution and risk assumed.

64. The arm's length principle also results in a broad parity of tax treatment for multinationals and independent enterprises. This avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

### ***Minimisation of double taxation***

65. Double taxation is undesirable from the Government's perspective, as well as from that of the multinational. While double taxation may increase tax revenue, at least in the short run, it is not conducive to the encouragement of international trade and investment. This could have a detrimental effect on the economy in the long run.

66. The potential for double taxation is illustrated by revisiting our earlier example. Consider the effect if Inland Revenue were to require a transfer price of \$12.00 to be adopted by the multinational, while the Australian Tax Office (ATO) required a price of \$10.00 to be adopted instead. The following profit allocations would then result:

	<b>New Zealand Operation</b>	<b>Australian Operation</b>
Transfer price	\$5.00	\$10.00
Sales	\$12.00	\$15.00
Costs	(\$ 5.00)	(\$10.00)
Profit	\$ 7.00	\$ 5.00

67. The true combined profit has remained unchanged at \$10.00 per unit. However, the multinational is required to return \$12.00 per unit for tax purposes. Clearly, tax is being imposed on more than 100% of the multinational's profit.

68. To address this concern, an important principle followed in developing New Zealand's rules was the need for consistency with the international norm. To this end, both the legislation and New Zealand's guidelines have been based on the international consensus expressed in the OECD guidelines, which deal with the appropriateness and application of the arm's length principle in transfer pricing matters.

69. Because New Zealand's approach is consistent with the arm's length approach adopted by other jurisdictions, it should be easier for Inland Revenue to work with foreign tax authorities to minimise the potential for double taxation.

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# Pricing methods: theoretical and practical considerations

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## Key points

- There are five acceptable transfer pricing methods. These methods are tools for determining an arm's length price, and require the exercise of judgement to be applied correctly.
- New Zealand's legislation does not impose an explicit hierarchy for the transfer pricing methods. However, there is effectively a hierarchy in that certain methods may provide a more reliable result than others, depending on the quality of available data and taxpayers' circumstances. As a general rule, the most reliable measure of the arm's length price will be determined by applying the method that requires the fewest and most reliable adjustments to be made.
- Intangible property is a significant feature in much transfer pricing analysis, but also one of the most difficult to deal with. Because of its unique nature, it is often difficult to identify relevant comparables. The difficulty is compounded if intangible property is applied by both parties to a transaction, or is not readily identifiable. Taxpayers may need to consider applying a profit split approach in such circumstances.
- Generally, a transfer pricing analysis would be expected to result in a range of arm's length outcomes, rather than a definitive arm's length price.
- A key aim of taxpayers in transfer pricing should be to present a persuasive argument to Inland Revenue that its transfer prices are set at arm's length. To this end, taxpayers' transfer pricing practices will be more credible if they are supported by brief analyses under one or more secondary methods.

## Introduction

70. There are several accepted pricing methods for determining arm's length transfer prices and a bewildering set of criteria for applying those methods. One could be forgiven for thinking that these point towards some scientific way of approaching the issue which, if discovered, will lead one to the completely correct conclusion on the amount of an arm's length transfer price.

71. In practice, transfer pricing is far from scientific. Instead, it requires first the identification of an independent firm or firms against which the pricing of a multinational is to be benchmarked and then a judgement on the extent to which the functions of the multinational are similar to, or differ from, those of the independent firm. It then requires a further judgement on the extent to which these similarities or differences have a material effect on the transfer price adopted by the multinational.

72. Several pricing methods have been developed in international practice for determining and appraising a taxpayer's transfer prices. These methods are based on measuring a multinational's pricing strategies against a benchmark of the pricing behaviour of independent firms in uncontrolled transactions.

73. New Zealand's transfer pricing legislation, in section GD 13(7), prescribes that the arm's length price is determined using one or more of the following methods:

- The comparable uncontrolled price (CUP) method
- The resale price method
- The cost plus method
- The profit split method

- Comparable profits methods.

74. The OECD refers to the CUP method, resale price method and the cost plus method as traditional transactional methods. The profit split method and the comparable profits methods are referred to as transactional profit methods.

75. This chapter considers the principles underlying each of the various transfer pricing methods. An understanding of these principles is useful for identifying the limitations of each method, and applying the methods in practice.

## Description of transfer pricing methods

76. A description of the acceptable transfer pricing methods and the differences between them is best given through the use of a simple example. Consider two members of a multinational that have the following profit and loss statements:

### Manufacturer Co:

Sales to Distributor Co	\$10,000	(transfer price)
Less manufacturing costs	<u>(\$ 5,000)</u>	
Gross profit	\$ 5,000	
Operating expenses	<u>(\$ 3,000)</u>	
Net profit	\$ 2,000	

### Distributor Co:

Sales to third parties	\$20,000	
Less purchases from Manufacturer Co	<u>(\$10,000)</u>	(transfer price)
Gross profit	\$10,000	
Operating expenses	<u>(\$ 4,000)</u>	
Net profit	\$ 6,000	

77. The **comparable uncontrolled price (CUP) method** focuses directly on the price of the property or services transferred between parties to a transaction. The price charged between independent parties forms the basis for determining the arm's length price under the CUP method.

78. Thus in the example, the issue to be determined is whether the transfer price adopted between Manufacturer Co and Distributor Co (\$10,000) is consistent with the price adopted by independent firms for a comparable product in comparable circumstances.

79. The **resale price method** focuses on the gross margin obtained by the distributor. This margin represents the amount from which a reseller would seek to cover its selling and other operating expenses and make an appropriate profit in relation to its functions performed, assets used, and risks assumed. The margin obtained by independent distributors performing similar functions, bearing similar risks and contributing similar assets is used as the basis for determining the appropriate margin for the member of the multinational.

80. In the example, the gross margin obtained by Distributor Co is 50% ( $10,000/20,000$ ). The issue to be determined is whether this margin is consistent with the gross margin earned by independent distributors performing comparable functions, bearing similar risks and employing similar assets to those of the multinational.

81. The **cost plus method** focuses on the gross mark-up obtained by the manufacturer. The arm's length price is determined by adding a mark-up to the costs incurred by the member of the multinational to determine an appropriate profit in relation to its functions performed, assets used and risks assumed. This mark-up is determined by reference to the mark-ups earned by comparable independent manufacturers performing comparable functions.

82. In the example, the gross mark-up obtained by Manufacturer Co is 100% ( $(10,000-5,000)/5,000$ ). The issue to be determined is whether this mark-up is consistent with the gross mark-up earned by independent manufacturers performing comparable functions, bearing similar risks and employing similar assets to those of the multinational.

83. The **profit split method** starts by identifying the combined profit to be split between the related parties in a controlled transaction. In general, combined operating profit is used, although gross profits may be appropriate in some circumstances (paragraph 3.17, OECD guidelines). That profit is then split between the parties based upon an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

84. In the example, the combined operating profit of Manufacturer Co and Distributor Co is \$8,000 (\$20,000 sales, less \$5,000 manufacturing costs, less \$7,000 operating expenses). One way that profit could be split might be on the basis of the relative contribution of each member to that profit.

85. The **comparable profits methods** are a range of methods that examine the net profit margin realised by a taxpayer from a controlled transaction relative to an appropriate base. Possible bases include the return on assets, operating income to sales, and other suitable financial ratios.

86. In the example, the distributor may apply the ratio of net profit to sales, giving a net margin of 30% ( $6,000/20,000$ ). The issue to be then determined is whether this net margin is consistent with the net margin earned by independent distributors performing comparable functions to those of the multinational.

87. The net profit approach recognised in the OECD guidelines is the “transactional net margin method” (TNMM).

88. Because of technical differences, there has been much commentary on the extent to which the comparable profits method favoured in the United States (referred to there as the CPM) is consistent with the OECD's TNMM.

89. Inland Revenue does not consider that there is any practical difference between the two approaches. This view is also reflected by the use of the term “comparable profits methods” in section GD 13(7)(e), which is sufficiently broad to encompass both approaches.

### ***Hierarchy of methods***

90. New Zealand's legislation does not impose a hierarchy for the transfer pricing methods. However, there is effectively a hierarchy in that certain methods may provide a more reliable result than others, depending on the quality of available data, and a taxpayer's circumstances. This should become clear from the discussions that follow.

91. There is, however, no requirement for taxpayers to test pricing methods down a hierarchy (either inferred or explicit) to determine an appropriate method. For example, if it appears fairly clear that a CUP will not exist for a particular good or service, taxpayers are neither expected nor required to conduct an exhaustive search for comparables to demonstrate that the CUP method cannot reliably be applied before considering the use of an alternative method.

92. The availability of data is likely to be very important in taxpayers' choice of method. New Zealand is a small market, and this means reliable comparables may be very difficult for taxpayers to locate. Inland Revenue acknowledges this concern, and this is reflected in the guidelines' approach to the use of foreign entities as tested parties and analyses prepared for foreign jurisdictions (see paragraphs 152-160). In addition, section GD 13(7)(d) contemplates the use of the profit split method, which is less dependent on comparables than the other pricing methods.

## Foundation of traditional transactional methods

93. The traditional transactional methods (the CUP, resale price, and cost plus methods) form the starting point for considering the theory underpinning the arm's length principle. The following discussion first builds a very simple scenario designed to illustrate the basic concepts behind the methods. The insights from this scenario are then developed in light of real world business factors.

94. The basic scenario is as follows:

- A country has a number of small factories that manufacture toasters. These toasters are identical to each other in all respects. Each of the manufacturers is similar in size and faces similar manufacturing costs.
- The toasters are sold to consumers by a number of retail firms. All of the retailers sell the toasters to consumers at the same price.
- No firm in the market is able to influence the market price by changing its output, nor is it possible for any firm to grow to such a size as to dominate the market.

95. The price we are interested in is the one at which the manufacturers sell the toasters to retailers (in a controlled cross-border transaction between related parties, this would be the transfer price). From the constraints of the scenario, it is clear that there will be an established market price for the toasters. This is because:

- A retailer is not going to pay more to a manufacturer for a toaster than it would need to pay to obtain the toaster from some other manufacturer (the established market price).
- A manufacturer is not going to accept less from a retailer for a toaster than it could receive from selling the toaster to an alternative retailer (the established market price).

96. No party can affect the market demand for toasters by changing the quantity of its output (meaning the price for toasters also cannot be affected). It follows, therefore, that there will be a standardised price in the market at which the toasters are sold by the manufacturers to the retailers.

97. The economics approach to this scenario is an unconventional way of considering the traditional transactional methods, and is therefore set out in the appendix to this chapter, rather than the main text. The essential points though are that:

- There are a number of identical manufacturers that, by definition, will have identical cost structures. Thus their return on costs will represent a standardised market return for the manufacturing function being performed.
- There are a number of identical distributors that, by definition, will face identical costs in distributing toasters. Thus the portion of the retail price that they retain as profit will represent a standardised market return for the distribution function being performed.
- All three approaches—determining the transfer price directly using the CUP, or indirectly by valuing either the manufacturing function or the distribution function—will result in the identical arm's length price being determined.

98. The resale price and cost plus methods are concerned with providing the retailer and the manufacturer respectively with an adequate reward for the economic functions that they perform. Thus the two methods place a strong focus on the functions performed by the parties to the transaction.

99. The CUP method is also implicitly concerned with rewarding the functions performed by each party to the transaction. However, it does this by focusing directly on the price of the product being transferred.

100. This is a key difference between the traditional transactional methods in practice. The CUP method primarily focuses on the product being transferred, whereas the resale price and cost plus

methods primarily focus on the functions being performed. In a perfect world, all three methods would separately result in the determination of the same arm's length price.

## Real world constraints

101. In practice, things are not as simple as the previous scenario suggests. The number of firms in a particular market may be small, or a single firm may even dominate the market. Toasters are not identical, but are differentiated by brand and quality. The question that needs to be addressed in practical transfer pricing is how such real world factors should be treated.

102. Transfer pricing uses the behaviour of an independent firm as a benchmark for the pricing behaviour that might be expected of a multinational if it were transacting under similar open market conditions. The traditional transactional methods, when applied in practice, make adjustments to the price used by the independent firm to reflect differences in the product of and the functions performed, assets employed, and risks assumed by the multinational.

103. A multinational's transfer pricing policy should therefore involve identifying as close an independent benchmark firm as possible, and then identifying and adjusting differences between the product and functions of the multinational from those of the independent benchmark firm. The multinational should then seek to quantify and adjust for the effect those differences would have on the price adopted for the transaction of the benchmark firm, and then compare that price with its own to see if the prices are consistent with each other. If the prices are consistent, it would be concluded that the multinational's price is consistent with the arm's length principle.

104. The toaster scenario outlined in paragraph 94 can be extended to reflect such differentiation. Consider the following examples:

### Example 1

One of the manufacturers discovers an improvement in the manufacturing process that significantly improves the quality of the toaster but at no additional manufacturing cost. This toaster is then branded and able to be sold to consumers at a premium to other toasters in the market. The distribution function performed by the retailer is no different for the branded toaster than for other toasters.

105. Considering first the resale price method, the key function to be priced is the distribution function. In the example, the manufacturer would not expect to have to reward the retailer of the branded toaster any more than it would to have an ordinary toaster distributed, because there are no abnormal functions being performed. The margin paid for normal toaster distribution would therefore also be applied in determining the arm's length price for the sale of the branded toaster.

106. Considering instead the cost plus method, the question is what mark-up on costs is appropriate. In this case, the manufacturer of the branded toaster has added something tangible beyond what the manufacturer of an ordinary toaster would. The retailer, therefore, would expect to have to pay a higher mark-up to the manufacturer for the branded toaster than for an unbranded toaster, to reflect the improvement made by the manufacturer.

107. Determining the value of the improvement in applying the cost plus method may have significant practical problems, because it is likely to be difficult to identify a comparable independent firm to determine what the improvement is worth. While possible in theory, such an approach may be unrealistic in practice. Thus in example 1, the resale price method is likely to provide a more reliable measure of the arm's length price, as there are fewer functions being valued under the resale price method and adjustments under that method will probably be more reliable than those required under the cost plus method (because of readier access to better quality comparables).

### Example 2

A retailer believes that it can profitably assign a brand to a toaster. By conducting a suitable advertising campaign, it considers it will be able to differentiate that toaster from other toasters in the market and sell it at a higher price. This turns out to be true, even though the toaster, apart from its branding, is no different from other toasters in the market.

108. In this example, if the cost plus method were to be used, the retailer would not expect to have to pay any more to the manufacturer for the branded toaster than it would pay to have an ordinary toaster manufactured. This is because the manufacturing function performed is the same for both branded and unbranded toasters.

109. If the resale price method is used instead, the manufacturer should not expect to pay only the same margin to the retailer to sell the product as it would to have an ordinary unbranded toaster distributed. This is because the advertising function performed by the retailer has added brand value to the toaster and requires greater compensation than is paid for the pure selling function performed for unbranded toasters.

110. Similar to the possible application of the cost plus method in example 1, an attempt to apply the resale price method in example 2 is likely to be unrealistic in practice, because of the difficulty in identifying reliable comparables to value the retailer's additional marketing function. The cost plus method is likely to result in a more reliable measure of the arm's length price, because it is only the simple manufacturing function that needs to be valued under that method.

### ***Most reliable method***

111. The previous two examples have highlighted an important general principle in determining which method is likely to result in the most reliable measure of the arm's length price. As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Thus in example 1, the resale price method required only that the gross margins of distributors be compared. By contrast, in addition to requiring that the gross margins of manufacturers be compared, the cost plus method required an adjustment to be made to price the value of the manufacturer's improvement.

112. Considering the application of the cost plus method in example 1 is still beneficial from a conceptual perspective. It highlights the need to make adjustments under that method to reflect the difference in functions performed by that manufacturer and the other manufacturers (the additional development function). Making such adjustments to reflect better the differences in product and functions of a multinational and a benchmark independent firm is an important feature of practical transfer pricing analysis.

### **Intangible property**

113. The previous discussion touched on, but did not directly identify, what is referred to as intangible property. In economic terms, intangible property is something that an entity owns, other than tangible property, that enables the entity to earn more from a particular activity than it could if it did not own it. The term "intangible" is given its economic sense in these guidelines.

114. Reference should be made to the chapter on intangible property for a detailed discussion of the issue (see paragraphs 406 to 511). The discussion immediately following provides only a fairly simplistic overview, consistent with the aim of this chapter to consider the principles underpinning the use of the acceptable pricing methods.

115. Two forms of intangible property were identified in the previous section:

- a manufacturing intangible, which produced a better quality toaster at no extra cost; and
- a marketing intangible, which established a reputation for the toaster resulting in a valuable favourable consumer perception of the product.

116. An important question with intangible property is to whom the return to any intangible should accrue. In the examples in the previous section, it was concluded that the returns should accrue to the party that created the intangible. If the “retailer” created the intangible, the discussion suggested that some form of a cost plus method might be used to determine an arm’s length price, with the return to the intangible accruing to the retailer. Similarly, some form of the resale price method might be used if the “manufacturer” created the intangible, with the return to the intangible accruing to the manufacturer.

117. This conclusion seems appropriate. Developing intangible property involves some degree of risk. At arm’s length, a firm undertaking such risk would expect to be compensated for bearing that risk. However, ultimately it will be the legal ownership of intangible property that determines the party that benefits directly from the exploitation of the property. Consequently, the compensation might take one of two forms, depending on whether the creator of the intangible property is entitled to legal ownership of that intangible or not:

- If the creator is entitled to legal ownership, it would benefit by directly exploiting the intangible property, directly accruing any gains that arise as a consequence.
- If the creator is not entitled to legal ownership, it would still expect to be compensated for the costs and risks it has borne. This compensation would be expected to be provided by the legal owner of the intangible property, perhaps in the form of a remuneration for services provided by the creator.

118. To illustrate, consider the development of a brand when it is introduced into a country. “XYZ” may be a brand of television set that is well recognised in its home country, but it may not be known when the television is first introduced into New Zealand. The subsequent development of the “XYZ” brand in New Zealand will attribute value to the television, but it may not be clear from where it has arisen. If the development is undertaken by the New Zealand operation, some of the value of the “XYZ” brand in New Zealand is attributable to that development. However, some of the value remains attributable to the value of the “XYZ” brand created in the home country.

119. The legal position of the intangible is quite clear – legal ownership remains entirely with the parent company, even though its value has been enhanced by the marketing activities of its New Zealand subsidiary. The question is how this marketing activity should be compensated if the New Zealand subsidiary does not share in the legal ownership of the brand name.

120. At arm’s length, an independent party would not be expected to incur the cost and risk of a marketing strategy without anticipating something in return. Similarly, application of the arm’s length principle implies that a member of a multinational should not, for tax purposes, be seen to incur the cost and risk of a marketing strategy without some form of compensatory benefit. In the case of the New Zealand subsidiary in the previous paragraph, one option may be through a reduced price for trading stock purchased from the parent company. Alternatively, the marketing might be treated as a service provided to the parent company, with reimbursement being provided on a cost plus basis. This treatment recognises that when independent firms incur costs and risks that will result in the creation of intangible value, they expect to also earn a return to adequately and appropriately compensate them for the assumption of those costs and risks.

### ***Joint ownership of intangible property***

121. To further complicate the issue, intangibles are often not, in practice, readily identified or owned by only one party to a transaction. It is this feature of intangible property that makes transfer pricing so difficult to apply in practice. Real world multinationals have operations that are often integrated over the full range of manufacturing, marketing and distribution functions. In such an environment it may not be readily identifiable that an intangible is being used in the process or which party (or parties) own, or have contributed to, that intangible.

122. Returning to the “XYZ” brand of television, for example, the parent company may have a manufacturing intangible that improves the quality of the television produced. The television may then be marketed in New Zealand under a new brand name, with legal ownership of that brand accruing to the New Zealand subsidiary. In that case, there would be valuable intangible property on both sides of the transaction. If comparables cannot be isolated to identify the value of the respective intangibles, two questions would need to be resolved:

- How is the total value attributable to the intangible property to be ascertained?
- How is this value to be allocated between the respective intangible property?

123. One approach may be to attempt a direct application of the cost plus and resale price methods to the New Zealand and foreign operations respectively. Adjustments could then be made to reflect the intangible value generated by each of those operations. For example, the parent company may increase its mark-up on costs to reflect the market value of its manufacturing intangible in the television. The subsidiary would similarly charge a higher margin on a normal distribution return to reflect the value of its marketing intangible in the sale price to the market.

124. One obvious difficulty with this approach is finding comparable independent firms from which benchmark rates for these adjustments to the margins could be obtained. That is not to say that such an approach may not be feasible in some circumstances. However, taxpayers may find it necessary or desirable to adopt the alternative approach, which is to determine the aggregate profit from the transaction between the parties and then divide this between the parties on the basis of their relative economic contributions. This is referred to as the profit split method.

### **Profit split method**

125. Two alternative approaches to the profit split method are outlined in the OECD guidelines. Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction.

126. The combined profit is then allocated as follows:

- Under the **residual profit split** approach, each of the parties to the transaction is assigned a return to the basic functions that it performs. The residual profit is then allocated between the parties on the basis of their relative contribution to the intangible property.
- Under the **contribution analysis** approach, it is generally the combined operating profit that is divided between the parties on the basis of the relative contribution of each party to that combined gross profit.

127. The OECD guidelines do note, however, that these approaches are not necessarily exhaustive or mutually exclusive (paragraph 3.15). There may be alternative ways to split a profit that lead to a reliable arm’s length result.

128. It is important to distinguish the profit split method from global formulary apportionment. The latter allocates profits between parties on the basis of an arbitrary pre-determined formula, perhaps based on weighting of relative labour costs, relative capital employed, and/or other relative factors. The criticism of the global formulary approach is that the formula is determined without regard to what the parties are actually contributing. By contrast, the profit split method seeks to allocate profits on the basis of the actual relative contributions of the parties to the profit. Thus it seeks to establish a more objective measure of each of the parties’ profit.

### ***Residual profit split analysis***

129. The residual profit split approach is intuitively the more appealing of the two approaches. It can be illustrated by returning to the earlier toaster examples.

130. In the first toaster example, a manufacturer developed a manufacturing process that resulted in a superior quality toaster at no additional manufacturing cost. In the second example, it was the extensive advertising by a retailer instead that increased the value of the toaster. Consider now the scenario when both activities occur simultaneously for a product.

131. The residual profit split approach first provides a basic return to both the manufacturer and the retailer based on what independent firms would obtain for the simple functions of manufacturing and selling an ordinary toaster. Applying a cost plus method to the manufacturer and a resale price method to the retailer could achieve this. The residual amount would then reflect the returns to the intangible property (the manufacturer's quality improvement and the retailer's marketing function). The question is how this residual should be split.

132. The residual profit split approach would seek to divide the residual amount based on the parties' relative contribution to the intangible property. This requires a judgement on what factors contribute to the residual profit and their relative contribution. For example, it may be determined that the process development and the marketing are the only relevant contributors to the residual profit and that each contributes 50% of that profit. A 50:50 split of the residual profit between the manufacturer and the retailer would then be justified.

133. There is no definitive guide on how the relative contribution of the parties should be measured. It is quite likely that the transaction between the parties will be unique, so there will be no external benchmark available against which to test the reliability of the assessment of relative contributions. In practice, the assessment of relative contribution may, of necessity, need to be a somewhat subjective measure based on the facts and circumstances of each case.

### ***Contribution analysis***

134. Multinationals are organisationally different from comparable domestic firms. One implication of this may be that an integrated multinational can reduce its costs below a level that can be achieved by a domestic firm. For example, the administration costs incurred by a multinational which both manufactures and retails toasters are likely to be less than the aggregated costs faced by two separate firms, one of which manufactures toasters, and the other which retails them. In the absence of intangibles, the price determined under the cost plus method would then be higher than the price determined under the resale price method. This means that there would be a negative residual if the residual profit split approach were to be used.

135. This phenomenon is referred to as economies of scope. Large integrated multinationals are able to benefit from cost savings attributable to the scope of their operations that are not available to independent firms.

136. Economies of scope do not fit nicely into traditional arm's length analysis. However, they are an important factor that needs to be addressed when determining whether a multinational's transfer prices are consistent with the arm's length principle.

137. One approach to this problem may be to use the contribution analysis profit split approach. Under this approach, the combined gross profit of the two parties to a transaction is allocated between them on the basis of their relative contribution to that profit. This differs from the residual profit split approach in that basic returns are not allocated to each of the parties to the transaction before the profit split is made.

### ***Reliability of method and acceptability in other jurisdictions***

138. There is some debate internationally about whether the use of the profit split method results in the determination of a true arm's length price. The residual profit split method, for example, is conceptually little more than the use of a traditional transactional method, with an adjustment made to reflect the value of each party's partial economic ownership of the intangible property. However,

there are difficulties with applying the method in practice. Taxpayers need to be aware, therefore, that not all jurisdictions will readily accept the determination of an arm's length price based on the profit split method.

139. Another important consideration generally is how reliably the profit split method measures the arm's length price in practice. Of particular relevance is the likelihood that relative contribution will need to be appraised on a subjective basis.

140. Taxpayers will need to be conscious of both of these considerations if they decide to apply the profit split method. They do not preclude the method being used to determine an arm's length price. They merely highlight that the method needs to be applied with caution.

## Comparable profits methods

141. The final set of methods to consider are the comparable profits methods. These involve the comparison of net profit margins attained by a multinational against those attained by a comparable independent firm, relative to some appropriate base, such as costs, sales, or assets. This section focuses on the transactional net margin method (TNMM) referred to by the OECD. However, as noted in paragraph 89, Inland Revenue does not consider that there is any practical difference between the TNMM espoused by the OECD, the comparable profits method favoured in the United States, and the profit comparison method adopted by Australia. It was also noted that the reference to "comparable profits methods" in section GD 13(7)(e) is wide enough to encompass all three approaches.

142. The TNMM, while being a transactional profit method, is more closely aligned to the resale price and cost plus methods than to the profit split method. The following income statement for a distributor illustrates this alignment in relation to a sales base:

Sales to unrelated third parties	\$1,000
Less transfer price from related manufacturer	<u>\$ 600</u>
Gross profit	\$ 400
Less operating expenses	<u>\$ 250</u>
Net profit	<u>\$ 150</u>

143. Under the resale price method, the distributor's relevant margin is its gross margin of 40% (the ratio of gross profit (\$400) to sales to unrelated third parties (\$1,000)).

144. The TNMM focuses on data from further down the distributor's profit and loss account. For example, if operating expenses are used as the basis for appraisal, the ratio of net profit to operating expenses is 60% ( $\$150/\$250$ ). Alternatively, using sales as the basis for appraisal, the ratio of net operating profit to sales is 15% ( $\$^{150}/\$1,000$ ).

145. The example illustrates why the TNMM is considered less reliable than the traditional transactional methods. The resale price method focuses only on the external sale price to third parties and the gross margin required to reward the function performed by the reseller. These factors are not overly sensitive to differences between the cost structure of a multinational and an independent firm. Thus if the multinational operates a more efficient distributorship than the independent firm, this will flow through to a higher net profit percentage when the resale price method is used.

146. By contrast, the TNMM is very sensitive to the relative cost structures of the entities being compared, because it includes operating expenses in its calculations. An efficient firm will be given the same net profit percentage as an inefficient firm, unless some adjustment can be made to the net margins to reflect relative efficiency. For the reliability of the TNMM to be maximised, the multinational and the independent firm being compared would need to have a very similar structure. In practice, firms are structurally unique, and comparisons of indicators between firms will tend to be less reliable than comparisons made at the gross margin level. It is for this reason that the

TNMM is considered in international practice, along with the profit split method, to be a method of last resort.

147. This observation does not preclude the TNMM from being used. It must be recognised that reliable information on gross margins may be difficult, if not impossible, to obtain. Thus information constraints may dictate the TNMM as the only practicable approach in many cases.

148. Further, there may be situations where an attempt to use gross margins is inappropriate. Consider, for example, a manufacturer that acquires a partially manufactured product from a related party, completes the production of that product, and then sells the finished product to another related party.

149. Based on the preceding discussions, an immediate reaction to these facts may be to consider how the cost plus method might be applied, because a manufacturer is involved. However, in this case, the costs on which a mark-up is based would include the purchase price of the partially manufactured product and that price is itself subject to question whether it is arm's length. Intangible property in the production process may further complicate the issue. A TNMM based on some cost base (excluding the transfer price) may, therefore, be an appropriate way to determine a basic return for the manufacturer's functions.

### **Some practical considerations**

150. The preceding discussions have outlined the broad principles on which the various transfer pricing methods are based. They have not provided detailed guidance on how the methods should be applied in practice. This will be the subject of subsequent guidelines to be issued by Inland Revenue. Those guidelines will also contain practical examples.

151. The remainder of this chapter considers some relevant issues that have not been addressed in the preceding discussions. These are:

- who the tested party in a controlled transaction should be
- the use of analyses prepared for overseas tax administrations
- the evaluation of separate and combined transactions
- the treatment of ranges of results
- the use of multiple methods.

#### ***Tested party***

152. From New Zealand's perspective, the concern is to determine the transfer pricing in relation to the New Zealand member of a multinational. This suggests that the focus should perhaps be on functions performed by the New Zealand member as the basis for determining and applying an appropriate pricing method. In other words, one might assume that the New Zealand member should automatically be the "tested party" for New Zealand transfer pricing purposes.

153. This assumption is not necessarily correct. The aim of transfer pricing is to determine the most reliable measure of the arm's length price. Taxpayers may, based on their circumstances and the information available to them, consider it more appropriate for the foreign party to a transaction involving the New Zealand member of a multinational to be the tested party in determining the most reliable measure of the arm's length price. For example, if the other party were a contract distributor, the obvious choice of method would seem to be the resale price method, based on the activities of that distributor. This might be the case, even though it involves applying the method to the functions of a foreign entity.

154. In deciding whether to use the foreign party to a transaction as the tested party, a taxpayer will need to consider its ability to obtain reliable information about comparable transactions from

which to determine an arm's length price. It may be that using a foreign tested party is impracticable because of information constraints.

155. From Inland Revenue's perspective, the important point is that a pragmatic approach is required. Effective transfer pricing is not about a rigid application of a defined process to determine an arm's length price. It is about using practical approaches that produce a reliable measure of the arm's length price. In determining which party to a transaction to use as the tested party, taxpayers should seek a practical solution that leads to a reliable measure of the arm's length amount.

156. Taxpayers should be aware, however, that Inland Revenue is likely to use the New Zealand party as the tested party in appraising whether a taxpayer's transfer prices are arm's length. It is important, therefore, that if a taxpayer uses a foreign party as the tested party, the price determined is also considered in relation to the New Zealand operations, to ensure that it results in an appropriate return to those operations.

### ***Acceptability of analyses prepared for foreign tax administration***

157. A question that is often raised by taxpayers is whether Inland Revenue will accept a transfer pricing analysis prepared for a foreign tax administration as evidence that a taxpayer's New Zealand transfer prices are at arm's length.

158. The answer to this will depend on whether the analysis prepared results in the most reliable measure of the arm's length price. Most analyses under the accepted pricing methods focus directly on only one side of a transaction (in the case of an analysis prepared for another jurisdiction, this is likely to be the foreign party to the transaction). In applying all but the profit split method, it is not necessary to consider specifically the implications of the price determined for the other party to the transaction.

159. In determining whether an analysis prepared for a foreign jurisdiction is likely to be acceptable to Inland Revenue, therefore, taxpayers should consider what effect the transfer prices adopted overseas would have for the New Zealand operations. Inland Revenue would expect an arm's length price to result in a return to the New Zealand operations that is commensurate with its economic contribution and risks assumed.

160. For example, if an analysis has been prepared that favours the foreign jurisdiction over New Zealand (perhaps because the other jurisdiction is more aggressive than New Zealand in administering its transfer pricing rules), that analysis is unlikely to be acceptable to Inland Revenue. However, if the analysis represents a fair application of the arm's length principle and results in a return from the New Zealand operation's perspective that is *prima facie* commensurate with that operation's economic contribution and risk assumed, that analysis is more likely to persuade Inland Revenue that the transfer prices are arm's length.

### ***Evaluation of separate and combined transactions***

161. Ideally, to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. The OECD guidelines, at paragraph 1.42, cite the following examples:

- some long-term contracts for the supply of commodities or services
- rights to use intangible property
- pricing a range of closely-linked products, such as in a product line, when it is impractical to determine pricing for each individual product or transaction

- the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer.

162. In such cases, it may be appropriate to determine the arm's length price with reference to some "basket of goods" or combination of transactions.

163. However, the converse may also be true. There will be cases where a multinational packages as a single transaction and establishes a single price for a number of benefits, such as licenses for patents, know-how and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as a package deal. In these cases, it may be necessary to consider the component transactions of the package deal separately. This may occur when it is unfeasible to evaluate, or inappropriate to consider, the package as a whole. This latter circumstance may occur if component parts are subject to different tax treatment under New Zealand tax law.

164. The OECD guidelines note, at paragraph 1.44, that even if a package deal combines elements that are subject to different tax treatments, it may still be appropriate to evaluate the transfer price for the entire package. Whether this overall price should then be allocated to each of the elements of the package for the transaction between related parties would then be determined by the Revenue Authority in the same way that it would treat a similar deal between independent enterprises.

165. Paragraph 1.44 of the OECD guidelines further notes that taxpayers should be prepared to show that any package deal or combination of transactions reflects appropriate transfer pricing.

### *Use of ranges*

166. Because transfer pricing involves the application of judgement, it is generally not appropriate to refer to *the* arm's length price. Instead, taxpayers can only be expected to determine an arm's length outcome.

167. One feature of applying the transfer pricing methods is that they often result in a range of arm's length prices, in which no one price is relatively more reliable than any of the others. As noted in paragraph 1.45 of the OECD guidelines, this may be because:

- Application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises.
- Different points in a range may represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction.

168. Some jurisdictions have introduced statistical measures to determine where, within a range, a taxpayer's transfer price must fall to be acceptable to the tax administration. Inland Revenue considers the more relevant issue is whether either:

- the comparable adopted by a taxpayer to determine an arm's length price is reliable, or
- the comparables applied by a taxpayer in identifying an arm's length range of prices in which the taxpayer's transfer price falls are reliable.

169. Provided a taxpayer has adopted a reliable comparable (or comparables) in determining an arm's length transfer price, Inland Revenue will not require that some other price also falling within an acceptable range of arm's length prices be adopted instead. However, Inland Revenue would expect any comparable used to be applied consistently from year to year, unless the taxpayer has a sound reason why it no longer represents a reliable comparable.

### ***Confirming transfer prices through multiple methods***

170. There are conceptual links between each of the transfer pricing methods. This means that there should be a general consistency between transfer prices determined under each of the methods.

171. One of the taxpayer's key aims in transfer pricing should be to present a persuasive argument to Inland Revenue that its transfer prices are set at arm's length. To this end, a taxpayer's transfer pricing practices may be more credible if they are supported by analyses under one or more secondary methods.

172. If a taxpayer does calculate the arm's length price under more than one method, analyses performed under a secondary method should not require the same level of detail as the primary analysis. Even a brief analysis under one or more alternative methods that supports a well established and documented transfer pricing policy determined under a primary pricing method will add further credibility to that transfer pricing policy and reduce the likelihood that Inland Revenue will examine the taxpayer's transfer prices in detail.

### **Summary**

173. Several important principles have been outlined in this chapter:

- Transfer pricing is not scientific. It requires judgements to be made on the extent to which differences in product and functions between a transaction of a multinational and one of a comparable independent firm would be expected to have on relative price.
- There are five acceptable transfer pricing methods. The direct focus of the comparable uncontrolled price (CUP) method is on product similarities. The other four methods focus instead on rewards to economic functions performed, assets employed and risks assumed.
- Both members of a multinational may own valuable intangible property, and valuation of this property may make application of the transactional or TNMM methods impractical. It may be appropriate to consider applying a profit split in such circumstances.
- It is not essential that a transfer pricing analysis focus on the New Zealand operations as a matter of course. There may be circumstances where an analysis based on the foreign party to a transaction may be more appropriate.
- Generally, a transfer pricing analysis would be expected to result in a range of arm's length outcomes, rather than a definitive arm's length price. Taxpayers will then be able to adopt any reliable price or comparable within that range.
- Taxpayers' transfer pricing practices will be more persuasive if they are supported by analyses under more than one acceptable pricing method.

## Appendix: Economics approach to applying traditional transactional methods

174. The economics approach to the traditional transactional methods is often perceived by tax professionals to be an unconventional approach, perhaps because most tax professionals undertake their primary training in law and accounting. However, the approach is useful for identifying the assumptions underpinning each of the traditional transfer pricing methods, and this in turn makes the user more aware of the methods' respective strengths and weaknesses. The purpose of considering the economics approach is to get beyond transfer pricing as a set of rules and processes to follow, and to get instead to the heart of what each of the methods is based on. By understanding the principles on which each method is based, taxpayers and Inland Revenue should be able to make a more realistic analysis of transfer pricing, given the nature of the tools being employed.

175. The traditional transactional methods, in their purest form, are based on the scenario in paragraph 94, namely:

- A country has a number of small factories that manufacture toasters. These toasters are identical to each other in all respects. Each of the manufacturers is similar in size and faces similar manufacturing costs.
- The toasters are sold to consumers by a number of retail firms. All of the retailers sell the toasters to consumers at the same price.
- No firm in the market is able to influence the market price by changing its output, nor is it possible for any firm to grow to such a size as to dominate the market.

176. These essentially are the conditions for the model of perfect competition common in economics literature. It follows from these constraints that there will be an established market price at which the manufacturers will sell the toasters to the retailers, because:

- A retailer is not going to pay more to a manufacturer for a toaster than it would need to pay to obtain the toaster from some other manufacturer (the established market price).
- A manufacturer is not going to accept less from a retailer for a toaster than it could receive from selling the toaster to an alternative retailer (the established market price).

177. Viewed through the eyes of an economist, the three traditional transactional methods effectively consider the transaction from three different perspectives. Regardless of the perspective taken, each method results in the same arm's length price being determined for the scenario in paragraph 94.

178. From an economics approach then, the **resale price method** considers the transaction from the perspective of the manufacturer. The manufacturer has a toaster that it wants to have sold to consumers. The problem it faces is how to get its toaster to the market. The question it is asking, therefore, is how much it will have to pay to have someone sell its finished toaster to the market. Thus the resale price method is seeking to determine what portion of the final selling price is required to adequately reward the services performed by the distributor of a product. This portion is called the resale price margin.

179. This approach is easily reconciled with the conventional approach, which focuses instead on the retailer and asks what margin the retailer could reasonably expect to receive for the functions performed, risks borne, and assets employed (paragraph 2.14, OECD guidelines). Essentially, the conventional approach treats the retailer as a seller of services. Although the retailer will set a price for those services, that price will ultimately be determined by what the market is prepared to pay for them. Thus the real question, even under the conventional approach, is how much the manufacturer will have to pay to have someone (the retailer) sell its finished toaster to the market.

180. Similarly, in relation to the **cost plus method**, the economics approach considers the transaction from the perspective of the retailer. The retailer wants to sell toasters to consumers, but needs to have someone manufacture the toasters to be able to sell them. The question it is asking, therefore, is how much it will have to pay to have someone manufacture the toaster so it can sell it to the market. Thus the cost plus method is seeking to determine what margin over the manufacturing costs would need to be paid to adequately reward the services performed by the manufacturer of a product.

181. Again, this approach is easily reconciled with the conventional approach, which focuses on the manufacturer. It seeks to add an appropriate mark-up to costs to reflect an appropriate profit in light of the functions performed, risks borne, assets employed and the market conditions (paragraph 2.32, OECD guidelines). But in a similar manner to the analysis for the resale price method, while the manufacturer may set a price based on some mark-up on costs, the ultimate price is determined by what the market (that is, the retailer) is prepared to pay for the product. So again, the real question is what margin over the manufacturing costs would need to be paid by the retailer to adequately reward the services performed by the manufacturer of a product.

182. Finally, from an economics approach, the **comparable uncontrolled price (CUP) method** effectively combines both the resale price and the cost plus methods into a single price. If a standardised market price exists for sales from the manufacturer to the retailer (which will be the arm's length price under the CUP method), both the resale price and cost plus methods will point to that price as the arm's length price. The resale price method will identify the arm's length margin based on the standardised resale price less the standardised market price for sales to the retailer. Similarly, the arm's length mark-up on cost will result in the standardised market price being determined. Economically speaking the CUP method implicitly considers the price from the perspective of both the manufacturer and the retailer, but it does this by direct reference to the market price adopted. For this reason, the CUP method, when it can be applied reliably, is considered to provide the most accurate measure of the arm's length price.

183. From an economics approach, therefore, the resale price and cost plus methods are concerned with providing the retailer and the manufacturer respectively with an adequate reward for the economic functions that they perform. Thus the two methods place a strong focus on the functions performed by the parties to the transaction.

184. The CUP method is also implicitly concerned with rewarding the functions performed by each party to the transaction. However, it does this by focusing directly on the price of the product being transferred. This is a key difference between the traditional transactional methods in practice. The CUP method primarily focuses on the product being transferred, whereas the resale price and cost plus methods primarily focus on the functions being performed.

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# Principles of comparability

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## Key points

- Comparability is fundamental to the application of the arm's length principle. Transactions involving an independent firm are used as a benchmark against which to appraise the transfer prices adopted by a multinational.
- For comparisons between an independent firm and a multinational to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable, or reasonably accurate adjustments must be able to be made to eliminate the effect of any differences.
- Functional differentiation between a multinational and a benchmark independent firm is often the most significant factor in analysing comparability. With the exception of the CUP method, which focuses directly on product differentiation, application of the acceptable transfer pricing methods hinges on the comparability of functions performed, assets employed and risks assumed.
- A functional analysis will, in most cases, be an essential tool for finding and organising facts about a business in terms of its functions, risks and intangibles. It identifies how the economically significant activities undertaken by a multinational are divided between each member involved in a transaction under review, and for which respective members should expect to be rewarded.
- Economic theory predicts that when various functions are performed by a group of independent enterprises, the enterprise that provides most of the effort, and more particularly, the rare or unique functions, should earn most of the profit. It is the relative importance of the functions performed, rather than their quantity, that determines the party to which returns should accrue.
- In determining the extent to which differences between the multinational and independent party should be identified and priced, taxpayers should be conscious of the materiality of the adjustments being made. If comparability is taken to extremes, there is a risk that the analysis will result in an absurd determination of the arm's length price.

## Introduction

185. Applying the arm's length principle involves an appraisal of whether the transfer price adopted by a multinational is consistent with the price adopted by independent parties in a benchmark transaction conducted at arm's length.

186. This appraisal process involves three steps:

- A transaction (or transactions) involving an independent firm has to be identified as a basis for comparison.
- Any differences between the transaction of the independent firm and that of the multinational must be identified. To be useful as a basis for determining the arm's length price, the transaction (or transactions) of an independent firm has to be sufficiently similar to the one undertaken by the multinational that either:
  - none of the differences between the situations being compared can materially affect the relevant price or margin being compared, or
  - reasonably accurate adjustments can be made to eliminate the effect of any such differences.

- The effect any differences would be expected to have on relative prices must be quantified. The price adopted by the independent parties is then adjusted to reflect these differences in determining an arm's length price for the transaction of the multinational.

187. The notion of comparability is fundamental to all three steps in this process.

188. Several factors affect comparability. At one end of the range is the relatively simple notion of product differentiation, when the characteristics of the property or services being transferred differ in some manner. In the middle of the range is functional differentiation, when the characteristics of the functions performed, assets employed and risks assumed differ in some manner. At the other end of the range are complex notions such as business strategies when, for example, a new product may be legitimately priced at a level well below that of competing products in order to establish market share in a new market.

189. This chapter considers the principles of comparability and how taxpayers might take these principles into consideration in determining transfer prices that are consistent with the arm's length principle.

## **Product differentiation**

190. The starting point for discussing comparability is with product differentiation. As noted in the previous chapter, the actual characteristics of the product or service being transferred are most critical when the CUP method is to be applied. This is because it focuses directly on the market price for a product, whereas the other methods focus more on the functions performed by each party to the transaction.

191. The OECD guidelines, at paragraph 1.19, cite a number of features that may be relevant in comparing two products:

Characteristics that it may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (eg, licensing or sale), the type of property (eg, patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

192. These characteristics can be illustrated by way of example. Consider an independent firm and a multinational that both manufacture 1.5 volt AA size batteries. Both batteries may have the same size and shape, but the similarities may end there. For example:

- An alkaline battery would sell at a premium to a standard (zinc carbon) battery, because the superior quality alkaline battery would be expected to last significantly longer than the standard battery.
- A battery with a known brand would sell for more than an unknown brand, even if the quality of the two batteries were identical. Other things being equal, consumers would be expected to prefer the battery with an established reputation for reliability.
- A multi-coloured battery may sell for more (or less) than an equivalent black battery, depending on the extent to which consumer preference is influenced by packaging.

193. These characteristics are not exhaustive. Even so, they illustrate the extent to which even apparently superficial differences, such as external colouring, can influence the price set. If the multinational were to use the CUP method as a basis for determining its transfer pricing for tax purposes, it would first need to identify all of the differences between its batteries and those of the independent manufacturer, and determine whether these differences are likely to have a material effect on price. The price of the batteries sold by the independent manufacturer would then need to be adjusted to reflect these differences in determining an arm's length price for the multinational's batteries.

## **Functional differentiation**

194. In practice, functional differentiation will tend to be more important than product differentiation. This is because it is often difficult to locate CUPs on which a transfer pricing analysis can be based. In that case, one of the other pricing methods will have to be used instead. Those other methods focus more directly on the functions being performed, assets employed and risks assumed, than on the product or service being transferred. It is the comparability of functions performed by the multinational and by the comparable independent party, therefore, that become central to the transfer pricing analysis.

195. An important tool in appraising functional differences between a multinational and an independent party is the use of functional analysis. Functional analysis is a method of finding and organising facts about a business in terms of its functions, assets (including intangible property), and risks. It aims to identify how these are divided between the parties involved in the transaction under review.

196. Economic theory predicts that when various functions are performed by a group of independent enterprises, the enterprise that provides most of the effort, and more particularly, the rare or unique functions, should earn most of the profit. For example, a subsidiary may be responsible for the entire assembly of a product. However, if the trademark, know-how and the selling effort rest with the parent, the subsidiary is only acting as a contract manufacturer. It should therefore be entitled to only a relatively small part of the profit (representing a fair return on the functions it performs).

197. Functional analysis serves to identify the economically significant activities (functions performed, assets employed and risks assumed) that are undertaken by the member of an multinational, and for which it should expect to be rewarded. This identifies the nature and characteristics of the related party dealings that have to be priced.

198. Functional analysis also serves to help appraise the validity of an independent firm as a benchmark for appraising the behaviour of a multinational. Consider, for example, an independent firm and a multinational that both sell toasters. The independent firm sells at the retail level with a liability for claims under warranty. By contrast, the multinational sells at the wholesale level with no liability for defects. In this case, the independent firm's functions are quite different from those of the multinational and would not ordinarily be used as a comparable. The multinational should instead attempt to locate a comparable independent firm operating at its own level of the market, and performing similar functions and assuming similar levels of risk to itself.

199. A functional analysis will help to highlight where such significant functional differences may exist. However, it must be noted that functional analysis is not a pricing method in its own right. Rather, it is a tool that assists in the proper determination of an arm's length price.

## **Characteristics of a functional analysis**

200. A taxpayer's main aim in determining and documenting its transfer prices should be to present a persuasive argument to Inland Revenue that its transfer prices are arm's length. A functional analysis can serve two important purposes in this regard.

201. First, the functional analysis should provide those considering the transfer pricing policy of the multinational with a quick overview of the organisation, to familiarise them with its general operations. Second, the functional analysis should seek to identify the functions performed by each member of the multinational, whether charged for or not, and assess the importance of each function to the overall operations of the multinational.

### ***Outline of multinational's operations***

202. The overview of the multinational will outline the overall structure and nature of the business undertaken by a multinational. Some internal documentation, such as organisational charts, may be useful in this regard.

203. General commercial and industry conditions affecting the multinational may also be relevant. This could include information such as

- an explanation of the current business environment and its forecasted changes; and
- how forecasted incidents influence the multinational's industry, market scale, competitive conditions, regulatory framework, technological progress, and foreign exchange market.

204. The multinational itself is not necessarily the only source of such information. Trade associations, for example, may publish trade journals or other documents, or have conducted studies of the market, or have access to industry experts, which may provide valuable information. Competitors and academics may also provide useful information for describing the environment in which the multinational operates.

### ***Analysis of functions of members of multinational***

205. The next step in the process would be to provide some more direct consideration to the transaction under review. Relevant information here could include:

- the nature and terms of the transaction
- economic conditions and property involved in the transaction
- how the product or service that is the subject of the controlled transaction in question flows among the related parties
- information that might indicate whether independent firms dealing at arm's length under comparable circumstances would have entered into a similarly structured transaction.

### ***Contractual terms***

206. The actual contractual terms of the transaction will also be relevant. The explicit contractual terms of a transaction involving members of a multinational may provide evidence as to the form in which the responsibilities, risks and benefits have been assigned among those members.

207. For example, the contractual terms might include:

- the form of consideration charged or paid
- sales or purchase volume
- the scope and terms of warranties provided
- rights to updates, revisions or modifications
- the duration of relevant licenses, contracts or other agreements, and termination or renegotiation rights
- collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services
- credit and payment terms.

208. The contractual terms will be relevant in determining the comparability of a controlled and uncontrolled transaction. Any differences between the contractual terms of the transactions being examined would need to be adjusted in determining an arm's length price for the controlled transaction.

209. However, there may be a limit to the usefulness of the contractual terms. In dealings at arm's length, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract. The contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties.

210. The same divergence of interests may not exist for related parties. It may be necessary, therefore, to evaluate whether the conduct of the parties conforms to the terms of the contract. In some cases, the conduct of the parties may suggest the contractual terms to be a sham, or that they have been amended or superseded by a subsequent oral agreement.

211. Thus even if members of a multinational enter into explicit contractual arrangements with each other, they should still examine the actual functions performed by each member as part of their transfer pricing analyses. This requires an identification of the critical functions in the multinational's operations and a determination of which member (or members) is responsible for performing that function.

### *Examples of relevant functions*

212. At its broadest level, a functional analysis would result in the identification of such general categories as:

- research and development
- product design and engineering
- manufacturing, production and process engineering
- product fabrication, extraction, and assembly
- purchasing and materials management
- marketing and distribution, such as inventory management, warranty administration and advertising
- transport and warehousing
- managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

213. Even so, dividing functions performed by a multinational into such broad category descriptions will not generally be sufficient. Activities within these categories may be divided between a number of members of the multinational. It is also necessary to consider more specific functions performed within these general categories.

214. Tables 1, 2 and 3 list relevant functions that could be assessed for the manufacturing, administrative, and marketing functions respectively. These tables are included for illustrative purposes only. They are not intended to provide an exhaustive list of the functions a multinational should identify as being performed by one or another of its members. Instead, they illustrate the types of functions that it may be relevant to assess in relation to the administrative, manufacturing and marketing operations of the multinational. The tables are neither exhaustive nor limiting, since in practice, the relevant functions in those areas may be more or less than those outlined below.

**Table 1: Functional analysis of manufacturing activity**

1. Develops products.
2. Develops manufacturing process and know-how.
3. Develops product specification plant design.
4. Designs manufacturing plant, machinery, and equipment.
5. Purchases capital equipment.
6. Supervises construction of manufacturing plants and other buildings.

7. Determines raw material and other supplies needed.
8. Develops source of raw material purchases.
9. Purchases raw material.
10. Warehouses raw materials and supplies.
11. Develops raw material flow technique.
12. Controls flow of raw materials.
13. Arranges for freight and insurance on purchases.
14. Plans productions schedules and output.
15. Co-ordinates production and selling.
16. Develops cost standards.
17. Develops quality control standards.
18. Performs quality control functions.
19. Manufactures components.
20. Manufactures other raw materials.
21. Manufactures finished goods.
22. Does manufacture engineering.
23. Determines factory personnel needs.
24. Hires and trains factory personnel.
25. Supervises the different manufacturing operations.
26. Performs maintenance of factory buildings, grounds and equipment.
27. Packages and labels products.
28. Plans investment in plant and equipment and handles financial needs of manufacturing functions.

**Table 2: Functional analysis of general, administrative and selling functions**

1. Develops financial needs and budgets for the group.
2. Plans investments and makes investment decisions.
3. Develops overall marketing strategy.
4. Plans, co-ordinates and supervises market research.
5. Performs market research.
6. Determines advertising and marketing policy.
7. Supervises advertising and marketing.
8. Determines the needs for general, administrative and selling personnel.
9. Hires personnel.
10. Develops training materials.
11. Supervises training of personnel.
12. Trains general, administrative and selling personnel.
13. Determines compensation of personnel.
14. Determines pricing and pricing policy.
15. Establishes credit terms.
16. Develops advertising formats and translations.
17. Determines media in which advertising is to be placed and places advertising.
18. Plans and develops TV commercials.
19. Plans sales promotion and develops promotional materials (eg, design point of display advertising, engineers manufacturing design and manufactures displays).
20. Plans trade conventions and shows.
21. Supervises sales force and does customer contact.
22. Designs and develops packaging material.
23. Manufactures packaging material.
24. Designs material for and develops catalogues.

25. Co-ordinates production schedules with sales.
26. Purchases finished goods.
27. Supervises purchasing and warehousing of finished goods.
28. Warehouses finished goods.
29. Performs inventory control.
30. Ships finished goods.
31. Provides insurance coverage.
32. Warrants product.
33. Handles patent and trademark protection.
34. Assumes inventory risk.
35. Assumes credit risk.
36. Develops accounting systems and software.
37. Maintains accounting records.
38. Performs tax planning and administration.
39. Handles customers' complaints.
40. Handles billing and collection.
41. Handles government matters.
42. Prepares statistical data and financial reports.

**Table 3: Functional analysis of marketing function**

1. Supervises marketing activities.
2. Develops new promotional themes for advertising and product promotion and to whom such services are provided.
3. Develops training material and trains personnel.
4. Develops marketing plans for new products and guidelines for marketing.
5. Co-ordinates the execution of planned marketing strategy of foreign subsidiaries.
6. Approves product authorisation.
7. Designs and develops packaging material to implement marketing strategy and effort.
8. Plans and develops TV commercials.
9. Plans and develops advertising formats, and determines media to be used, such as magazines, newspapers, etc.
10. Co-ordinates production schedules with sales.
11. Plans and develops other promotional material, such as brochures, catalogues, display advertising, etc.
12. Plans trade conventions and shows.
13. Determines personnel needs.
14. Establishes compensation and other personnel incentives.
15. Determines pricing and pricing policy and co-ordinates policy with foreign subsidiary.
16. Establishes credit terms.
17. Responsible for customer contact.
18. Supervises sales force.
19. Performs market research and develops new markets,
20. Identifies need for product modification.
21. Warehouses finished product.
22. Ships product and provides insurance coverage.
23. Warrants product.

**Relative contribution of various functions**

215. The sheer weight of functions performed by a particular member of a multinational is not decisive in determining whether that member should derive the greater share of the profit. It is the relative importance of each function that is relevant. The functions of a member relative to the

other members of a multinational may be few, but if they are the most significant functions in the multinational's operations, the member should be entitled to the major share of the profit.

216. Therefore, it is also relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as whether it is plant and equipment, or valuable intangibles. It should also consider the nature of the assets used, such as their age, market value, location, and property right protections available.

217. When intangibles are identified, it is necessary to clearly establish their nature before attempting to attribute to them any value or to take them into account in applying an arm's length pricing method. Intangibles with different strengths will need to be rewarded differently. For example, a patented production process may be useful, but it may be fairly simple to design around the patented aspects in order to achieve a similar outcome. This type of intangible should not receive the same level of relative reward as a breakthrough patent that uniquely reduces production costs and improves the product so that there is greatly improved customer demand.

218. A functional analysis can assist in identifying the intangibles and the way in which they are used. While judgement will still be needed to determine an appropriate reward for their use, a better decision is likely to be made once the nature of the intangibles and their role in the profit making process are properly understood.

219. For example, an enterprise may be the legal owner of a trademark and the name that it legally protects. It may attribute a high value to these trademarks for which it seeks a direct reward. Under license, subsidiary enterprises in different countries may separately produce, market and support goods bearing this name and trademark. A functional analysis should identify each party's contribution to any manufacturing or marketing intangible. If the economic contribution to the intangible is shared between the parties, but only one party enjoys legal ownership of the intangible, the other party would, at arm's length, be expected to seek some form of reward for its contribution. This would need to be taken into consideration in determining the arm's length price and could influence the selection of a transfer pricing method or the manner by which comparability is assessed against uncontrolled license agreements.

## **Treatment of risk**

220. A significant portion of the rate of return earned by a company reflects the fact that the company is bearing risks of various kinds. In the open market, this assumption of increased risk will be compensated by an increase in the expected return (although this does not mean that the actual return must necessarily also be higher, because this will depend on the degree to which the risks are actually realised).

221. An appraisal of risk is also important in determining arm's length prices. For example, controlled and uncontrolled transactions and entities will not be comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made.

222. The possible risks assumed that should be taken into account in the functional analysis include:

- risks of change in cost, price, or stock
- risks relating to success or failure of research and development
- financial risks, including change in the foreign exchange and interest rates
- risks of lending and payment terms
- risks for manufacturing liability, and
- business risk related to ownership of assets, or facilities.

223. The functions carried out will determine, to some extent, the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length dealings. For example, a distributor taking on responsibility for marketing and advertising is risking its own resources in these activities. It would, therefore, be expected to have a commensurately higher anticipated return from the activity than if it did not undertake the functions. This is in contrast to a distributor acting merely as an agent, who is reimbursed for its costs and receives the income appropriate to that lower risk activity. Similarly, a contract manufacturer or a contract research provider that takes on no meaningful risk would be entitled to a smaller return than if it had assumed the risk.

### ***Consistency of risk allocation with economic substance***

224. It must also be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. A manufacturer may, for example, sell property to a related distributor in another country and claim that the distributor assumes all of the exchange rate risk. However, if the transfer price appears to be adjusted to insulate the distributor from the effects of exchange rate movements, the purported allocation of exchange rate risk may be challenged on the basis that it is inconsistent with the conduct of the parties.

225. Examples 3 and 4, which further illustrate the economic substance of risk allocation, are adapted from the United States' transfer pricing regulations (Reg. 1.482-1(d)(3)(iii)(C)):

#### **Example 3**

A wholly owned subsidiary (Sub Co) enters into a contract with its parent company (Parent Co). Under the contract, it is required to buy and take title to 20,000 units of Product X for each of the next five years. The price is fixed at \$10 per unit. Sub Co markets Product X under its own label, and is responsible for financing all marketing for the product.

Sub Co has adequate financial capacity to fund its obligations under the contract in any circumstances that could reasonably be expected to arise. As it transpires, Sub Co is able to sell only 11,000 units in each of the first three years, at a price of \$11 per unit. In year 4, Sub Co sells its entire inventory of Product X (47,000 units) at a price of \$25 per unit.

226. In example 3, the contractual terms allocating risk were determined before the risk was known or reasonably knowable. Sub Co also had the financial capacity to bear the risk, and its conduct was consistent over time. The conduct of the parties therefore confirms the contractual allocation of the risk to Sub Co.

#### **Example 4**

The facts are the same as example 3, except that Sub Co has only limited capital, and is able to finance its obligations under the contract only through the provision of credit from Parent Co.

227. In example 4, the assignment of the risk to Sub Co is inconsistent with the conduct of the parties. Parent Co has, in substance, assumed the market risk that a large number of Product X would remain unsold. This is because Sub Co would be unable to repay Parent Co in the event that sales of Product X did not eventuate.

228. An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes commercial sense for parties to be allocated a greater share of those risks over which they have relatively more control and from which they can insulate themselves more cheaply than can the other party. This is illustrated in example 5:

**Example 5**

Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B.

229. In example 5, Company A would be unlikely, at arm’s length, to agree to take on substantial inventory risk. This is because it exercises no control over the inventory level, while Company B does.

230. There are many risks, such as general business cycle risks, over which, typically, neither party has significant control. At arm’s length, these risks could be allocated to either party to a transaction. Analysis is required to determine to what extent each party bears such risks in practice.

231. For example, when considering who bears any currency exchange or interest rate risk, it will be relevant to consider the extent to which the taxpayer or the multinational group has a business strategy that deals with the management of such risks. Financial arrangements such as hedges, forward contracts, and put and call options, both “on-market” and “off-market”, are now in common use. Failure on the part of a taxpayer bearing currency exchange and interest rate risk to address such exposure may result from a business strategy of the multinational group that seeks to hedge some or all of the group’s overall exposure to such risks, which indicates that the taxpayer may not actually be bearing the economic exchange rate risk. Such a practice, if not accounted for appropriately, could lead to significant profits or losses being made which are capable of being inappropriately sourced in the most advantageous place to the multinational group.

**Example of a functional analysis**

232. A company resident in country Y (Parent Co) manufactures automobile wheel balancing weights. It sets up a subsidiary in country Z (Sub Co) which does some manufacturing and some processing. In most cases, sales by Sub Co are made to Parent Co and the output warehoused by Parent Co until it is on-sold to independent parties. However, Parent Co on occasion instructs Sub Co to freight the completed wheel weights directly to large independent companies from which Parent Co has taken orders. The freight-inclusive price for sales to large independent companies by Sub Co are the same as if the sales had been made directly by Parent Co.

233. An analysis of the respective functions of Parent Co and Sub Co is shown in table 4:

**Table 4: Functional analysis for Parent Co and Sub Co**

<b>Functions performed</b>	<b>Parent Co (country Y)</b>	<b>Sub Co (country Z)</b>
Design and development of product and machinery	X	
Sourcing materials	X	
Manufacture and packaging of basic components	X	X
Manufacture of specialised components	X	
Warehousing and sales	X	
Arranging and paying for freight	X	X
Provision of technical services	X	

234. The functional analysis suggests that most of the profits should accrue to Parent Co. The number of functions performed is not the controlling factor in this determination. The most important functions generate the profit, and none of the functions performed by Sub Co are sufficiently significant in the overall operation to justify a large share of the profit.

235. A review of the functions performed indicates that the only functions performed by Sub Co are simple operations. Any contract manufacturer, who would not expect to earn a very high rate of return on its operations, could perform these functions.

236. Having determined the essential elements in the operation, consideration could now be given to locating third party information for comparable pricing. In this case, it would be necessary to identify a firm that performs a similar function to that of Sub Co, which is to mould lead around other objects. For example, firms that make fishing sinkers and battery connectors could be comparable, since they perform a similar function to Sub Co. Firms that mould other materials, such as plastic, might also be comparable. The important point is that the functions performed, assets employed and risks assumed by the independent firms are comparable to those of Sub Co.

## **Concluding comments on functional analysis**

237. The preparation of a functional analysis is an important tool that can assist in ensuring that an arm's length consideration is determined in accordance with internationally accepted principles. Inland Revenue would expect to see a functional analysis as part of a taxpayer's transfer pricing documentation in most cases.

238. A functional analysis can be performed with varying levels of detail and can serve a variety of purposes. The scope of the analysis will be determined by the nature, value and complexity of the matters covered by international dealings and the nature of the taxpayer's business activities. These include the strategies that the enterprise pursues and the features of its products or services. Also, factors such as the pricing method that is used and availability of data will affect the extent to which the analysis can be conducted.

239. By determining the relevant functions to be priced, the functional analysis can assist in the selection of a transfer pricing method. It can also assist in the analysis of the level of comparability present in controlled and uncontrolled dealings, and in an assessment of the relative contribution of the parties when a profit split method is used.

240. It is important, however, not to confuse the use of functional analysis with the determination of a transfer price. Functional analysis is not an alternative to searching for comparables. It is a means to establish what sort of comparables should be sought, and what method is likely to be appropriate.

241. The next chapter sets out a four-step practical approach for determining transfer prices. The discussion in that chapter further considers functional analysis in a practical context.

## **Other factors affecting comparability**

242. Factors other than product specification and functions performed may, at arm's length, affect the returns derived by a party to a transaction. The three most important of these factors are:

- economic circumstances;
- business strategies;
- government policies.

243. As with product specification and functions performed, an analysis of these factors involves an appraisal of whether, and to what extent, they would be expected, at arm's length, to have a material effect on price.

### ***Economic circumstances***

244. Arm's length prices may vary across different markets, even for transactions involving the same property or services. To achieve comparability requires that the markets in which the

independent and related parties operate are comparable. Any differences must either not have a material effect on price, or be ones for which appropriate adjustments can be made.

245. The OECD guidelines, at paragraph 1.30, identify a number of relevant factors for comparing markets. They include:

- the geographic location of the market
- the extent of competition in the market
- the availability of substitute goods and services
- transport costs
- the size of the market
- the level of the market, such as whether it is at the retail or wholesale level.

246. These factors may have particular relevance for New Zealand. Because New Zealand is a small country, it may be difficult to obtain comparables from the New Zealand market. Inland Revenue will accept the use of overseas comparables (eg, data from the Australian and United States markets) in taxpayers' transfer pricing analyses. However, taxpayers using such comparables would be expected to assess the expected impact geographic differences have on the price.

247. For example, there may be data to indicate that the gross margins paid to distributors of product X in the United States is 20%. This does not mean that 20% will necessarily be an appropriate gross margin for New Zealand distributors. There are a number of factors that may indicate an alternative gross margin to be more appropriate. For example:

- Consumer preferences may result in a different retail price for a product in the two countries. This raises the question of which party to the transaction should capture any premium in price.
- There may be higher transport costs associated with the New Zealand market. The relative gross margins may be affected by who bears this cost.
- The relative competitiveness of the distribution industries in New Zealand and the United States may differ. This could result in lower gross margins being paid in the more competitive market.
- There may be differences in accounting standards that, if not adjusted for, could distort the relative margins of the parties being compared.

248. Thus while overseas comparables may be useful, taxpayers will need to exercise caution to ensure that appropriate adjustments are made to reflect differences between the New Zealand and foreign markets.

### ***Business strategies***

249. Business strategies are also relevant in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion and other factors bearing upon the daily conduct of business.

250. Business strategies could also include market penetration schemes. A taxpayer seeking to penetrate a new market or to expand (or defend) its market share might temporarily charge a lower price for its product than the price for otherwise comparable products in that market. Alternatively, it might temporarily incur higher costs (perhaps because of start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

251. The important issue is how one should appraise whether a business strategy that temporarily decreases profits in return for higher long-run profits is consistent with the arm's length principle. The relevant question here is whether a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions. For example, it would be expected that a company bearing the cost and risk of a market

penetration strategy would, if successful, create a marketing intangible. The value of this intangible might then be expected to be reflected in future profit margins.

252. Taxpayers can expect business strategies to be subject to closer scrutiny by Inland Revenue. This is not because such strategies are illegitimate. A business strategy such as market penetration can, and does, fail. However, the failure does not of itself allow the strategy to be ignored for transfer pricing purposes.

253. The reason for closer scrutiny is because the time bar on reassessment (section 108, Tax Administration Act 1994) places a limit on the time within which the Commissioner can adjust a taxpayer's transfer prices. If projected increased profits fail to materialise because a purported business strategy is not actually followed by the taxpayer, Inland Revenue would not want to be time-barred from adjusting the taxpayer's transfer prices.

254. Inland Revenue may consider a number of factors in evaluating a taxpayer's claim that it is following a strategy that temporarily decreases profits in return for higher long-run profits.

255. First, the conduct of the parties could be examined to determine if it is consistent with the professed business strategy. For example, a manufacturer may charge its related distributor a below-market price as part of a market penetration strategy. However, one would expect the cost savings to the distributor to be reflected either in the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. Furthermore, unusually intensive marketing and advertising efforts would often accompany a market penetration or market share expansion strategy.

256. Second, the nature of the relationship between the parties to the controlled transaction could be examined to see if it is consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length dealings a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy.

257. Third, Inland Revenue could examine whether there is a plausible expectation that the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. If the expected outcome is implausible at the time of the transaction, the taxpayer's claim may be doubtful. Similarly, Inland Revenue would question a claimed business strategy that is unsuccessful, but nonetheless is continued beyond what an independent enterprise would accept.

### ***Government policies***

258. The OECD guidelines, at paragraphs 1.55 to 1.59, discuss circumstances in which an arm's length price might be adjusted to account for government interventions. Such interventions might include price controls, interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy.

259. The OECD guidelines conclude that as a general rule, these interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The difficulty, however, is that because independent enterprises might not engage in a transaction subject to government interventions, it is unclear how the arm's length principle should apply.

260. In the absence of comparables, the appropriate test would appear to be one of what independent enterprises might have insisted upon if faced by similar circumstances. No clear guidance can be given on the issue. Taxpayers faced with having to deal with the implications of government interventions in the market will, unless independent enterprises are similarly affected, have to exercise their best judgement on what independent enterprises might have done in similar

circumstances. This remains a question of how an entity should most appropriately be rewarded for the functions it performs, assets it employs, and risks it assumes.

## **Materiality in a practical assessment of comparability**

261. There is a limit to how far differences in comparability should be assessed in practice. This chapter has had a strong theoretical emphasis, which has meant that the discussion has generally ignored the concept of materiality.

262. If taken to extremes, an assessment of comparability could be argued to require that even immaterial differences, such as perhaps the choice of a red letter to emboss an otherwise plain white handkerchief in preference to a green letter, should be priced if the arm's length principle is to be applied properly.

263. To draw such a conclusion would miss the purpose of this chapter. The determination of an arm's length price must be a practicable exercise. Although theory suggests that each difference in product, functions, assets and risks should be priced, irrespective of how important it is, transfer pricing remains a practical, rather than a theoretical, science.

264. The purpose of a functional analysis, for example, is to understand the qualitative nature of the functions, assets and risks, to enable a comparison to be made with other enterprises that have similar functions, assets and risks. Allocating actual income to specific functions, assets and risks may be far too difficult a task, and is likely to lead to complexities in analysis.

265. Taking comparability to extreme levels can lead to an absurd examination. Many factors should instead be assessed as part of the business risks, and comparisons made at that level. The application of the transfer pricing methods is ultimately concerned with creating an analysis that is capable of producing a quantifiable result. Some factors that cannot be quantified may need to be addressed indirectly instead.

## **Summary**

266. This chapter has addressed the following key points:

- The principle of comparability is fundamental to the determination of arm's length transfer prices. This is because the prices and returns of an independent firm are used to benchmark the expected prices and returns of a multinational, and a reliable comparison requires comparable products or functions between the two.
- The aim of taxpayers should be to demonstrate to Inland Revenue that their transfer prices are consistent with the arm's length principle. This is likely to involve identifying an independent firm as a benchmark, determining what the material differences are between the transactions of the multinational and the benchmark independent firm, and then pricing those differences to determine an arm's length price.
- A functional analysis will, in most cases, be an essential tool for finding and organising facts about a business in terms of its functions, risks and intangibles. It identifies how the economically significant activities undertaken by a multinational are divided between each member involved in a transaction under review. It identifies the activities for which each member should expect to be rewarded and thereby the nature and characteristics of the related party dealings to be priced.

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# Practical application of arm's length principle

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## Key points

- Practical transfer pricing generally involves following a process to determine arm's length transfer prices. The four-step process developed by the Australian Tax Office (ATO) is one such process that may be followed.
- Inland Revenue endorses the four-step process as a useful tool for taxpayers to develop their reasoning and documentation needed to support their evaluation of their transfer prices. However, taxpayers are not obliged to use the process in determining their transfer prices.
- In developing a process for determining transfer prices, taxpayers need to be aware that their purpose is ultimately to be able to persuade Inland Revenue that their transfer prices are consistent with the arm's length principle. Taxpayers are encouraged to consider discussing their transfer pricing processes with Inland Revenue if they are concerned about their acceptability to the Department.

## Introduction

267. Previous chapters considered the theory behind the acceptable transfer pricing methods, and the principles of comparability that underpin all transfer pricing analysis. This chapter aims to work these theoretical building blocks into a coherent process that can be followed by taxpayers to determine their transfer prices.

268. Inland Revenue's view is that when taxpayers use the four-step process outlined in this chapter, it will help develop the reasoning and documentation needed to support their evaluation of their transfer prices. However, the process outlined is neither mandatory nor prescriptive—the process can be costly and sometimes require expert assistance. The process adopted by a taxpayer will, therefore, still depend on that taxpayer's individual circumstances. Taxpayers should weigh up the costs of developing a more comprehensive transfer pricing analysis against the risk that Inland Revenue will audit and adjust the taxpayer's transfer prices (see paragraphs 317 to 323).

269. Credit must be given here to the Australian Tax Office (ATO). The four-step process below follows their process outlined in paragraphs 509 to 591 of their draft transfer pricing ruling TR 95/D22 (issued 29 September 1995). It is noted that the ATO has subsequently refined its exposition of the process in chapter 5 of TR 98/11 (issued 24 June 1998).<sup>2</sup> Taxpayers may wish to refer to that ruling for further background information on applying the process.

270. If taxpayers would like to discuss the four-step process further with Inland Revenue, they should contact either Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340, or John Nash, the Chief Advisor (International Audit), on (04) 802-7290

## Caveats to four-step process

271. Several caveats must be borne in mind when considering the following process:

- (a) The approach outlined below assumes that the nature of the international dealings is fairly extensive and necessitates a thorough analysis. For enterprises with relatively simple and/or

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<sup>2</sup> Most of TR 95/D22 was issued in final form in TR 97/20. However, the material on the four-step process was separated and released in TR 98/11 instead.

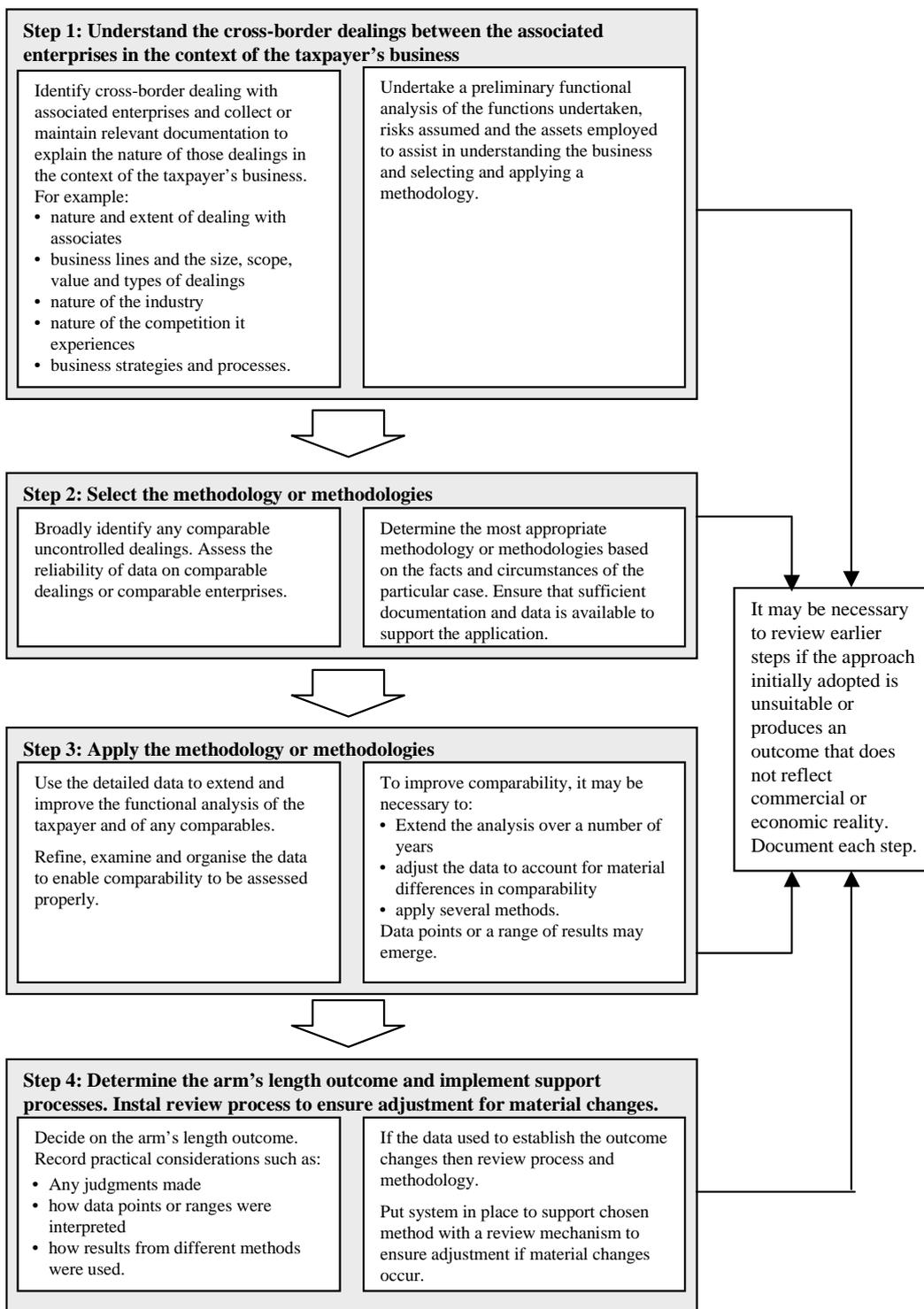
low value international dealings with related parties, the extent of any data collection and analysis may be minimal.

- (b) It may be possible in some cases to adopt either a pricing method or a specific price that has been developed and applied by a multinational on a global basis, after some confirmatory analysis and consideration of its suitability and reliability in relation to the New Zealand member of the multinational. However, the data used to support the pricing method will need to be carefully considered in terms of its relevance and reliability for New Zealand market conditions.
- (c) The analysis contained in this chapter complements the documentation created by enterprises in the normal course of their business dealings. Related parties need to show that their association has not inappropriately affected the nature and terms of their dealings. This requires them to undertake more analyses and keep specific records to demonstrate the arm's length nature of their dealings in circumstances where independent enterprises could merely rely on their normal business records. This additional requirement cannot be eliminated without sacrificing the integrity of New Zealand's transfer pricing rules.

272. Table 5 summarises the four-step process.

**Table 5: the four-step process**

This is an illustration of the four-step process for setting or reviewing transfer prices between associated enterprises. If this process is properly undertaken, the taxpayer should have a lower risk of audit adjustment or penalty.



## **Step 1: Understand the cross-border dealings between related parties in the context of the business**

273. The taxpayer and Inland Revenue staff will need to understand the nature and extent of the dealings between the taxpayer and related parties in the context of the taxpayer's business. It is important for a taxpayer to be able to explain:

- how the international related-party dealings of the enterprise are undertaken
- the purpose or object of the dealings
- what the taxpayer obtains from its participation in the dealings, such as products, services, or strategic relationships
- the significance of the dealings to the taxpayer's overall business activities and those of the multinational group.

274. At this stage of the process, therefore, the taxpayer should prepare some documentation that outlines these considerations. The insight developed in this process will assist in determining the extent of any functional analysis that might be needed for an analysis of comparability in applying the arm's length principle.

275. The taxpayer should also develop a preliminary functional analysis to consider the broad functions performed by the relevant members of the multinational. This will assist in determining an appropriate pricing method in step 2 of the process.

276. The functional analysis should not be comprehensive at this stage. As will be discussed in step 3 of the process, the detail included in a functional analysis is affected by a taxpayer's choice of pricing method. At this stage, the aim of the functional analysis should be to determine which method (or methods) is likely to be appropriate to the taxpayer's circumstances, and the nature of the information that will be required to apply that method.

### ***Location of comparables***

277. A taxpayer should also, at this stage, begin to assess potential sources of information on which to base its analysis. These comparables may be identified internally within the group (if a member of the multinational transacts with an independent external party), or by reference to transactions between independent external parties.

278. If internal comparables can be located, it is likely that they will be more reliable than external comparables. This is because:

- They are more likely to "fit" the affiliated transaction as they occur within the context of the group's business.
- More information about the comparable situation should be readily available.
- One internal comparable may be sufficient to support a defence of the transaction under review, whereas a wider base of support may be required if external comparables are used.

279. It should be noted, however, that internal transactions may not provide reliable comparables for determining an arm's length price if they do not occur on normal arm's length terms. This might be the case if:

- they are not made in the ordinary course of business, or
- one of the principle purposes of the uncontrolled transaction is to establish an arm's length price in relation to the controlled transaction.

280. The following examples illustrate these points:

**Example 6:**

A company is forced into bankruptcy and, as a result, sells all of its products to unrelated distributors for a liquidation price. Because those sales are not made in the ordinary course of business, they will not represent a valid comparable for transfer pricing purposes.

**Example 7**

A firm, operating at 95% of capacity, sells all of its output to related parties. To utilise its excess capacity and to establish an arm's length price, the firm increases its output to capacity. The additional output is then sold to an independent firm at a nominal margin above marginal cost, with that margin being established with a view to creating a desirable comparable for transfer pricing purposes.

The sale to the independent firm would not represent a valid comparable for transfer pricing purposes because one of the principle purposes of the transaction is to establish an arm's length price.

**Step 2: Select the pricing method or methods**

281. Section GD 13(8) requires that the choice and resultant application of a method or methods for calculating an arm's length price must be made having regard to:

- the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer
- the completeness and accuracy of the data relied on
- the reliability of all assumptions
- the sensitivity of any results to possible deficiencies in the data and assumptions.

282. The application of these criteria will depend on the quality of the information available to the taxpayer. Thus at this stage of the process, the taxpayer will need to make an assessment of the quality of the data it has available. This assessment should be made for the purpose of determining which pricing method (or methods) is likely to provide the greatest consistency with the factors in section GD 13(8), and result in the most reliable measure of the arm's length price required under section GD 13(6).

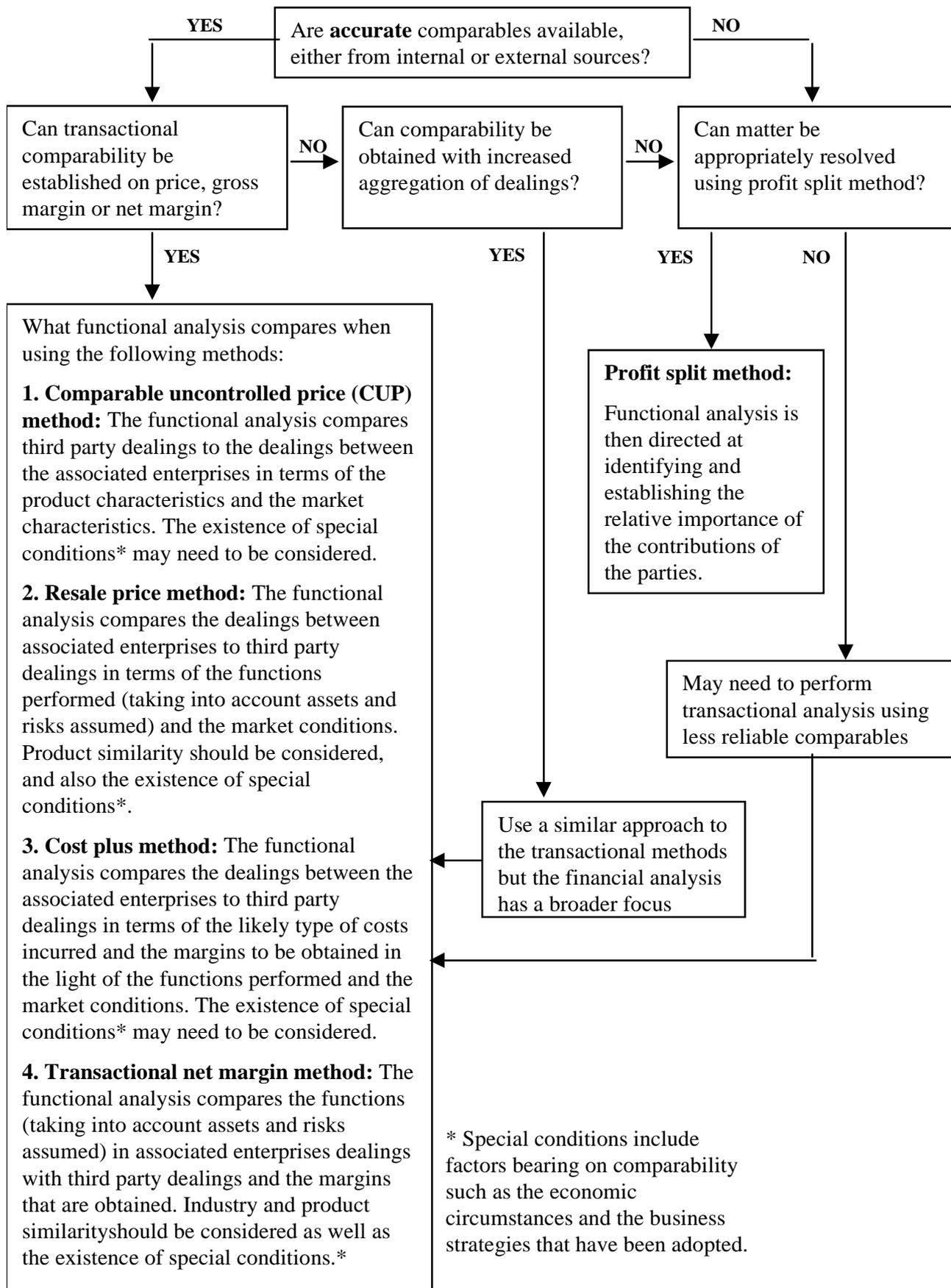
283. To this end, the information obtained in step 1 can assist with the:

- determination of comparability when traditional transactional methods are appropriate, and/or
- determination of comparability between enterprises when pricing methods using profit comparisons are appropriate, and/or
- allocation of the consideration between the enterprises when a profit split method is applicable.

**Step 3: Application of the pricing method or methods**

284. Once a pricing method (or methods) has been chosen, the preliminary functional analysis prepared in step 1 can be extended to reflect that choice of method. Figure 1 shows how the functional analysis may be used differently depending upon the method that is used.

**Figure 1: Use of functional analysis with each methodology**



285. If a pricing method involving external benchmarking with independent enterprises is being used, the functional analysis assists in determining the comparability of the dealings of the multinational with uncontrolled dealings of the independent parties. The main purpose of this is to establish the degree of comparability. It is not, therefore, necessary to value the functions, assets and risks of each of the enterprises separately. However, it is essential to ensure that if there are differences in the significance of the functions, assets and risks to each of the businesses that these differences be taken into account.

286. The functional analysis can be performed with varying levels of detail and can serve a variety of purposes. The analysis may be applied on a product or divisional basis for individual transactions, or it could be applied up to a corporate group basis. The scope of the analysis will be determined by the nature, value and complexity of the matters covered by international dealings. It will also be determined by the nature of the taxpayer's business activities, including the strategies that the enterprise pursues and the features of its products or services.

#### **Step 4: Arriving at the arm's length amount and introducing processes to support the chosen method**

287. The taxpayer will be required to demonstrate how its data has been used in the application of its chosen pricing method to determine an arm's length amount.

288. The process to date can deliver to a taxpayer an objective, documented and considered review of the available material and possible choices for arriving at an arm's length outcome. However, the nature of the arm's length principle is such that there are a number of practical problems in its application. Transfer pricing will always require an element of judgement, and taxpayers and Inland Revenue need to bear this in mind in undertaking their transfer pricing analysis.

289. It also needs to be noted that transfer pricing does not end with the initial analysis. Taxpayers will need to implement appropriate processes to:

- ensure the availability of data for subsequent review analyses, and
- allow modifications to be made in the choice and application of a pricing method to reflect changes in their circumstances or market conditions, or if the process followed does not result in a commercially realistic outcome given their facts and circumstances.

#### **Concluding comments**

290. This chapter has outlined a four-step process that can be used to assist taxpayers develop their transfer pricing analysis. For a more detailed exposition of the process, reference can be made to paragraphs 509-591 of the draft ATO ruling TR 95/D22, or to chapter 5 of the ATO final ruling TR 98/11.

291. The process in this chapter is not intended to be prescriptive. Each taxpayer's circumstances are unique, and a taxpayer will have to develop a process that suits its individual circumstances.

292. If taxpayers are concerned about whether their transfer pricing process will be acceptable to Inland Revenue, they are encouraged to discuss the matter with either Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340, or John Nash, the Chief Advisor (International Audit), on (04) 802-7290. By doing this, taxpayers can be certain from the beginning that their processes will be acceptable to Inland Revenue, before the Department undertakes any risk identification or review action in relation to their transfer prices.

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# Documentation

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## Key points

- A taxpayer's main purpose in preparing and maintaining documentation should be to place itself in the position where it can readily demonstrate to Inland Revenue that its transfer prices are consistent with the arm's length principle.
- There is no explicit statutory requirement to prepare and maintain transfer pricing documentation. However, if, in Inland Revenue's view, a taxpayer's documentation inadequately explains why its transfer prices are considered to be consistent with the arm's length principle, Inland Revenue is more likely to examine those transfer prices in detail. The lack of adequate documentation may also make it difficult for the taxpayer to rebut an alternative arm's length transfer price proposed by Inland Revenue.
- Inland Revenue considers it to be in taxpayers' best interests to prepare documentation that demonstrates the process followed in determining arm's length transfer prices.
- If Inland Revenue adjusts a taxpayer's transfer prices, the quality of the taxpayer's analysis and documentation will be a factor in determining the extent to which penalties might apply under the compliance and penalties provisions enacted in 1996.
- Taxpayers are not expected to prepare levels of documentation that are disproportionate to the amount of tax revenue at risk in their transfer pricing transactions. The cost of preparing documentation should be weighed against the risk that Inland Revenue will make a transfer pricing adjustment in determining the extent to which documentation should be prepared.

## Introduction

293. A taxpayer's main purpose in preparing and maintaining documentation should be to place itself in the position where it can readily demonstrate to Inland Revenue that its transfer prices are consistent with the arm's length principle.

294. This may not necessarily entail a lot of work on a taxpayer's behalf. For example, if a taxpayer follows the four-step process outlined in the previous chapter, it would be normal to create working papers in the course of this process. In simplest terms, these papers could form the basis for the taxpayer's transfer pricing documentation. The final form of the documentation could then include an introduction and description of the process followed, and end with a conclusion about the arm's length nature of the prices.

295. A number of factors must be considered in determining the extent to which taxpayers should prepare documentation.

296. First, Inland Revenue requires information to be able to appraise whether taxpayers' transfer prices are arm's length. Documentation makes Inland Revenue's reviewing task easier and, to the extent that it readily demonstrates that taxpayers have complied with the arm's length principle, reduces the likelihood that Inland Revenue will examine those transfer prices in detail. It will also assist in the resolution of any transfer pricing issues that may arise.

297. On the other hand, preparing documentation involves both time and financial cost to taxpayers. They should not be required to go to such lengths that the compliance costs associated with preparing documentation are disproportionate to the amount of tax revenue at risk.

298. A balance between Inland Revenue's need for information and the potential compliance costs faced by taxpayers is achieved in the legislation through the burden of proof rule in section

GD 13(9). That rule provides that the price determined by a taxpayer will be the arm's length price, except if:

- the Commissioner can demonstrate a more reliable measure of the arm's length amount than that adopted by the taxpayer; or
- the taxpayer does not co-operate with the Commissioner's administration of the transfer pricing rules.

299. Taxpayers are still required to comply with the arm's length principle. However, by documenting using a credible analysis that their transfer prices are arm's length, they can ensure that the statutory burden of proof remains on the Commissioner. This reduces the likelihood that a transfer pricing adjustment will be made by the Commissioner in terms of section GD 13(9).

300. It is important to recognise Inland Revenue's role in administering the transfer pricing rules. The latter part of this chapter sets out a number of options that can be pursued if Inland Revenue is to challenge taxpayers' transfer prices. The earlier part of the chapter sets out what taxpayers can do to reduce this risk. It is important to note, however, that Inland Revenue's approach to administering the rules will not involve a presumption that taxpayers' transfer prices are not set at arm's length.

301. Whether or not Inland Revenue examines a taxpayer's transfer prices in detail will depend largely on the extent to which its transfer prices are perceived to present a risk to the revenue. Taxpayers who are perceived to represent a high tax risk are more likely to have their transfer prices examined in detail than low risk taxpayers.

302. Importantly, however, if a taxpayer can demonstrate that it has set its transfer prices in accordance with the arm's length principle and documented how those prices have been determined, Inland Revenue is likely to conclude that its transfer pricing practices represent a low tax risk. Inland Revenue's role will then primarily be one of monitoring. While this does not necessarily preclude those transfer prices from being examined in detail, Inland Revenue considers the likelihood of a lower risk rating to be a compelling reason for taxpayers to determine and document their transfer prices adequately.

303. An important question is what documentation it is prudent for taxpayers to prepare if they are to demonstrate compliance with the arm's length principle. Unfortunately, it is not possible to specify a comprehensive pre-defined set of documentation requirements that meet the requirements of all taxpayers because appropriate documentation depends on each taxpayer's specific facts and circumstances. This chapter therefore can go no further than attempt to set out the factors that should be considered by taxpayers in determining an appropriate level of documentation in their specific circumstances.

304. As a general rule, however, Inland Revenue considers that taxpayers should look to document the process they have followed and their analysis in determining transfer prices. This should include some justification of why those transfer prices are considered to be consistent with the arm's length principle.

305. The extent to which taxpayers should undertake such analysis will be dependent on their assessment of the level of business risk they carry in their transfer pricing policies. Clearly, taxpayers do not want to incur costs that are disproportionate to the amount of tax at risk, nor does Inland Revenue expect such a level of costs to be borne.

306. However, it is not Inland Revenue's place to specify the amount of analysis and documentation that would be prudent in a taxpayer's circumstances. That is a business decision to be determined by the taxpayer, based on its assessment of risk and the degree of security it desires in relation to its transfer pricing policies.

307. This chapter is divided into two parts:

- **Part A** considers statutory and other factors that must be considered by taxpayers in determining the amount and quality of the transfer pricing documentation that should be prepared and maintained in their particular circumstances.
- **Part B** then considers Inland Revenue's transfer pricing enforcement strategy and the tools available for obtaining and applying information if taxpayers' transfer prices are to be examined in more detail.

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## **Part A: Statutory and other considerations in determining documentation to be maintained**

### **Statutory requirements to maintain documentation**

308. The starting point for considering documentation is with taxpayers' statutory obligations to prepare and maintain records. This sets the framework within which taxpayers' transfer pricing documentation obligations must be established.

309. Section 22 of the Tax Administration Act 1994 requires taxpayers to maintain sufficient business records to enable the Commissioner to ascertain their net income. However, the general tenor of section 22 is to require the retention of source documents in relation to entries in a taxpayer's books of account. It does not contemplate the preparation and retention of documentation to justify, on economic and commercial considerations, that those prices are consistent with the arm's length principle. Inland Revenue accepts, therefore, that section 22 has little direct application for the preparation and retention of transfer pricing documentation.

310. Section GD 13 also does not explicitly require taxpayers to prepare and maintain transfer pricing documentation. The onus is instead on the Commissioner, based on an analysis consistent with section GD 13(6) to (8), to demonstrate a more reliable arm's length amount than that adopted by a taxpayer.

311. However, section GD 13 does require taxpayers to determine their transfer prices in accordance with the arm's length principle. To demonstrate compliance with this requirement, Inland Revenue considers it would be necessary for taxpayers to prepare and maintain documentation to show how their transfer prices have been determined, and why these prices are considered to be consistent with the arm's length principle.

312. The first consideration in reaching this conclusion is the burden of proof rule in section GD 13(9). The burden of proof rule is important because it will influence whether an alternative price proposed by Inland Revenue will be acceptable to the Courts. It is therefore an important factor for Inland Revenue to consider in determining whether an alternative measure of the arm's length amount can be substituted for the one adopted by a taxpayer.

313. Section GD 13(9) provides that the price determined by the taxpayer will be the arm's length price, unless:

- the Commissioner can demonstrate a more reliable measure of the arm's length amount than that adopted by the taxpayer; or
- the taxpayer does not co-operate with the Commissioner's administration of the transfer pricing rules.

314. A taxpayer electing not to prepare transfer pricing documentation leaves itself exposed on two counts. First, it is more likely that Inland Revenue will examine a taxpayer's transfer pricing in detail if the taxpayer has not prepared documentation. Second, if Inland Revenue, as a result of this examination, substitutes an alternative arm's length amount for the one adopted by the taxpayer, the

lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to Inland Revenue or in the Courts.

315. The second consideration in concluding that it would be prudent for taxpayers to prepare and maintain documentation to show how their transfer prices have been determined is the required standards of care under the compliance and penalties provisions. Section GD 13(9) contemplates that a taxpayer will do more than merely select an arbitrary transfer amount. Specifically, section GD 13(9) contemplates that a taxpayer will determine its transfer prices for tax purposes in accordance with the rules in section GD 13(6) to (8). Section GD 13(6) requires a taxpayer to determine the arm's length amount using whichever of the method or methods in section GD 13(7) produces the most reliable measure of the arm's length amount. Further, section GD 13(8) requires a taxpayer to determine the most reliable measure of the arm's length amount, having regard to:

- the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer
- the completeness and accuracy of the data relied on
- the reliability of all assumptions
- the sensitivity of any results to possible deficiencies in the data and assumptions.

316. In Inland Revenue's view, adequate documentation is the best evidence that can be presented to demonstrate that these rules have been complied with. If a taxpayer has not prepared any transfer pricing documentation, and Inland Revenue is able to demonstrate a more reliable measure of arm's length amount, Inland Revenue's view is likely to be that the taxpayer has, at a minimum, not exercised reasonable care (carrying a 20% penalty under section 141C of the Tax Administration Act 1994) or has been grossly careless (carrying a 40% penalty under section 141C of the Tax Administration Act 1994) in its determination of an arm's length amount under section GD 13.

### **Trade-off between compliance cost and tax risk**

317. An important issue that needs to be considered concerns the trade-off between the costs of complying in determining an accurate measure of the arm's length amount and the risk that Inland Revenue will audit and adjust a taxpayer's transfer prices.<sup>3</sup>

318. A taxpayer's determination of the arm's length price will be more persuasive in the face of an inquiry by Inland Revenue if its analysis is sound and is supported by good quality documentation. Inland Revenue is likely to use a taxpayer's documentation (or lack of it) as an important factor in determining whether the taxpayer's transfer prices present a risk to the revenue, and whether they should receive further attention. If a taxpayer has developed a sound transfer pricing policy and that policy is clearly documented and made available to Inland Revenue, the risk of an in-depth audit and possible adjustment will be diminished.

319. However, the creation and maintenance of documentation imposes costs on taxpayers. A prudent business manager would weigh the risk of a transfer pricing adjustment being made by Inland Revenue against the cost of developing and documenting an appropriate transfer pricing analysis in determining the extent to which documentation should be prepared. Inland Revenue does not expect taxpayers to prepare levels of documentation that are disproportionate to the amount of tax revenue at risk in their transfer pricing transactions.

320. This raises the important question of how the compliance and penalties provisions would apply if a taxpayer argued that it was prudent, on the basis of a sensibly prepared cost-risk analysis

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<sup>3</sup> See paragraphs 351 to 354. Tax risk should be measured in terms of revenue at risk, including the cash value of any losses that might be foregone.

(an assessment of business risk), not to pursue a full transfer pricing analysis for the transactions in question.

321. In Inland Revenue's view, if a taxpayer has reached the conclusion on the basis of a sensible cost-risk analysis that it is not prudent to pursue a fuller transfer pricing analysis, this would be strongly suggestive that reasonable care has been taken by that taxpayer. Inland Revenue would still expect to see, however, documentation explaining how the conclusion was reached.

322. However, more would be expected from the taxpayer if Inland Revenue is to be persuaded that the taxpayer has an acceptable interpretation. Section GD 13 requires a taxpayer to determine its transfer prices in accordance with the arm's length principle. For an acceptable interpretation to exist, Inland Revenue considers that a taxpayer must have explicitly considered whether its transfer prices are at least broadly consistent with the arm's length principle in assessing the risk of a potential transfer pricing adjustment. To demonstrate this, Inland Revenue would expect to see, at a minimum, the following documentation:

- an identification of the cross-border transactions for which the taxpayer has a transfer pricing exposure
- a broad functional analysis of the taxpayer's operations, to identify the critical functions being performed
- an estimation of the business risk of not undertaking and documenting a more detailed transfer pricing analysis
- an estimation of the costs of complying with the transfer pricing rules.

323. Even if the taxpayer concludes that it is not prudent to undertake a full transfer pricing analysis, it must be noted that Inland Revenue is not precluded from examining and substituting a more reliable measure of the arm's length price (although it should not be assumed that Inland Revenue will review a taxpayer's transfer prices in detail merely because limited documentation has been prepared on the strength of a cost-benefit analysis). Further, a cost-risk analysis will be insufficient to avoid the unacceptable interpretation penalty (if applicable) if it is not a reasonable conclusion on the strength of the analysis that it is unnecessary to pursue a full transfer pricing analysis.

The extent to which documentation should be maintained will be determined by the taxpayer. In making this determination, the taxpayer will need to weigh the benefits of having well-documented transfer pricing practices against the costs involved in producing the documentation and the consequences of having inadequate documentation.

## **Evidence of adequate documentation**

324. Assuming that a cost-risk analysis indicates that a taxpayer should pursue a full transfer pricing analysis, the question arises as to what documentation would indicate adequate consideration by a taxpayer of the factors in section GD 13(8). In Inland Revenue's view, this would be documentation that records the processes followed and the analysis undertaken by the taxpayer in the course of pursuing an adequate transfer pricing policy.

325. An adequate transfer pricing policy will seek to establish transfer prices based upon information reasonably available to the taxpayer at the time of the determination. For example, the OECD guidelines, at paragraph 5.3, note that a taxpayer ordinarily should consider whether its transfer pricing policy is appropriate for tax purposes before its transfer prices are set, and in doing so, could be expected to have:

- made a determination regarding whether comparable data from uncontrolled transactions is available; and

- examined conditions used to establish transfer pricing in prior years, if those conditions are to be used to determine transfer pricing for the current year (in New Zealand's case, this is only likely to have application for prices set for the 1997/98 and subsequent income years under the new transfer pricing rules).

326. As regards the extent of the process that would need to be documented, the OECD guidelines, at paragraph 5.4, go on to state that:

The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance.

327. The extent to which a taxpayer prepares documentation should reflect the exercise of such principles.

### ***Time for determining transfer prices***

328. Ideally, a taxpayer will set and document its actual prices for a transaction in accordance with the arm's length principle when or before the relevant transaction occurs.

329. However, Inland Revenue recognises that taxation transfer prices of a multinational can legitimately differ from the actual transfer prices it adopts for other purposes. From the perspective of operating the multinational's day-to-day business, it may not necessarily be important to determine arm's length transfer prices at the time a transaction occurs if, for example, the transfer price adopted will not affect the level of output of members of the multinational. In that case, a transaction within a multinational might proceed on the basis of one price, with an arm's length price being determined for tax purposes only once the taxpayer prepares an income tax return for the period in which the transaction occurs. Any transfer pricing documentation would then be fully compiled at the time the income tax return is completed.

330. In deciding whether taxation transfer prices should be determined when a transaction occurs or when an income tax return is being prepared for the relevant income year, a taxpayer will need to have regard to the persuasiveness of the resulting analysis in demonstrating to Inland Revenue that transfer prices have been set at arm's length. A particular consideration here will be the accuracy with which the facts and circumstances that existed at the time the transaction occurred can be determined, and valid comparables correspondingly identified. If there is insufficient relevant information available, it may be necessary to reconstruct the conditions under which the transaction occurred, which may reduce the quality of the transfer pricing analysis.

331. To avoid this difficulty, Inland Revenue considers that a taxpayer should, as far as practicable, seek to collect and retain documentation that is:

- existing at the time the taxpayer was developing or implementing any arrangement that might raise transfer pricing issues; or
- brought into existence close to the time the transaction occurs.

332. Such documentation might include books, records, studies, analyses, conclusions and any other written or electronic material recording information that may be relevant in the subsequent determination of transfer prices under section GD 13.

333. Inland Revenue views the maintenance of such documentation as a prudent business practice, which should make an evaluation of transfer prices at the time of preparing an income tax return more reliable than a prudential review performed after the event without the aid of such documentation. This would enhance the persuasiveness of a taxpayer's transfer pricing practices, as it reduces the likelihood that the taxpayer's transfer pricing analysis will seek to justify retrospectively its transfer prices without regard to the true facts and circumstances under which the transaction occurred.

A taxpayer will need to weigh up the likely effect of delays between the time a transaction occurs and the time at which an arm's length price is determined in deciding the appropriate time to determine and document its transfer prices. In any case, maintaining documentation that either existed at the time a relevant transaction occurred, or was brought into existence as close as practicable to the occurrence of that transaction, will improve the persuasiveness of the taxpayer's transfer pricing analysis.

### ***Process for determining transfer prices***

334. In determining the arm's length price, a taxpayer would generally complete initially some form of functional analysis, and gather data on relevant comparables. This would be expected to point to some appropriate pricing method under which the arm's length price will be determined. Once the appropriate method has been determined, the process becomes one of applying the relevant data to determine the arm's length price.

335. Inland Revenue would expect, therefore, that a taxpayer's documentation would generally reflect this process. The Department would expect to see:

- some form of functional analysis
- an appraisal of potential comparables
- an explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's length principle
- details of any special circumstances that have influenced the price set by the taxpayer.

336. A taxpayer may choose, for example, to document a process such as the ATO's four-step process outlined in the previous chapter. The adoption of such a process would be acceptable to Inland Revenue.

337. Alternatively, the taxpayer may choose to develop its own process for determining arm's length transfer prices. The key point, however, is that whatever process is adopted, a taxpayer should aim to evidence in its documentation how its transfer prices have been determined, and why they are considered to be consistent with the arm's length principle.

### **Preparation of transfer pricing-specific documentation**

338. The arm's length principle imposes requirements on related parties that independent parties dealing at arm's length would not have. For example, independent firms are not required to justify the price of their transactions for tax purposes, but multinationals are required to justify the price adopted in their controlled transactions to evidence compliance with the arm's length principle. Taxpayers may, therefore, be required to prepare or refer to written materials to which they would not otherwise prepare or refer to, such as documents from foreign related parties.

339. The OECD guidelines, at paragraph 5.7, outline the general rule for the preparation of transfer pricing-specific documentation:

While some of the documents that might reasonably be used or relied upon in determining arm's length transfer pricing for tax purposes may be of the type that would not have been prepared or obtained other than for tax purposes, the taxpayer should be expected to have prepared or obtained such documents only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred. The taxpayer should not be expected to have prepared or obtained documents beyond the minimum needed to make a reasonable assessment of whether it has complied with the arm's length principle.

340. In general, Inland Revenue agrees with the rule outlined by the OECD. However, Inland Revenue does not categorically endorse the OECD position that the taxpayer should provide information only if the cost of obtaining such information is not disproportionately high, if such information is being sought from a foreign related party and is indispensable to the transfer pricing analysis.

341. In Inland Revenue's view, the close relationship between the parties *prima facie* discredits the argument that the costs of obtaining the information are disproportionately high and that it should not, therefore, be obtained. Inland Revenue will, therefore, not generally accept such an argument from a taxpayer.

## **Retention of records**

342. Section 22 of the Tax Administration Act 1994 requires that records be kept for:

- seven years after the income year for which they apply
- if requested by the Commissioner in writing, for up to three more years.

343. To the extent that a taxpayer's transfer pricing documentation is not governed by section 22, there is no direct statutory obligation on the taxpayer to retain that documentation for any specified period of time. However, consistent with section 22, it would seem prudent for a taxpayer to retain its transfer pricing documentation for at least the normal statutory period.

344. Further, it may be prudent to maintain some documentation beyond this period, if that documentation is relevant to the setting of transfer prices for a year later than that for which the documentation was originally prepared. Such documentation might include:

- records in relation to long-term contracts, or
- records to determine whether comparability standards relating to the application of a transfer pricing method in a subsequent year are satisfied.

345. The key issue to be considered in deciding whether to retain documentation beyond a seven-year period is whether the documentation in question is likely to be important to support the integrity of a transfer pricing analysis for a subsequent year.

## **Maintaining records other than in English**

346. Section 22 requires certain records to be kept in New Zealand, and maintained in the English language. However, the Commissioner may approve a written request to keep some records outside New Zealand, or maintain them in a language other than English.

347. To the extent that a taxpayer's transfer pricing documentation is not governed by section 22, there is no statutory requirement for transfer pricing documentation to be prepared and retained in English. However, for records retained in a language other than English that are indispensable to the transfer pricing analysis, Inland Revenue would expect the taxpayer to comply with reasonable requests for translation of those documents.

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## **Part B: Inland Revenue's approach to transfer pricing administration**

### **Introduction**

348. This part of the chapter considers several important issues in Inland Revenue's administration of the transfer pricing rules.

349. Consideration is given first to Inland Revenue's approach to transfer pricing audits. The discussion confirms that Inland Revenue will, *prima facie*, assign a taxpayer a low risk rating if the

taxpayer has a considered and sustainable transfer pricing policy and is willing to demonstrate how its transfer prices have been determined.

350. It then gives consideration to responses that are available to Inland Revenue if a taxpayer's transfer pricing practices are to be reviewed, and those practices, or the taxpayer's co-operation, are found to be inadequate.

### **Inland Revenue's approach to transfer pricing reviews and audits**

351. The transfer pricing rules enacted in New Zealand are designed to be effective, but are not intended to impose compliance costs beyond the minimum needed for a reasonable assessment of whether taxpayers have complied with the arm's length principle. However, taxpayers must recognise that the Commissioner has a statutory obligation to quantify the correct amount of tax for all taxpayers, and this includes ensuring that taxpayers involved in cross-border transactions comply with the transfer pricing rules.

352. Resource constraints dictate that Inland Revenue cannot look at all transactions in detail. As a consequence, Inland Revenue's Compliance Programme focuses its resources on perceived risk to the revenue. Taxpayers with a high perceived risk are more likely to be reviewed or audited than those perceived to have a low risk.

353. Inland Revenue's general approach in developing a compliance strategy and determining the type of review or audit that is appropriate for a specific taxpayer is to identify and rate potential tax risk. Transfer pricing is only one of a number of potential risk areas that would be considered in determining whether or not a full tax audit of a taxpayer is warranted.

354. Transfer pricing-specific reviews or audits could be undertaken if Inland Revenue considers them appropriate. However, their prevalence would ultimately depend on the extent of the perceived tax risk associated with the affected taxpayer's transfer pricing practices.

### **Inland Revenue's assessment of risk**

355. Several key factors can be identified to assist in the measurement of risk associated with transfer pricing. Using these factors, Inland Revenue will be able to assess whether a taxpayer's transfer pricing practices represent a low, medium or high tax risk. A taxpayer falling in the medium to high tax risk brackets is more likely to have some attention focused on its transfer pricing practices.

356. Figure 2 provides a quick summary of the main factors Inland Revenue will consider in determining a company's risk rating. It should be noted, however, that the facts of specific cases may mean either that additional factors become relevant to the rating of audit risk, or that they may alter the general indications given in the diagram. The factors outlined in figure 2 are given for guidance only.

**Figure 2: Rating of audit risk**

Low risk	Medium risk	High risk
APA exists. Actively-negotiated prices based on third party pricing	Limited involvement in negotiations with parent	No involvement in negotiations with parent
Strong economic and commercial basis	Limited economic and commercial basis	No economic or commercial basis
Very co-operative	Moderate co-operation	Poor co-operation
Documents clearly support most reliable method and are available	Documents support most reliable method and are available	Limited documents made available
Excellent compliance record	Good compliance record	Poor compliance record

357. A taxpayer's risk rating will be a weighting of the various factors. A company will not automatically be rated as a high risk taxpayer merely because it rates a high risk for one of the relevant factors.

### **Binding ruling/Advance pricing agreement (APA) exists**

358. If a taxpayer seeks a binding ruling or an advance pricing agreement (APA) (see paragraphs 31 to 33), Inland Revenue will be actively involved in the process of establishing whether the taxpayer's transfer pricing practices are consistent with the arm's length principle. Any Inland Revenue compliance activity for the income years for which the APA applies is therefore likely to be confined only to checking that the taxpayer is complying with the terms of the APA (and the assumptions on which the APA is based).

### **Basis for establishment of transfer pricing practice**

359. The way a taxpayer's transfer prices have been established will also provide a guide to the potential tax risk of the taxpayer's practices. Factors that may be considered here will be the extent to which there is real local input and negotiation of the transfer prices based on pricing between independent parties (local input and negotiation do not, of themselves, necessarily lead to arm's length prices) and the extent to which those prices conform to underlying economic and commercial considerations.

360. Internal financial analyses could prove useful in this regard, as they may act as compelling evidence that prices have been set on a commercial basis even if, in retrospect, the prices appear to have led to unreasonable outcomes (for example, poor cost controls by one of the parties has resulted in that party making losses while the other party has remained profitable). Financial projections undertaken before a transaction occurs could also indicate whether the transfer prices adopted would provide sufficiently acceptable commercial returns that parties transacting at arm's length might proceed with the transaction on those terms.

## **Transactions involving non-DTA countries**

361. Taxpayers should be aware that Inland Revenue may look at certain transactions more closely than other transactions. For example, Inland Revenue is likely to inspect a transaction involving an entity resident in a country with which New Zealand does not have a double tax agreement (and in particular, a low-tax jurisdiction country) more closely than a transaction involving tax treaty countries.

362. The existence of a double tax agreement is important here. The exchange of information provision in each of these agreements enables Inland Revenue to verify information provided by taxpayers.

363. It may, therefore, be prudent for a taxpayer to prepare a higher level of justification for the transfer prices it adopts in transactions with non-treaty countries, to reduce the likelihood that Inland Revenue will assign the taxpayer an unfavourable risk rating.

364. This consideration becomes even more important in relation to low-tax jurisdiction countries. Inland Revenue's perception is that transactions involving these countries are often (but not always) motivated by tax, rather than strictly commercial, reasons. Taxpayers must be conscious of this perception in determining how much justification should be given to their transfer prices.

## **Burden of proof rule**

365. Two important factors in Inland Revenue's appraisal of a taxpayer's risk rating will be the quality of a taxpayer's documentation and the credibility of the analysis underpinning it, and the taxpayer's co-operation with Inland Revenue's enquiries. These two factors are closely linked to the burden of proof rule. Implicit in Inland Revenue's consideration of these factors will, therefore, be an appraisal of the likelihood that a taxpayer's transfer prices could be overturned if Inland Revenue is not satisfied that they are set at arm's length.

366. The Income Tax Act 1994 formally places the burden of proof in New Zealand in transfer pricing matters initially on the Commissioner (although this does not remove the onus on a taxpayer to comply with the arm's length principle). However, under section GD 13(9), the burden can be shifted to the taxpayer in two situations:

- The Commissioner can demonstrate a more reliable measure of the arm's length amount than that adopted by the taxpayer; or
- The taxpayer does not co-operate with the Commissioner's administration of the transfer pricing rules.

367. Without adequate information, Inland Revenue will not be able to administer the transfer pricing rules effectively. Failure to voluntarily produce documentation that shows how transfer prices have been set is likely, therefore, to result in the taxpayer being assigned a higher risk rating by Inland Revenue. It may also result in the non-co-operation rule being invoked.

368. It will not be sufficient for Inland Revenue to attempt to substitute an arbitrary arm's length amount if section GD 13(9) applies. Section GD 13(9) requires the Commissioner to determine an arm's length price with reference to the factors in section GD 13(6) to (8). However, if this onus is met, the burden of proof will be shifted to the taxpayer, and it will be up to the taxpayer to then demonstrate that Inland Revenue's position is incorrect.

## ***Demonstration of more reliable measure of arm's length price***

369. The first way Inland Revenue can overturn the taxpayer's determination of the arm's length price is to demonstrate a more reliable measure of the arm's length price. In determining whether to investigate a taxpayer's transfer prices further, Inland Revenue will appraise the likelihood of

whether this onus to demonstrate a more reliable measure can be discharged. A key factor in this appraisal will be the extent to which the taxpayer can (and is willing to) demonstrate that its transfer prices are based on a well-considered appraisal of relevant factors affecting its operations. The quality of a taxpayer's documentation and the credibility of the underlying analysis will be an important factor here.

370. For example, if a taxpayer has merely selected an arbitrary amount as the transfer price, it may be a relatively straightforward matter for Inland Revenue to demonstrate a more reliable measure of the arm's length price under section GD 13(9)(a) than that adopted by the taxpayer.

371. By contrast, if a taxpayer has a thoroughly considered transfer pricing policy, with well-documented analyses and conclusions, it will probably be very difficult for Inland Revenue to discharge the burden of proof in demonstrating a more reliable measure of the arm's length price.

372. Unless there is clear evidence to the contrary, a well-considered and documented transfer pricing policy is likely to result in the taxpayer being assigned a favourable risk rating. However, the same cannot be said for a taxpayer with inadequately documented transfer pricing policies. Such a taxpayer is likely to be assigned a high level of perceived risk, and is, therefore, more likely to be subject to a more in-depth audit inquiry.

### ***Co-operation***

373. The extent to which a taxpayer co-operates with Inland Revenue will also have a significant influence on that taxpayer's risk assessment. Importantly, if a taxpayer does not co-operate with the Commissioner's administration of the transfer pricing rules, and that non-co-operation materially affects the Commissioner's administration of the transfer pricing rules, section GD 13(9) permits the burden of proof to be transferred to the taxpayer.

374. Section GD 13(9) is primarily intended to help Inland Revenue obtain information from a taxpayer to examine its transfer prices. In this context, Inland Revenue considers that non-co-operation occurs in its broadest sense if a taxpayer decides not to provide to Inland Revenue relevant information that it has reasonably available.

375. The important point, however, is that access to information is required if the Commissioner's statutory functions under the Act are to be administered. Inland Revenue considers that it is in a taxpayer's best interest to prepare and retain documentation that indicates that it has adequately considered the factors in section GD 13(8) in setting its transfer prices. If a taxpayer has undertaken such an approach and voluntarily produces its documentation to Inland Revenue, the application of the non-co-operation rule becomes irrelevant.

376. Neither a taxpayer's failure to prepare, and provide to Inland Revenue if requested, adequate documentation, nor Inland Revenue attempting to invoke the non-co-operation provision, is conducive to the efficient administration of the transfer pricing rules, from either the taxpayer's or Inland Revenue's perspective. Inland Revenue's preference is, therefore, clearly for a co-operative environment to exist in which transfer pricing issues might be readily resolved.

### ***Conclusions on burden of proof rule***

377. Despite the burden of proof being placed initially on the Commissioner, Inland Revenue considers it to be clearly in a taxpayer's best interests to make reasonable efforts to:

- develop an appropriate transfer pricing policy
- determine the arm's length amount in accordance with section GD 13(6) to (8)
- voluntarily produce documentation to evidence their analysis.

378. If a taxpayer co-operates with Inland Revenue's administration of the transfer pricing rules and has a considered, sustainable and well documented transfer pricing policy that supports an

arm's length price, it is likely to be very difficult in practice for Inland Revenue to discharge the burden of proof to substitute an alternative transfer price to the one adopted by the taxpayer.

379. A co-operative approach between taxpayers and Inland Revenue is considered the ideal way to administer the transfer pricing rules, and this will be borne in mind in Inland Revenue's application of the rules. However, if co-operation breaks down as a result of an act or acts of the taxpayer, Inland Revenue may invoke the non-co-operation rule as necessary.

### **Inland Revenue's access to and use of documentation**

380. There are two general sources from which Inland Revenue can obtain information. The first is from the taxpayer, by way of enquiries into its transfer pricing practices. Alternatively, information may be sought from sources external to the taxpayer, such as:

- other taxpayers within the same or similar industry
- other jurisdictions, through the exchange of information provisions in a double tax agreement.

381. In the context of a review of a taxpayer's voluntary compliance with the transfer pricing rules, Inland Revenue's primary source for obtaining information will be from the taxpayer itself. However, in certain circumstances, Inland Revenue's ability to obtain adequate information from this source may be limited for reasons other than that taxpayer's non-co-operation. For example, Inland Revenue does not expect taxpayers to produce documents that are not available to the taxpayer because they are unpublished and cannot be obtained by normal inquiry or from market data.

382. Inland Revenue will take these limitations into consideration in determining whether taxpayers have complied with their documentation obligations. However, taxpayers must recognise that despite limitations on their ability to obtain documentation, Inland Revenue may, if a risk assessment suggests that the taxpayer's transfer prices should be examined in greater detail, have to seek information from alternative sources if the taxpayer is unable to provide complete information.

383. Consequently, taxpayers should take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing. This will be true whether the case is relatively straightforward or complex, but the greater the complexity and irregularity of the case, the more significance will attach to documentation.

### ***Obtaining information from foreign related parties***

384. Specific mention needs to be made of obtaining information from foreign related parties. Two issues need to be considered here:

- the relevance of the information to the transfer pricing analysis
- difficulties that may be faced by taxpayers in obtaining the information.

385. If a non-resident parent dictates the transfer price adopted by its New Zealand subsidiary, and the subsidiary has limited, if any, documentation to demonstrate why its transfer prices comply with the arm's length principle, then it may be necessary to have recourse to documentation held by the non-resident parent if the taxpayer's transfer prices are to be reviewed. However, if a taxpayer has a well-documented policy for determining arm's length transfer prices based on appropriate economic and commercial considerations, it is unlikely that Inland Revenue would need to have such recourse.

386. Inland Revenue acknowledges that taxpayers may face difficulties obtaining information from foreign related parties that would not be encountered if they were required to produce only their own documents. For example:

- When the taxpayer is a subsidiary of a foreign related party, information may be difficult to obtain because the taxpayer does not have control of the related party.
- Accounting standards and legal documentation requirements (including time limits for preparation and submission) may differ from country to country.
- The documents requested by the taxpayer may not be of the type that prudent business management principles would suggest the foreign related party would maintain.
- Substantial time and cost may be involved in translating and producing relevant documents.

387. In considering whether to request that taxpayers provide information from foreign affiliates, Inland Revenue will take these potential difficulties, and the relevance of the required documentation, into consideration. However, Inland Revenue considers that the integrity of the transfer pricing rules would be undermined if such arguments were considered to be sufficient to justify the non-provision of relevant information from foreign affiliates.

388. To resolve issues efficiently, Inland Revenue considers it to be in taxpayer's best interests for foreign affiliates to provide relevant information when requested. Because of the close relationship between the parties, Inland Revenue considers it reasonable to expect taxpayers to obtain such information.

389. If foreign affiliates do not co-operate in providing relevant information, it is uncertain as to whether the non-co-operation provision can be applied by Inland Revenue. However, regardless of whether the provision can be applied, taxpayers must be aware that the failure to provide information is likely to result in a higher risk rating. Further, Inland Revenue is likely to have a greater need to access information from alternative sources to test whether their transfer prices are arm's length.

390. Taxpayers should also be aware of the provisions of section 21 of the Tax Administration Act 1994, relating to payments made for acquisitions from a related foreign party. That section allows the Commissioner to deny a deduction in relation to an offshore payment made by a taxpayer if the taxpayer, or any other person, fails to provide information requested under section 17 of the Tax Administration Act 1994 within 90 days of the date that request is mailed. The information requested by the Commissioner would then not be admissible by the taxpayer as evidence in judicial proceedings. Taxpayers must be aware that Inland Revenue can invoke the provision if relevant information from foreign affiliates is not provided voluntarily.

### ***Storage and submission of records to Inland Revenue***

391. It is prudent for transfer pricing documentation to be prepared by taxpayers as close as practicable to the time the relevant transactions occur. However, there will not be any obligation on taxpayers to provide this documentation to Inland Revenue for review at the time the pricing is determined or the tax return is filed. Inland Revenue's ultimate interest will be satisfied if the necessary documents are submitted in a timely manner if requested by Inland Revenue during an examination. The document storage process will therefore be subject to taxpayers' discretion. For example, taxpayers may choose to store relevant documents as unprocessed originals, in a well-compiled book or in electronic form.

### ***Access to and protection of confidential information***

392. Inland Revenue has strong information collection powers that enable confidential information (such as trade secrets) or commercially sensitive information to be obtained. One concern expressed by taxpayers in relation to these powers is the possibility that this information may be disclosed somehow to some third party, such as a competitor.

393. The Commissioner is bound by the secrecy requirements of the Tax Administration Act 1994 to ensure that there is no public disclosure of trade secrets, scientific secrets, or other confidential data. This requirement does not extend to disclosure required in court proceedings. However, every endeavour will be made to ensure that confidentiality is maintained as far as possible in such proceedings.

### **Inland Revenue's use of non-publicly available information**

394. Inland Revenue does not intend as a matter of course to use non-publicly available information in attempting to substitute an alternative measure of the arm's length amount. There are procedural difficulties in using such information, such as the likelihood that such information could not be provided to taxpayers whose transfer prices are under review, because of the secrecy provisions in the Tax Administration Act.

395. Inland Revenue does not rule out the possibility that non-publicly available information will be used in administering the transfer pricing rules, as section GD 13(6) requires that the most reliable measure of the arm's length amount be determined. However, Inland Revenue accepts that it is desirable to rely on publicly available information to the greatest extent possible.

### **Inland Revenue's use of multiple year data**

396. A further concern is that, because Inland Revenue will often examine taxpayers' transfer pricing practices well after the transactions under consideration have occurred, Inland Revenue may seek to use information that becomes available after the transaction occurs to assess taxpayers' transfer pricing. This is, effectively, the use of hindsight.

397. The concern is that this hindsight might be used to appraise taxpayers' transfer prices in light of the relative profits derived by the parties to a transaction over one or more income years. If one party earned a significantly higher profit than the other party, the use of hindsight might attempt to reallocate these profits without regard to the facts and circumstances under which the transactions occurred. This reallocation might then form the basis for a transfer pricing adjustment.

398. Such an approach is inconsistent with the arm's length principle.

399. At arm's length, events occurring after a taxpayer determines its prices would not, unless they can be reasonably predicted at the time those prices are set, affect the determination of those prices.

400. An examination of relative profits from a controlled transaction over a period of time should not, therefore, form the basis for a transfer pricing adjustment. For example, a newly-developed intangible may be difficult to value because of uncertainty as to its future value. Even if time does prove the intangible to be valuable, this is not grounds for automatically adjusting the transfer price. Based on the projected probability of success at the time the transfer occurred, the transfer price may well have been arm's length. Unless reasonably predictable, what eventuated after the transfer does not affect its arm's length price at the time of transfer.

401. An appraisal of a taxpayer's transfer prices must, as a starting point, focus on the conditions under which the taxpayer was operating at the time the relevant transaction occurred. Examining relative profits may, however, form the legitimate basis for Inland Revenue to identify potential review or audit cases.

402. The appropriate use of data from periods subsequent to a transaction being examined is discussed in the OECD guidelines at paragraph 1.51:

Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions for the purpose of determining whether the uncontrolled transaction is an appropriate

comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties.

403. The use of multiple year data may, therefore, be valuable for appraising the reliability of comparables used by a taxpayer in its transfer pricing analysis. However, this is not of benefit only to Inland Revenue. It may be that a taxpayer's transfer pricing policy gains greater persuasiveness as a result of such data becoming available if it supports the reliability of the taxpayer's comparables.

404. The availability and use of documentation in a taxpayer's transfer pricing analysis that is prepared when, or close to when, the relevant transaction occurs will enhance the credibility of a taxpayer's analysis. It will also reduce the likelihood that Inland Revenue will need to look to other information sources to appraise the taxpayer's transfer prices.

## **Summary of general documentation principles**

405. Several important principles have been expressed in this chapter:

- To reduce the likelihood of an audit and a potential transfer pricing adjustment, it is in taxpayers' best interests to document how they have set their transfer prices. That documentation should attempt to demonstrate adequately that the transfer prices adopted are consistent with the arm's length principle.
- Taxpayers should, as far as practicable, make reasonable efforts at the time their transfer prices are set to determine whether they are consistent with the arm's length principle. At the very latest, taxpayers might reasonably be expected to have determined and documented arm's length transfer prices for a transaction by the time they file their relevant income tax return.
- Inland Revenue needs to have recourse to documentation prepared by the taxpayer as a means of verifying compliance with the arm's length principle. However:
  - Transfer pricing should be evaluated based on the same prudent business management principles that would govern the evaluation of any other business decision of a similar level of complexity and importance, and the extent to which a taxpayer prepares documentation should reflect this.
  - Taxpayers are not expected to prepare or obtain documents beyond the minimum needed to make a reasonable assessment of whether they have complied with the arm's length principle.
  - Documentation requirements should not impose on taxpayers costs and burdens disproportionate to their circumstances.
- Taxpayers should recognise that adequate record-keeping practices and voluntary production of documents improves the persuasiveness of their approach to transfer pricing. It also facilitates examinations and the resolution of transfer pricing issues that arise.
- Inland Revenue and taxpayers should co-operate in dealing with documentation issues to avoid an excessive burden being placed on either party. Co-operation should help to:
  - determine what information will be adequate if taxpayers are to apply the arm's length principle reliably and Inland Revenue is to review their analysis, and
  - avoid excessive documentation requirements on taxpayers.

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## Intangible property

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### Key points

- The process for applying the arm's length principle to intangible property is no different than for other property. It can be more problematic to apply, however, because:
  - Valid comparables can be difficult, if not impossible, to locate.
  - For entirely commercial reasons, multinational enterprises (MNEs) may structure their arrangements in different ways to independent firms.
- Functional analysis is critical in determining the real nature of intangible property being transferred. The value of intangible property can be more sensitive to small differences than other property, so it is important that the nature of the transaction (and relevant pricing factors) be fully understood.
- If one party to a transaction does not contribute intangible property, the most straightforward analysis is likely to involve using that party as the “tested party”, even if it is outside New Zealand.
- The value of intangible property is broadly based on perceptions of its profit potential. If there are no reliable comparables on which to apply the pricing methods directly, alternatives may be to:
  - Apply the profit split method, which requires a less rigorous application of comparables than do the other methods.
  - Value intangibles based on evaluations of profit potential.

When dealing with marketing activities of firms that do not own the marketing intangible, it is important to ensure that their compensation is commensurate with what independent entities would have accepted given the rights and obligations under the arrangement.

### Introduction

406. Paragraph 6.2 of the OECD guidelines provides a general description of intangible property:

The term “intangible property” includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets. ... These intangibles are assets that may have considerable value even though they may have no book value in the company's balance sheet. There also may be considerable risks associated with them (eg, contract or product liability and environmental damages).

407. The OECD guidelines focus on trade and marketing intangibles (referred to collectively as commercial intangibles). The reason for distinguishing between these two types of intangibles is that they have different features that lead to the creation of their respective values. Understanding the distinction aids significantly in applying the arm's length principle correctly.

408. The treatment of intangible property can be one of the most difficult areas to apply correctly in transfer pricing practice. Transactions involving intangible property are often difficult to evaluate for tax purposes, because:

- It can be difficult to discern the precise nature of the transaction – the transaction may represent a number of components, both tangible and intangible, bundled together to form a single product.
- The property may have a special character complicating the search for comparables—this might make value difficult to determine at the time of the transaction, or to confirm subsequently as being arm’s length.
- MNEs may, for entirely commercial reasons, structure their transactions in ways that would not be adopted by independent firms.

409. A sound functional analysis (see paragraphs 194 to 241) is an important first step in applying the arm’s length principle to intangible property. Functional analysis can help identify:

- the factors that have led to the creation of intangible value, and consequently where one might expect the rewards to that intangible to accrue
- who the “owner” of the intangible is
- what the true nature of the property being transferred is
- the terms and conditions under which a related party is using an intangible (for example, whether the user is a licensee of the intangible, or merely a contract distributor).

410. The results of the analysis can identify those features of a transaction for which comparables ideally should be identified. It also better enables a check that the price determined is consistent with the true nature of the property being transferred. (Table 7, which contains a list of specific factors that can be particularly relevant in determining the nature of intangible property being transferred, is a key reference in this chapter.)

411. The most desirable way to determine the arm’s length price is through the direct application of reliable comparables. For example, the arm’s length price might be determined directly by reference to the transfer of similar intangible property in an uncontrolled transaction (a comparable uncontrolled price, or CUP), or by comparing the return to a manufacturing function incorporating equivalent intangible property (a cost plus approach). One possibility here is that if one of the parties to the transaction does not contribute any intangible property, that party might be used as the “tested party”, even if it is not the New Zealand party to the transaction (see paragraphs 152 to 156). Alternatively, internal comparables (the transfer of the same property to an independent third party), if available, could prove a valuable source of information (see paragraphs 277 to 280).

412. The often unique nature of intangible property does mean, however, that applying comparables directly may not always be practicable. Further, even if an apparent comparable can be located, it would be erroneous to assume it can usefully be applied mechanically. The key issue in section GD 13 is whether the most reliable measure of the arm’s length price has been determined, not whether a comparable has been identified and applied in a process. In some cases, it may be better that no comparable is applied, rather than applying a patently bad comparable.

413. If comparables cannot be applied directly, recourse might be made to the profit split method, which requires a less rigorous application of comparables than the other methods. Alternatively, the intangible might be valued by reference to reliable projections of future cash flows attributable to that property. Comparables might still be usefully applied in such an approach, possibly, for example, as support for the variables underlying the valuation.

414. One issue that taxpayers should be conscious of, and will need to address in their analysis, is the possibility that a double deduction might arise if a local operation, either directly or indirectly, is

meeting the costs of maintaining intellectual property (generally an issue associated with marketing intangibles). If an independent party would not be required to maintain the intangible in a similar transaction, the local operation should not be paying the same price for the property being transferred as the independent firm, as well as meeting the maintenance expenditure.

415. As with any other area of transfer pricing, the quality of a taxpayer’s analysis and documentation will be a factor in supporting the credibility of its transfer prices. As discussed in the documentation chapter in the draft of Part 1 of the guidelines, taxpayers should weigh the cost of preparing documentation against the risk that Inland Revenue might make an adjustment in determining the extent to which documentation should be prepared for a transaction. In this regard, taxpayers might usefully consider whether an APA would represent a cost-effective way of obtaining greater certainty that their transfer prices will be acceptable to Inland Revenue.

416. This chapter discusses first the identification of the nature of the intangible property being transferred. It then considers ways in which the arm’s length price for the transfer might be determined. Finally, it considers specifically the treatment of marketing intangibles.

417. This chapter is based on the OECD guidelines, and cross-referenced to paragraphs in those guidelines when relevant. If further detail is required, reference should be made to those guidelines.

### Identifying types of intangible property

418. The OECD guidelines begin their discussion of intangible property by distinguishing between two broad types of intangible property – marketing intangibles and trade intangibles (which are essentially non-marketing intangibles). An important reason for this distinction is that the two types of intangible property have different characteristics that give rise to the creation of their intangible value. An awareness of the distinction can be useful in identifying the factors contributing to an intangible’s value, and aids significantly in applying the arm’s length price correctly.

419. For example, the effectiveness of the promotion of a trade name (a marketing intangible) is likely to be a significant factor in determining its value (although the quality of the underlying product or service will also be important). This suggests that an important factor in assessing the value of a marketing intangible used in a transaction will be how that intangible is maintained. For example, a marketing intangible may have a very limited life unless supported by current marketing expenditure (in other words, if current marketing is eliminated, its value will quickly evaporate). Such an intangible is likely to have little or no inherent value, and it would be inconsistent with the arm’s length principle for the intangible to earn anything beyond a nominal return.

420. The value of a trade intangible, by contrast, is more likely to be determined by the use to which it can be applied. It is the inherent quality in the intangible property that is dominant in creating its value.

421. Table 6 summarises the general differences between the two types of intangibles.

<b>Table 6: Distinguishing trade and marketing intangibles</b>	
<i>Trade intangibles</i>	<i>Marketing intangibles</i>
1. Tend to arise from risky and costly research and development.	1. Often cheap to create legally (such as trademarks and trade names) but very costly to develop and maintain value.
2. Generally associated with the	2. Associated with the promotion of

production of goods.	goods or services.
3. Use of a patented trade intangible may result in a monopoly for a product.	3. Competitors are able to enter the same market if products are differentiated.
4. Any legal rights established (for example, a patent) are likely to have a limited life.	4. May have an indefinite life (if properly maintained).

422. Consideration of these differences will be important in determining the nature of any intangible property that is applied in a transaction, and the type of comparables that might need to be identified to assess the value of that property. Thus it will be important in determining:

- the value of any intangible property transferred within a MNE, and
- the amount of income attributable to intangible property and how:
  - the income should be allocated between the parties if ownership of the property is shared.
  - one party to a transaction should be compensated if it contributes to the value of intangible property owned by the other party.

423. The focus, however, should be not so much the ability to correctly classify intangibles into trade and marketing intangibles (because the boundary may be blurred in many instances), but rather on developing an awareness of factors that lead to the creation of value in intangible property of different natures. If the nature of the intangible property under consideration is better understood, so too will be the ability to ascertain effectively the appropriate arm's length price for its transfer.

### **Applying arm's length principle**

424. In principle, the arm's length standard applies to intangible property in the same way as for any other type of property – the methods in section GD 13(7) are applied to determine the most reliable measure of the arm's length price. As noted in paragraph 408, however, the arm's length principle can be difficult to apply in practice to controlled transactions involving intangible property, because:

- It can be difficult to discern the precise nature of the transaction – the transaction may represent a number of components, both tangible and intangible, bundled together to form a single product.
- The property may have a special character complicating the search for comparables – this might make value difficult to determine at the time of the transaction.
- MNEs may, for entirely commercial reasons, structure their transactions in ways that would not be adopted by independent firms (paragraph 6.13, OECD guidelines).

425. For example, a MNE might transfer property that an independent firm would not be prepared to transfer. It is common for MNEs to licence technology to their subsidiaries because they retain control over how that technology is exploited. An independent firm, by contrast, may be more reluctant to licence its technology, out of concern that the other party might use or disclose the detail of the property inappropriately.

426. When attempting to apply comparables to transfer pricing analyses involving intangible property, a key consideration is how reliable those comparables are in practice. Because of the

special character of intangible property, it is possible that even apparently small differences between two items being compared could have a significant effect on their relative value. Consequently, a greater level of care is likely to be required in assessing comparability when intangible property is involved. It cannot be automatically assumed that because two items of intangible property appear comparable outwardly, they are directly comparable. Detailed analysis will often be necessary to determine the extent to which the two items are truly comparable.

427. It is also important to consider both parties to the transaction (paragraph 6.14, OECD guidelines). One might, for example, perform an analysis that demonstrates, from a transferor's perspective, the price at which an independent party would be prepared to transfer property. However, this may not be the same price that an independent party would be prepared to pay, based on the value and usefulness of the intangible in its business. At arm's length, the transaction would not proceed at the price determined from the transferor's perspective. That price could not, therefore, be an arm's length price. (The asymmetry of the interests of the transferor and transferee is commented on further in paragraph 482, in the context of valuation-based approaches to determining the arm's length price.)

### **Ascertaining what the transaction involves**

428. Before appraising whether the price for intangible property is arm's length, it is necessary to ascertain exactly what the transaction involves. This identifies what it is that will need to be priced, ideally by reference to independent comparables. For example, a transaction may involve the transfer of a bundle of rights in a way that is not representative of how independent firms might have undertaken a similar transaction. Segmenting the transfer into its component parts may give a clearer picture of exactly what is being transferred. It might also permit reliable comparables to be more readily identified for each component part, rather than requiring comparables to be located for the transaction as a whole.

429. A central tool for ascertaining what the transaction involves will be a functional analysis. Failure to perform an adequate functional analysis has the potential to cause much controversy and confusion over inter-company transfer pricing for intangible property. In the absence of an adequate analysis, it is likely there will be no meeting of the minds between taxpayers and Inland Revenue on what the transaction involves, let alone how it should be priced.

430. Functional analysis can be used to answer three threshold questions for appraising intangible property:

- Who is the "owner" of the intangible property for transfer pricing purposes?
- What is the true nature of the intangible property being transferred?
- What are the terms and conditions under which a related party is using an intangible? For example, is the user a licensee of the intangible, or merely a contract distributor?

431. The answer to the first question is relevant in identifying where returns to the intangible might be expected to accrue. The answers to the second and third questions identify factors that will be relevant in actually pricing the transfer of the intangible.

### **Ownership of intangible property**

432. A general rule of thumb is that intangible property is owned initially by the party that bears the expenses and risks associated with its development, whether incurred directly, or indirectly through recompensing another entity undertaking work on its behalf. The owner of that property is then entitled to all of the income attributable to that intangible. The principle behind this is that, at arm's length, an independent party would not be prepared to incur such expenditure and assume such risk if it were not going to benefit from what is produced by its efforts.

433. The initial owner of an intangible may choose to transfer some or all of the rights to exploit the intangible. However, an arm's length charge should be imposed for the transfer of those rights. The party to whom the rights are transferred will then be entitled to the income attributable to the intangible rights that are transferred.

434. It is possible, however, that legal ownership of intangible property (such as a patent) does not vest with the party that has developed the property. In that case, the arm's length principle would treat the legal owner as being entitled to the income attributable to that intangible, even though the legal owner has not contributed to its development. However, the developer of the intangible property would be expected to have received an arm's length consideration for its development services. This might, for example, take the form of:

- a cost reimbursement (with an appropriate profit element), if the developer is a contract developer (effectively a service provider), or
- lump-sum compensation, if the developer bore all of the expenses and risks of development.

435. Whether or not the developer is a contract developer should be determined on the facts of the relationship between the parties during the development process. If the developer is a contract developer, it would seem reasonable to expect that at the outset of the development process, an arrangement would be in place for costs to be reimbursed during the process or a formal understanding already established that the developer will not own any intangible property produced.

## Factors in pricing

436. An understanding of the exact nature of the intangible property being transferred is fundamental to the correct evaluation of the arm's length price for that property.

437. There are two aims in identifying the nature of the intangible property being transferred.

438. First, the key features of the intangible property that have led to the creation of its value are identified, giving an indication of the important factors that will need to be priced. This helps identify what it is that will give rise to the expected benefits, and to differentiate profit attributable to that intangible from the profit attributable to other factors, such as functions performed and other assets employed.

439. Second, if the intangible property is to be valued by reference to comparables, and it must be acknowledged that in many cases, this may not readily be possible, it will enable the true extent of comparability between the transactions being compared to be better ascertained.

440. The OECD guidelines (paragraphs 6.20 to 6.24) and the United States section 482 regulations (1.482-4(c)(2)(iii)(B)(2)) identify a number of specific factors that may be particularly relevant to consider in determining the nature of intangible property being transferred. Table 7 lists the more significant of these factors (but is not an exhaustive list).

**Table 7: Factors in determining nature of intangible property**

- |   |
|---|
| <p>(a) The expected benefits from the intangible property, determined possibly through a net present value calculation.</p> <p>(b) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or non-exclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights might be exploited.</p> <p>(c) The stage of development of the intangible in the market in which the intangible is to be exploited, including, where appropriate:</p> |
|---|

- ◇ the extent of any capital investment, start-up expenses or development work required, and
  - ◇ necessary governmental approvals, authorisations, or licenses required.
- (d) Rights to receive updates, revisions, or modifications of the intangible.
- (e) The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries, and the value that the process in which the property is used contributes to the final product.
- (f) The duration of the license, contract, or other agreement, and any termination or negotiation rights.
- (g) Any economic and product liability risks to be assumed by the transferee.
- (h) The existence and extent of any collateral transactions or on-going business relationship between the transferee and transferor.
- (i) The functions to be performed by the transferee, including any ancillary or subsidiary services.

441. Each of the factors in the table will influence the price for the intangible property. For example, if the transferee is to assume economic and product liability risks (paragraph (g)), the arm's length price for the property transferred will be lower (perhaps by way of a lower royalty rate) than if the transferor retained those risks.

## Terms and conditions of transfer

442. The conditions for transferring intangible property may be those of an outright sale of the intangible or, perhaps more commonly, a licensing arrangement for rights in respect of the intangible property (paragraph 6.16, OECD guidelines). This identifies those aspects of the transaction for which a price needs to be determined. It also identifies the type of comparables that need to be identified if the arrangement is to be benchmarked against an uncontrolled transaction.

443. Determining the conditions of the transfer will not necessarily be a straightforward task. For example, it may be difficult to differentiate between a transfer of an intangible, and the supply of a product or service that benefits from the intangible.

444. One area of potential confusion is the treatment of embedded intangibles—for example, tangible property carrying rights to use a tradename or trade mark, which is sold by a manufacturer to a related distributor.

445. There are a number of issues to be considered when dealing with the transfer of tangible property that includes an intangible element such as a trademark. First, it must be considered whether intangible rights have actually been transferred. For example, the mere acquisition of branded goods will in many cases not involve the transfer of intangible rights.

446. Second, if it is considered that an intangible right has been transferred then consideration must be given to whether that right should be valued separately from the tangible property. This will be a question of fact and will depend on the available comparable data and available transfer pricing methods. In addition, a consideration of the industry specific factors might also be made. For example, in some industries the mere fact that an intangible right has been transferred with the tangible property may not give rise to a valuable right, such as when the intangible element has no value. In such a case, there would be no reason to attempt to separate the arm's length value of the tangible property from the intangible property.

## Calculating arm's length price

447. Several issues arise when calculating the arm's length price for intangible property.

448. First, in applying the traditional transactional methods (CUP, resale price and cost plus methods) or the comparable profits methods (including the transactional net margin method (TNMM)) to determine the arm's length price for a transaction involving intangible property, it will be very important to identify that the independent transaction used as a benchmark is truly comparable. If the independent transaction is not comparable, perhaps because an important functional difference has not correctly been identified, the analysis based on that comparable is likely to have no value. The principles of comparability applied to intangible property are discussed in paragraphs 453 to 462 below.

449. Second, in many cases, taxpayers will face difficulties in identifying reliable comparables on which to base a sound transfer pricing analysis. Taxpayers may then need to examine alternative approaches for performing an analysis.

450. One option available to taxpayers is the use of the profit split method. This is discussed in paragraphs 463 to 470. A key feature of the profit split method is that it requires a less rigorous application of comparables than is required for analysis under the other methods. The downside of this, however, is that because the method tends to be more subjective in application than the other methods, it can increase the potential for disagreement between taxpayers and Inland Revenue over what transfer prices are appropriate.

451. As an alternative, recourse might be made to a valuation-based approach to determining the arm's length price. As paragraph 6.29 of the OECD guidelines notes, in relation to transactions when valuation is highly uncertain at the time of the transfer:

One possibility is to use anticipated benefits (taking into account all relevant economic factors) as a means for establishing the pricing at the outset of the transaction.

452. It is likely that comparables might still play a part in a valuation-based approach. For example, comparables might be located to lend support to the assumptions underlying the valuation model applied. The use of comparables is not essential to this approach, but would be expected to increase the credibility of the analysis, if applied. Valuation-based approaches are discussed further in paragraphs 471 to 492.

## Comparability

453. As noted in paragraph 448, it will be very important to identify that the independent transaction used as a benchmark is truly comparable when considering transactions involving intangible property. If the independent transaction is not comparable, perhaps because an important functional difference has not been correctly identified, the analysis based on that comparable is likely to have no value.

454. The OECD guidelines, at paragraph 6.25, contain a detailed example illustrating various considerations in determining comparability for controlled transactions. The example contemplates how the arm's length price for a branded athletic shoe might be determined.

455. The first approach suggested is to value the shoe, including its brand value, by reference to a comparable uncontrolled price. This might be done if there is a similar athletic shoe, both in terms of the quality and specification of the shoe itself and also in terms of the consumer acceptability and other characteristics of the brand name in that market, transferred under a different brand name in an uncontrolled transaction.

456. The second approach involves estimating the value of the brand name itself, with the price of the unbranded shoe and the extra value attributable to the brand name being determined

separately. The OECD guidelines, at paragraph 6.25, suggest the following as one approach that might be taken:

Branded athletic shoe 'A' may be comparable to an unbranded shoe in all respects (after adjustments) except for the brand name itself. In such a case, the premium attributable to the brand might be determined by comparing an unbranded shoe with different features, transferred in an uncontrolled transaction, to its branded equivalent, also transferred in an uncontrolled transaction. Then it may be possible to use this information as an aid in determining the price of branded shoe 'A', although adjustments may be necessary for the effect of the difference in features on the value of the brand.

457. Paragraph 6.25 does conclude, however, by noting that:

... adjustments may be particularly difficult where a trademarked product has a dominant market position such that the generic product is in essence trading in a different market, particularly where sophisticated products are involved.

Example 8, adapted from the United States' section 482 regulations (1.482-4(c)(4), example 4), further illustrates considerations in identifying intangibles.

### **Example 8**

458. A German pharmaceutical company has developed a new drug that is useful for treating migraine headaches and produces no significant side effects. The new drug replaces an older drug that the company had previously produced and marketed as a treatment for migraine headaches.

459. A number of drugs for treating migraine headaches are already on the market. However, because all of these other drugs have side effects, the new drug can be expected quickly to dominate the worldwide market for such treatments and to command a premium price. Thus the new drug can be expected to earn extraordinary profits.

460. The German company had previously marketed its drug through an independent company in New Zealand. It now decides to establish a New Zealand subsidiary, and assign that subsidiary the rights to produce and market the new drug in New Zealand. The question arises as to what might be an appropriate royalty rate to charge for those rights.

461. On further research, it is determined that the old and new drugs were licensed at the same stage in their development and the agreements conveyed identical rights to the licensees. There has also been no change in the New Zealand market for migraine headache treatments since the earlier drug was introduced. *Prima facie*, therefore, it might be concluded that the licence agreement for the new drug might be closely comparable to the previous licence agreement with the independent company, allowing the previous agreement to be used as a CUP.

462. Given the nature of the new drug, however, it is clear that its profitability is likely to be higher, and that the reward for that additional profitability should lie with its developer. This consideration would need to be factored into the license agreement for the new drug.

### **Profit split method**

463. As noted in paragraphs 449 and 450, taxpayers will, in many cases, face difficulties in identifying reliable comparables on which to base a sound transfer pricing analysis. The profit split method might then be a useful alternative approach for performing an analysis, particularly as it requires a less rigorous application of comparables than is required for analysis under the other methods.

464. Paragraph 6.26 of the OECD guidelines similarly states that:

In cases involving highly valuable intangible property, it may be difficult to find comparable uncontrolled transactions. It therefore may be difficult to apply the traditional transactional methods and the transactional net margin method, particularly where both parties to the transaction own valuable intangible property or unique assets used in the transaction that distinguish the transaction from those of

potential competitors. In such cases the profit split method may be relevant although there may be practical problems in its application.

465. Inland Revenue acknowledges that comparable uncontrolled transactions may be particularly difficult to locate for New Zealand, given the size of our market and the nature of adjustments that might be required if overseas data is applied. In the absence of reliable comparable transactions, Inland Revenue considers the profit split method could represent a useful tool. If the method is to be used for more significant transactions, however, it may be prudent for taxpayers to consider whether there would be sufficient merit to seeking an APA.

466. Application of the profit split method requires that profit be allocated based on the relative contribution of each party to a transaction. Although this allocation ideally should be made by reference to how independent firms have allocated profits in similar transactions, it may not be essential to apply comparables in practice, particularly if locating comparables will not be a practicable exercise.

467. In such cases, profits will need to be allocated based on a subjective assessment of the relative contribution of each of the parties to the transaction. There is, however, no prescriptive way in which this judgement should be exercised, and each case will need to be assessed on its own facts and circumstances. In allocating profits, taxpayers should aim to determine compensation for each party that is consistent with each party's functions, assets used and risks assumed in relation to the transaction (to put it another way, an appropriate allocation based on a sound functional analysis).

468. Second, in many cases, taxpayers will face difficulties in identifying reliable comparables on which to base a sound transfer pricing analysis. Taxpayers may then need to examine alternative approaches for performing an analysis. As paragraph 133 noted:

in practice, the assessment of relative contribution may, of necessity, need to be a somewhat subjective measure based on the facts and circumstances of each case.

469. An important caveat should be noted in applying the profit split method. The subjective nature of the profit allocation between the parties means that the method might reasonably be considered the least reliable of the transfer pricing methods. Because of this, the method is perhaps less likely to be, or may not be, acceptable in foreign jurisdictions, particularly if a more reliable alternative method can be applied. This has the potential to result in double taxation.

470. A further consideration is that the profit split method is predicated on an adequate level of information being available about the related party. Consequently, a taxpayer seeking to rely on the profit split method will need to ensure that appropriate information on the offshore party or parties can be made available if requested by Inland Revenue.

### **Valuation-based approach to intangible property**

471. The traditionally perceived role of comparables in analyses involving intangible property is that the comparables should be applied to support a transfer price for intangible property directly. For example, a CUP might be used to support the actual royalty rate adopted, or the cost plus method might be used to value a manufacturing function incorporating a production (trade) intangible.

472. In the absence of reliable comparables on which to base this more traditional analysis however, recourse might be made to determining an arm's length price for the transfer of intangible property on a valuation-based approach. Such analyses are based on realistic projections of future benefits (paragraph 6.29, OECD guidelines) attributable to the intangible. In lay terms, it is the question, "how much extra value does the intangible create?"

473. Paragraph 6.29 of the OECD guidelines is drafted with specific reference to intangible property for which valuation is highly uncertain at the time of transfer. Inland Revenue considers that the specific difficulties created by the size of the New Zealand market means that the approach

could usefully have broader application here than a superficial reading of the OECD guidelines might imply, particularly for determining arm's length royalty rates. Taxpayers should be aware, however, that while Inland Revenue considers a broader ambit fully consistent with the tenor of the OECD guidelines, other tax administrations might not hold the same view.

## Applying a valuation-based approach

474. As a broad principle, the value of an item of intangible property is based on perceptions of its profit potential. More formally, this might be determined by calculating the net present value (NPV) of the expected benefits to be realised (potential profits or cost savings) through the exploitation of that property.

475. Example 9 illustrates this principle, and offers valuable insights into how:

- an arm's length price for a transfer of intangible property might legitimately be estimated in the absence of reliable comparables; or
- comparables might be applied in a non-traditional manner to support the assumptions underlying a valuation approach to intangible property.

### Example 9

476. A New Zealand company is to be provided with intangible property that is expected to increase sales by \$1 million for each of the next three years, but have no effect on sales beyond that time. Costs for those years will remain constant, except for an initial outlay of \$500,000 to update machinery to utilise the property. There will be some risk to the company, and the risk-adjusted cost of capital is determined to be 20% (in practice, this would need to be based on commercial considerations).

477. The net present value of the cash flows for the intangible are calculated as follows:

Year		Cash flow	Discount rate	Present value
0	Initial outlay	( 500,000)	1.000	( 500,000)
1	Additional receipts	1,000,000	0.800	800,000
2	Additional receipts	1,000,000	0.640	640,000
3	Additional receipts	1,000,000	0.512	512,000
<b>NPV (r = 20%):</b>				<u>\$ 1,452,000</u>

478. Based on this calculation, the New Zealand company might be prepared to pay a royalty of up to \$743,852 for each year (that royalty rate also having a NPV of \$1,452,000). If it paid such a royalty, the company would still earn its required rate of return from the project:

Year		Cash flow	Discount rate	Present value
0	Initial outlay	( 500,000)	1.000	( 500,000)
1	Receipts less royalty	256,148	0.800	204,918
2	Receipts less royalty	256,148	0.640	163,934
3	Receipts less royalty	256,148	0.512	131,148
<b>NPV (r = 20%):</b>				<u>\$ 0</u>

## Observations on valuation approach

479. A couple of important principles for applying the arm's length principle can be derived from considering the difficulties in making such NPV calculations in practice.

480. First, determination of the values for most of the variables applied in the NPV calculation (in particular, expected benefits and the appropriate discount rate) can be very subjective. Further, the arm's length principle does not appear to apply NPV calculations directly. However, in

appraising how independent firms have valued intangible property, the arm's length principle is implicitly testing what the market has established the variables in the NPV (or similar) calculation should be.

481. Consider, for example, a CUP that is being used to determine an arm's length price for the transfer of intangible property. In negotiating their price, the independent firms would each have evaluated the profit potential of the intangible property. Although these evaluations may not have used formal NPV calculations, it is to be expected that they would at least have been based on some views of what the likely future income attributable to the intangible property would be, and the costs and risks involved in its exploitation. If a CUP is being used, therefore, the projections made by the uncontrolled participants in the market are implicitly forming the basis for establishing the transfer price in the controlled transaction.

482. Second, it is important to consider both parties to the transaction (paragraph 6.14, OECD guidelines), a point noted in paragraph 427. Example 9 determined the maximum value the transferee would be prepared to pay for the intangible property—the price commensurate with the value and usefulness of the intangible property in its business, given its risk-tolerance preference. At arm's length, however, the transferor is unlikely to have access to the same information as the transferee, and may for example, based on its own perceptions of profit potential, be prepared to license the intangible property for a royalty of only \$500,000 per year. The parties might then be expected to negotiate a royalty somewhere between these two reservation prices.

483. In principle, therefore, it should be possible to appraise intangible property without reference to comparables, and in the absence of reliable comparables or where only a limited amount of revenue is at issue, this may be the prudent approach for a taxpayer to take. Several cautions should, however, be noted.

484. First, ideally, transfer prices will be benchmarked against comparable transactions between independent firms, because this allows the reliability of assumptions made in performing NPV (or similar) calculations to be tested against a more objective base. The absence of one or more reliable comparables may reduce the credibility of the analysis.

485. Second, although Inland Revenue considers a valuation-based approach can be undertaken to fall broadly within the acceptable transfer pricing methods, this view may not be respected by other tax administrations. Double taxation may then result. Taxpayers should, therefore, exercise caution in adopting such an approach if the resulting analysis is also to be provided to justify the transfer price to an overseas tax administration.

486. Finally, the analysis in this section does not exhaust the theoretical underpinnings of valuation-based approaches. For example, it does not deal nicely with relatively immaterial transactions (because the size of the transaction is small relative to the overall size of operations), when cost of capital considerations may become unimportant in determining whether a transaction proceeds at a given price. If a valuation-based approach is to be adopted, particularly for larger value transactions, greater consideration will need to be given to the theoretical underpinnings of valuation techniques.

At arm's length, the value of intangible property is often ascertained from perceptions of its profit potential. This approach may also be feasible in many transfer pricing cases. The value of comparables is then found in the support they give to values adopted in that calculation, such as appropriate discount rates and whether independent firms would have been prepared to rely on the projections made in entering into the transaction on the terms agreed. Applying comparables in this manner is not essential, but is likely to add to the credibility of the analysis.

For more complex or high-valued transactions, it may be prudent for taxpayers to consider the merits of seeking an APA.

## Valuation highly uncertain at time of transaction

487. The OECD guidelines, at paragraphs 6.28 to 6.35, discuss the application of the arm's length principle to transfers of intangible property when valuation of that property is highly uncertain when it is transferred. One important issue in the discussion is whether tax administrations should be able to review the transfer price adopted by reference to a form of the arrangement that differs from that adopted by the taxpayer.

488. When the value of the intangible property is uncertain, the risks and rewards of transferring that property will typically be shared between the parties when it is transferred. A MNE might structure a transaction in a number of ways, depending on the level of risk, and the various types of risk, each of its members are to assume. For example, the initial owner of intangible property (see paragraphs 432 to 435) may choose to exploit that property with the following levels of market risk (paragraphs 6.29 to 6.31, OECD guidelines):

- **No risk:** The developer sells the entire results of its development for a fixed sum, with the purchaser then assuming the entire risk of the commercial success or failure of the intangible.
- **Complete risk:** The developer might manufacture and market the final product itself, using a contract distributor to get the product to the market.
- **Partial risk:** The developer might retain ownership, but license the use of that property to another entity in return for some form of royalty. Such an arrangement results in risk being shared between the developer (the licensor) and the other party (the licensee). The developer's royalty return depends on the level of sales by the other entity, and is subject, therefore, to market risk. The other entity's return will similarly be dependent on how well the product performs in the market. Royalties with periodic adjustments are a subset of this category.

489. Given that the structure of the arrangement can be seen to be a way of sharing market, credit, country and other risks between the parties, the form of the transaction is not usually the most important aspect for transfer pricing purposes. Rather, the central issue in any audit activity should generally be whether the allocation of rewards, including the royalty rate set in a taxpayer's arrangements, is consistent with the level of all the risks assumed by the taxpayer. This examination needs to be set in the context of the functional analysis for each party's actions. As with third party dealings, consideration should also be given to the circumstances of other dealings between the parties, and each party's overall level of risk. An appropriate allocation of risk and reward would be determined by reference to what independent parties would have done in similar circumstances.

490. In evaluating a taxpayer's transfer price, Inland Revenue will need to benchmark its analysis against an objective external standard. If the form of a taxpayer's arrangement is unique, therefore, Inland Revenue might, in evaluating the transfer price adopted, need to look to:

the arrangements that would have been made in comparable circumstances by independent enterprises ... Thus, if independent enterprises would have fixed the pricing based on a particular projection, the same approach should be used ... in evaluating the pricing. ... [Inland Revenue] could, for example, enquire into whether the associated enterprises made adequate projections, taking into account all the developments that were reasonably foreseeable, without using hindsight (paragraph 6.32, OECD guidelines).

491. As with other transfer pricing issues, taxpayers are in the best position to ensure there are no surprises in the way Inland Revenue reviews their transfer prices. This can be achieved by documenting, in as much detail as prudent, why a transaction has been structured in the way it has, and how the components of that price have been determined by reference to what independent parties in similar circumstances would have done.

492. Further, the more thorough a taxpayer's analysis, the less likely it will be that the Commissioner will be able to meet the burden of proof required if the taxpayer's determination of the arm's length price is to be overturned. Taxpayers should consider costs, risks and benefits in determining the extent to which they should develop and document their policy, as indicated in the previously published draft chapter on documentation.

### **Use of standard international royalty rate**

493. One question that is often posed is whether a royalty rate established as arm's length in relation to one member of a MNE will be accepted automatically by Inland Revenue as also being arm's length in relation to New Zealand. This issue is discussed in the example 10.

#### ***Example 10***

494. A United States company licences technology to a number of subsidiaries around the world. A comprehensive analysis has been performed to support that an arm's length royalty rate for its Japanese subsidiary is 7%. On the basis of this analysis, the company also charges the same royalty rate to all of its other subsidiaries. The question arises as to whether Inland Revenue will accept 7% as an arm's length royalty rate for the New Zealand subsidiary.

495. There are two issues in this question. First, there is the question of whether 7% is actually an arm's length royalty rate for the Japanese subsidiary. Second, if it is an arm's length rate for Japan, are the economic features of the New Zealand and Japanese markets sufficiently similar that the same royalty rate should be expected to apply in both markets?

#### ***(a) 7% is an arm's length royalty for Japan***

496. Even if 7% is an arm's length royalty rate for Japan, it is still necessary to examine the relative economics of the New Zealand and Japanese markets to test whether 7% is also appropriate for New Zealand. If the differences between the markets were relatively small, 7% would be an appropriate royalty rate for New Zealand. However, if significant differences exist, adjustments could be made to reflect these if they can be valued.

497. At arm's length, both the licensor and licensee will look at profit potential from intangible property in negotiating a royalty rate. If markets are different, potential profits from those markets are also likely to differ, and so too would acceptable royalty rates.

#### ***(b) Arm's length royalty for Japan is not 7%***

498. From an alternative perspective, even if 7% is not an arm's length royalty rate for the Japanese subsidiary, it may still be an arm's length rate for the New Zealand subsidiary. For example, it might be determined that an arm's length royalty rate for Japan is only 5%, but that a 2% premium is justified by the geographical differences between Japan and New Zealand.

499. Significantly, even though incorrect analysis might have been used to ascertain the 7% royalty rate for New Zealand, the important thing is that a correct royalty rate has been determined. There would, therefore, be no justification for Inland Revenue to attempt to substitute an alternative royalty rate under section GD 13.

### **Marketing activities of enterprises not owning marketing intangible**

500. Marketing activities are often undertaken by enterprises that do not own the trademarks or trade names they promote. The question is how the marketer should be compensated for those services. Two key issues arise:

- Should the marketer be compensated as a service provider or might it be entitled to a share in any additional return attributable to the marketing intangibles?

- How should the return attributable to marketing intangibles be identified?

501. Whether the marketer is entitled to a return on the marketing intangibles above a normal return on marketing activities will depend on the obligations and rights *implied* by the agreement between the parties (paragraph 6.37, OECD guidelines) – in other words, what compensation would an independent party have sought given its rights and obligations under the agreement. The OECD guidelines contain a couple of illustrative examples:

- A distributor acting merely as agent and being reimbursed for its promotional expenditure would be entitled to compensation appropriate to its agency activity, but not to any share in returns attributable to marketing intangibles (paragraph 6.37).
- A distributor bearing the cost of its own marketing activity would expect to share in the potential benefits of those activities (paragraph 6.38). However, it is important to consider the rights of the distributor in determining whether any extra return is justified. For example:
  - The distributor may benefit directly from its investment in developing the value of a trademark from its turnover and market share if it has a long-term sole distribution contract for the trademarked product.
  - Unless a distributor bears expenditure beyond that which an independent distributor with similar rights would bear, there is no justification for it to receive an additional margin relative to an independent distributor.

502. A further factor to consider, not explicitly addressed above, is the extent to which the distributor is bearing real risk, relative to independent firms in the market. If a controlled distributor were bearing relatively greater risk than comparable independent firms, it would, *prima facie*, also be expected to derive a greater margin from its activities.

503. Example 11, adapted from examples 2 & 3 of the United States section 482 regulations at 1.482-4(f)(3)(iv), illustrates these principles further.

### ***Example 11***

504. Gizmo Co owns all of the worldwide rights for a name. The name is widely known outside New Zealand, but is not known within New Zealand. Gizmo Co decides to enter the New Zealand market and establishes a subsidiary here, to distribute in New Zealand and to undertake the advertising and other marketing efforts required to establish the name in the New Zealand market.

505. The New Zealand subsidiary incurs expenses in developing the New Zealand market that are not reimbursed by Gizmo Co. However, the level of these expenses are comparable to those incurred by independent firms in the same industry when introducing a product in the New Zealand market under a brand name owned by a foreign manufacturer.

506. Because the subsidiary would have been expected to incur the development expenses if it were unrelated to Gizmo Co, no adjustment needs to be made in respect of the marketing expenses.

507. The situation would be different, however, if the subsidiary incurred expenses that are significantly larger than would independent firms under similar circumstances. Expenses incurred in excess of the level incurred by independent firms should be treated as a service to Gizmo Co, as they effectively represent a service adding to the value of Gizmo Co's intangible property.

508. There is a caveat to this conclusion. The analysis does not contemplate whether the price for the product being transferred is arm's length. If, for example, the New Zealand subsidiary were undercharged for the product it receives, this would compensate for its excessive expenses. When both the transfer price for the product and the expenses are considered together, it may be determined that there is no overall transfer pricing issue. This observation also illustrates that it may often not be appropriate to stop with an analysis at the gross level. From Gizmo Co's

perspective, charging inadequate consideration would reduce its gross margin relative to comparable firms. However, this is offset by the New Zealand subsidiary not charging explicitly for its services, which reduces the costs Gizmo Co would recognise in calculating its net profit.

## **Allocating return attributable to marketing intangibles**

509. Identifying the return attributable to marketing activities if it is to be allocated between the parties to a transaction is not straightforward (paragraph 6.39, OECD guidelines). The OECD guidelines identify several difficult questions that must be considered in identifying the amount of any return:

- To what extent have advertising and marketing activities contributed to the production or revenue from a product?
- What value, if any, did a trademark have when introduced into a new market – it is possible that its value in a particular market is wholly attributable to its promotion in that market.
- Does a higher return for a trademarked product relative to other products in the market trace back to the marketing of the product, its superior characteristics relative to other products, or a mixture of both?

510. Little guidance can be given on how these questions should be evaluated, and each case will need to be determined based on its own facts and circumstances. However, as with the general application of the arm's length principle, taxpayers should aim to determine transfer prices that result in the compensation a distributor receives for its marketing activity being consistent with what an independent entity would have accepted given similar rights and obligations.

## **Summary**

511. This chapter has considered the following key points:

- Intangible property poses some special difficulties in determining the arm's length price, particularly because of the complexity of some arrangements and the difficulties in identifying comparable transactions.
- If one party to a transaction does not contribute intangible property, the most straightforward analysis is likely to involve using that party as the "tested party", even if it is outside New Zealand.
- Two particular areas where sufficient care is often not taken are:
  - A local operation is meeting costs for maintaining intellectual property that an independent party would not be required to meet, while at the same time paying the same amount as the independent firm for property it acquires (a double deduction).
  - Analysis being based on what outwardly appear to be reliable comparables but that are not reliable, because the nature of intangible property (potentially high price variations for differences that superficially appear quite small) has not been considered adequately.
- In many cases (particularly using the profit split method), the analysis of intangible property may need to be based on a subjective judgement with limited recourse to reliable comparables. In exercising such judgement, taxpayers will need to be conscious that the final result should seek to ensure that each party to the transaction obtains a return that is broadly consistent with its functions performed, assets employed and risks assumed in relation to the transaction involving the intangible property.

- Valuing intangible property based on realistic projections of future benefits may be an appropriate response to the limited availability of comparables in the New Zealand market, particularly in relation to determining arm's length royalty rates.
- When dealing with marketing activities of firms that do not own the marketing intangible, it is important to ensure that their compensation is commensurate with what independent entities would have accepted given the rights and obligations under the arrangement.

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## Intra-group services

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### Key Points

- The OECD guidelines identify two key issues in the treatment of intra-group services:
  - Has a service been provided?
  - If so, how should the arm's length price be determined?
- The central test of whether an intra-group service is provided is whether the recipient of an activity receives something that an independent enterprise in comparable circumstances would have been prepared to pay for or perform for itself in-house.
- The arm's length price can be determined using either:
  - a direct charge approach, when charges are identified for specific services, or
  - an indirect charge approach, when costs are indirectly allocated against all services provided in determining a cost base on which charges are to be determined.
- The costs attributable to a particular service will often not be able to be discerned directly, meaning that an indirect cost allocation will need to be applied:
  - An appropriate allocation key will need to be used, based on the facts and circumstances of each case.
  - The key focus is a realistic allocation, not accounting perfection – Inland Revenue is looking for a fair charge for the services provided and a reasonable effort into establishing a basis for future calculations.

### Introduction

512. Essentially, this chapter summarises the material in the OECD guidelines. For greater detail, recourse should be made to those guidelines.

513. This chapter does, however, discuss issues that will be of particular interest to Inland Revenue in administering the transfer pricing rules. The discussion includes, for example, an analysis of possible allocation keys that might be applied in determining the cost base if the cost-plus method is to be applied to determine the arm's length price.

514. Inland Revenue expects that cost allocations will be commonly employed in determining an arm's length price for services. This being the case, however, it is important not to lose sight of the big picture. Inland Revenue is looking for a realistic allocation of costs (with due regard to considerations of materiality), not accounting perfection. Ultimately, the test is whether a fair charge is determined for services provided to a related company from the perspective of both the provider and the recipient. Inland Revenue would also expect to see that taxpayers have put a reasonable effort into establishing a framework from which the price for future services can be readily determined.

## Key issues in intra-group services

515. The OECD guidelines, in paragraph 7.5, identify two key questions in applying the arm's length principle to intra-group services:

- Has an intra-group service in fact been provided?
- If so, what charge for that service is consistent with the arm's length principle?

## Has a service been provided?

516. Each case must be tested on its own facts and circumstances (paragraph 7.7, OECD guidelines). However, as a general rule, the central issue in determining whether an intra-group service has been provided will be whether the recipient of an activity receives something that an independent firm in comparable circumstances would have been willing to pay for, or would have performed in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle (paragraph 7.6, OECD guidelines).

517. The OECD guidelines contain several examples that illustrate this principle:

- If a service is performed to meet an identified need of one or more specific members of the group, an intra-group service would ordinarily be found to exist, because an independent party would be willing to pay to have that need met (paragraph 7.8).
- "Shareholder activities" performed because of an ownership interest in a group member (such as meetings of the shareholders of the parent company of the group) would not justify a charge to the recipient company, because the group members do not need the activity (paragraph 7.9).
- An incidental benefit derived by a group member from an activity performed for another group member does not mean that it has received a service, because independent enterprises would not be willing to pay for the activities giving rise to the benefit (paragraph 7.12).
- An "on call" service may be an intra-group service to the extent that it would be reasonable to expect an independent enterprise in comparable circumstances to incur 'standby' charges to ensure the availability of the services when the need for them arises (paragraph 7.16).

518. The OECD guidelines also confirm that the provision of centralised services by a parent company or a group service centre and made available to some or all members of the group will ordinarily be treated as intra-group services. Paragraph 7.14 contains an illustrative list of a number of centralised services that are likely to be intra-group services because independent enterprises would be willing to pay for or perform them for themselves:

- Administrative services:
  - planning, co-ordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services.
- Financial services:
  - supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks, and refinancing.
- Assistance in the fields of production, purchasing, distribution and marketing.
- Services in staff matters such as recruitment and training.
- Research and development or administration and protection of intangible property for all or part of the MNE group.

**Central test for intra-group service:** Does the recipient of an activity receive something that an independent enterprise in comparable circumstances would have been prepared to pay for or perform for itself in-house? If so, that activity will ordinarily be treated as an intra-group service.

## Determining an arm's length charge

519. Once it has been determined that a service has been provided, the issue is to determine what would constitute an arm's length charge. As with other transactions, the arm's length charge is one that is consistent with what would have been charged and accepted in a transaction between independent enterprises in comparable circumstances.

520. The OECD guidelines identify two general approaches to determining arm's length prices for intra-group services. Which approach is followed will tend to depend on whether each service provided and its recipient is identified separately, or whether the services are more generic in nature and their recipients not specifically identified.

521. The direct-charge approach can be applied when a member of the group is charged for specific services. In principle, it should be a relatively straightforward exercise to determine the arm's length price for that service, either by reference to the charge for that service when provided to independent third parties (an internal CUP) or by reference to charges made for comparable services between independent firms.

522. The indirect-charge approach may be applied if the direct-charge approach is impractical, or if arrangements within the group are not readily identifiable and either incorporated into the charge for other transfers, allocated among group members on some basis, or in some cases not allocated among group members at all (paragraph 7.22, OECD guidelines). In such cases, cost allocation and apportionment approaches, often with some degree of estimation or approximation, may need to be used (paragraph 7.23, OECD guidelines).

523. Examples in the OECD guidelines of when the indirect-charge approach may be applicable include:

- The proportion of the value of the services rendered to various members of a group cannot be quantified except on an approximate basis (for example, central sales promotion activities).
- Separate recording and analysis of the relevant service activity for each beneficiary would involve a burden of administrative work disproportionate to the activities themselves (paragraph 7.24).

524. If a specific service forms part of the provider's main business activity and is provided both to members of the group and to third parties, the direct-charge approach generally should be applied as a matter of course (paragraph 7.23, OECD guidelines). The method by which the services provided to third parties are priced should also be able to be applied to services provided within the group.

## Applying a pricing method

525. In applying the arm's length principle to intra-group services, it is necessary to consider both the provider and the recipient of the service. The price charged for the service should not be more than an independent recipient in similar circumstances would be willing to pay (a test of benefits received). Similarly, an independent supplier would not be prepared to offer the service below a certain price. Costs incurred by the service provider will be a relevant consideration in determining what this reservation price is (paragraph 7.29, OECD guidelines).

526. In practice, the CUP and cost plus methods tend to be most widely used in determining arm's length prices for intra-group services. However, there is no reason why other methods should not be used if they result in the determination of an arm's length price.

527. The CUP method is likely to be used if there is a comparable service provided between independent enterprises in the recipient's market, or the service is also provided to independent parties under similar circumstances to which it is provided to another group member (paragraph 7.31, OECD guidelines). However, care would need to be taken to ensure that necessary adjustments are made to reflect differences in comparability.

528. For example, there may be overheads borne by an independent firm that a MNE may not need to incur, such as promotional activities to obtain new and retain existing clients, the costs of obtaining professional indemnities, and any other differences in the functions performed by the MNE and the comparable firm. Such differences would require adjustments in determining an arm's length charge for the MNE.

529. The cost plus method is widely used because, in many cases, the difficulty of identifying market prices and the general objectivity with which costs can be identified and measured make it the most practicable and reliable method to apply. The costs associated with the provision of a service are first identified (a discussion on how costs might be determined indirectly is set out below). Reference is then made to services provided by independent firms in comparable circumstances to determine what, if any, mark-up would be added at arm's length.

530. When applying the cost plus method, it is important to ensure that the functions for which a margin is being determined are comparable. If the MNE provides only an agency function, it would not be appropriate to use the mark-up added by an independent distributor as an unadjusted comparable. Having said that, the reliability of the cost allocation is likely, in practice, to be a more material issue than the reliability of the mark-up adopted. In this regard, taxpayers may find the administrative practice set out in paragraphs 557 to 567 of some assistance.

## **Profit element**

531. In an arm's length transaction, an independent enterprise would normally seek to earn a profit from providing services, rather than merely charging them out at cost. However, there may be circumstances when services would be provided without a profit element. The OECD guidelines give the following examples:

- The costs of providing the service are greater than an independent recipient would be prepared to pay, but the service complements the provider's activities in a way that increases its overall profitability (for example, providing the service generates goodwill) (paragraph 7.33).
- For whatever reason, an incidental service is provided in-house when it could have been sourced more cheaply from an independent party (a CUP). In this case, the CUP would be the arm's length price, rather than a price based on the costs incurred by the service provider (paragraph 7.34).

532. Thus it will not always be the case that the arm's length price will reflect a profit for the service provider (paragraph 7.33, OECD guidelines).

## **Determining cost base for cost-plus method**

533. Paragraph 7.23 of the OECD guidelines notes that:

Any indirect-charge method should be sensitive to the commercial features of the individual case (eg, the allocation key makes sense under the circumstances), contains safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.

534. There are a number of allocation keys that might be applied to allocate costs between members of a group. The OECD guidelines, for example, make reference to allocation keys based on turnover, staff employed, and capital applied (paragraph 7.25). The following discussion, which moves beyond the material in the OECD guidelines, considers the strengths and weaknesses of various allocation keys that might be applied. Whether one of the keys, in the form discussed below or in an adapted form, might be appropriate will depend on the facts and circumstances of each case.

535. In performing cost allocations, it is important not to lose sight of the big picture. Inland Revenue is looking for a realistic allocation of costs, not accounting perfection. Taxpayers should be seeking to determine a fair charge for services provided to a subsidiary, and at the same time, making a reasonable effort to establish a coherent basis for determining the price for future services.

536. It is also important that taxpayers perform any cost allocation with regard to the services are being provided. The question is what costs are being incurred to provide a service. Care must, therefore, be taken to exclude costs that do not relate to the services under consideration.

537. If taxpayers are in any doubt over an appropriate cost allocation, they may find it useful to discuss the allocation they propose with their account manager in Inland Revenue. Alternatively, they could contact either Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340, or John Nash, the Chief Advisor (International Audit), on (04) 802-7290.

538. While any advice would not be binding on Inland Revenue, it may give taxpayers a useful insight into how Inland Revenue may approach the issue. If more certainty is required, taxpayers could consider applying for an APA.

### **Global formula approach**

539. One approach is to apportion costs on the arbitrary basis of gross turnover of the worldwide group as follows:

$$\frac{\text{New Zealand gross sales}}{\text{Worldwide group's gross sales}} \times \text{Costs to be allocated}$$

540. The global formula approach does not always arrive at a reasonable or realistic result. Deficiencies in the approach include the inappropriate allocation across all subsidiaries of:

- Start-up costs of new subsidiaries.
- Costs relating to specific functions performed for, or product lines carried by, only certain members of the group.
- Charges for services available to the group but not taken advantage of by all of its members.

541. Another issue to be aware of concerns the level of costs associated with certain activities. For example, a MNE may derive its income from a number of sources, such as product sales, providing services and leasing assets. However, the ratio of income to expenditure may not be uniform across all these income types, with some types of income having higher valued inputs per dollar of output.

542. It may, therefore, be appropriate to associate the income and expenditure with the relevant functions. Then, once the specific functions of the New Zealand enterprise have been identified, the costs relating to functions that the New Zealand enterprise performs could be allocated as follows:

$$\frac{\text{Gross New Zealand turnover for relevant functions}}{\text{Gross worldwide turnover for relevant functions}} \times \text{Net central expenditure on relevant functions}$$

## **Time expended**

543. When dealing with the service industry, it is common to talk in units of time expended to perform a task. When a central service provider performs functions for the group as a whole, therefore, it may be appropriate to allocate costs based on the amount of time expended on providing services to each member of the group.

544. If services are provided that have varying degrees of value (for example, the provision of both specialist technical assistance and general clerical activities), an allocation based only on time spent may not be appropriate. Instead, the costs should be determined for each category of service provided by the central service provider. Costs associated with each category might then be allocated between members of the group based on time spent providing those services.

545. It should be noted that the purpose of dividing costs between categories of service is to ascertain an allocation of costs between members of the group that better reflects the benefits they derive. In undertaking this division, however, taxpayers should not attempt to over-refine their service categorisation. In many cases, the gains in accuracy from further refining the service categorisation will not be sufficient to justify the additional cost of performing the further analysis. Inland Revenue would, however, expect taxpayers to record the basis for any cut-off decision.

546. If a group is not completely service oriented, the costs of the service provider will need to be divided to identify those expenses associated with the service industry.

## **Income producing units**

547. Corporations in the business of leasing plant and equipment are generally able to identify the generation of income from the utilisation of specific units. Expenditure incurred in producing the income can also be more readily identified. Once it is determined what assets the New Zealand operation is leasing out, as compared to the leasing of assets by the worldwide group, centralised costs might be allocated based on the number of units being utilised. This principle is illustrated in example 12.

### ***Example 12***

548. A New Zealand shipping company charters ships that it owns. In allocating head office costs incurred by a foreign parent, it is likely to be appropriate to make an allocation of head office costs relating to chartered vessels over the number of chartered vessels worldwide. However, it is not likely to be appropriate to allocate head office charges of the group's entire shipping operations over the number of ships operated and leased. This type of allocation does not recognise that different types of ships have different costs – for example, support vessels for oil exploration and production platforms as contrasted with roll-on roll-off freighters.

549. If only support vessels are present in New Zealand it is appropriate only to identify the world costs applicable to support vessels. It is also necessary to distinguish between those vessels leased fully manned and bareboat charters.

550. Once the relevant costs have been identified, they could be allocated as follows:

<u>Support vessels in New Zealand</u>	x	Allocation expenditure
Support vessels worldwide whether working or not		

## **Gross profit allocation basis**

551. There will be situations where allocating costs on the basis of gross revenue will not be appropriate. This may be through an inability to make like comparison of the turnover of the various members of a group, because the mix of activities is not consistent throughout the group and some activities may require greater support than others. For example, one member's gross turnover may be distorted by a high turnover activity, conducted only by that member, that

generates little, if any, profit and requires relatively less assistance to administer (for example, a lease that is sub-leased or a contract that is sub-contracted).

552. In this situation, it may be worthwhile exploring the possibility of allocating costs on the basis of relative gross profits instead. Income from non-active business sources would need to be excluded. Whether this approach is appropriate will depend on the circumstances of the case and whether it results in a fair allocation.

### **Other methods**

553. There are various other keys that might be employed to allocate central expenditure. These include, for example, units produced, material used, and number of employees. However, as with any other key, use of alternative keys would need to provide a cost allocation that is consistent with the benefit derived by the New Zealand entity.

### **Pitfalls and potential audit issues**

554. One obvious issue for taxpayers is what needs to be done to minimise the likelihood that Inland Revenue will attempt to adjust taxpayers' transfer prices. Provided taxpayers adopt transfer pricing that is consistent with the principles expressed earlier in the chapter, they should have few difficulties.

555. There are, however, certain areas where audit experience indicates mistakes are commonly made:

- Charges are made for services that do not meet the test of whether an intra-group service has been provided, such as the charging by a parent of shareholder activities.
- Errors are made in determining the cost base when the cost-plus method is applied, such as the use of a cost allocation key that is inappropriate for a taxpayer's circumstances.
- Taxpayers have taken a double deduction, for example, by including a service fee implicitly in a license fee while charging separately in allocating group service centre costs (paragraph 7.26, OECD guidelines).

556. Taxpayers should be conscious of these issues in determining their transfer prices.

### **Administrative practice for services**

557. As a general rule, Inland Revenue does not endorse the use of safe harbours. This is because they can result in prices being determined that are clearly inconsistent with the arm's length principle but are consistent with the safe harbour. One example is the previously mentioned incidental service provided in-house where the costs alone of providing the service exceed a CUP for the service.

558. Inland Revenue is conscious, however, of the desirability of minimising compliance costs, particularly if this can be achieved without compromising the integrity of the arm's length principle. To this end, Inland Revenue will, with the exception of the level of the *de minimis* threshold, be following the administrative practice of the Australian Tax Office for services (Australian Tax Office Ruling TR 99/1 refers). It should be noted, however, that taxpayers are not obliged to follow the administrative practice. They can, if they prefer, follow the normal application of the arm's length principle in determining their transfer pricing for services.

559. The administrative practice applies to:

- Non-core services. These services refer to activities that are not integral to the profit-earning or economically significant activities of the group. They include activities that are supportive of

the group's main business and are generally routine but are not similar to activities by which the group derives its income; and

- Services with costs below a *de minimis* threshold. This will apply when the total direct and indirect costs of supplying services to New Zealand or foreign associated enterprises, as appropriate, is not more than \$100,000 in a year. The practice applies to all intra-group services supplied or acquired where the relevant cost limit is not exceeded.

560. It is considered that the use of transfer prices permitted by the administrative practice will give rise to a realistic prices that still approximate arm's length pricing.

561. The criteria for the administrative practices are set out in Table 8.

**Table 8 Criteria for administrative practices for services**

	Services acquired from foreign associated enterprises		Services supplied to foreign associated enterprises	
	Administrative practice for <i>non-core</i> services	Administrative practice in <i>de minimis</i> cases	Administrative practice for <i>non-core</i> services	Administrative practice in <i>de minimis</i> cases
<i>Applies to all services?</i>	No	Yes	No	Yes
<i>Restrictions on the application of the administrative practices</i>	The total amount charged for the services is not more than 15% of the total accounting expenses of the New Zealand group companies  Adequate documentation is maintained by the taxpayer	The total direct and indirect costs of providing the services is not more than \$100,000 in the year  Adequate documentation is maintained by the taxpayer	The total amount charged for the services is not more than 15% of the total accounting revenues of the New Zealand group companies  Adequate documentation is maintained by the taxpayer	The total direct and indirect costs of providing the services is not more than \$100,000 in the year  Adequate documentation is maintained by the taxpayer
<i>Acceptable transfer prices</i>	Not more than the lesser of:  (a) the actual charge, and  (b) the cost of providing the services plus a mark- up of 7.5%	Not more than the lesser of:  (a) the actual charge, and  (b) the cost of providing the services plus a mark- up of 7.5%	Not less than the greater of:  (a) the actual charge, and  (b) the cost of providing the services plus a mark- up of 7.5%	Not less than the greater of:  (a) the actual charge, and  (b) the cost of providing the services plus a mark- up of 7.5%

562. To accommodate the varying requirements of other jurisdictions and lessen the possibility of double taxation, taxpayers may instead use the following alternative prices for non-core services in the preparation of their tax returns, if relying on the Commissioner's application of the administrative practice. A transfer price of up to cost plus 10% of relevant costs would be accepted for non-core services supplied by associated enterprises resident in a particular foreign country where it is established by the taxpayer's group that it is the practice of that country to require that

price for the services for its tax purposes, and to accept such prices (or mark-ups) for similar services supplied by New Zealand companies to associated enterprises resident in that country (ie, that the other country does or would be expected to accept symmetrical mark-ups for such services). Therefore, the New Zealand group may use different prices in respect of services acquired from associated enterprises in different countries, but none that exceed cost plus 10% of relevant costs.

563. Similarly, a transfer price not less than cost plus 5% of relevant costs but less than cost plus 7.5% of relevant costs would be accepted for non-core services supplied to associated enterprises resident in a particular foreign country where it is established by the taxpayer's group that it is the practice of that country to require, for its tax purposes, that the price for the services be no higher than the selected price, and to accept such prices (or mark-ups) as an upper limit for similar services supplied by an associated enterprise in that country to New Zealand companies. In other words, the other country does or would be expected to accept symmetrical mark-ups for such services. Again, the New Zealand company group might use different transfer prices for services supplied to associated enterprises in different countries, but none less than cost plus 5% of relevant costs.

564. All companies in the group must use the same mark-up on costs for services supplied to, or acquired from, associated enterprises in the same country, if they are relying on the administrative practice.

### **Caveat to administrative practice**

565. The administrative practice does not absolve taxpayers from the requirement to establish that a service (i.e., a benefit) has actually been supplied. If no service has been supplied, then no charge would be made at arm's length. The administrative practice does not override this.

566. To rely on the administrative practices, the taxpayer (whether a supplier or recipient of services) must maintain documentation to establish the nature and extent of services supplied/acquired and to address the issues (as far as is relevant) considered in calculating the relevant total costs. If the taxpayer wishes to use a mark-up other than 7.5% (see paragraphs 562 and 563), documentation of other countries' practices to support that choice should be kept. Further, a record of the relevant group companies should be retained.

567. If taxpayers require further information on the application of the administrative practice, they should contact either Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340, or John Nash, the Chief Advisor (International Audit), on (04) 802-7290.

### **Practical solutions**

568. Determining arm's length prices must remain a practicable exercise. The aim of the exercise is to determine practically an arm's length price, rather than attempting to over-refine the analysis which, at the end of the day, may not actually result in a more reliable measure of the arm's length price being determined.

569. The OECD guidelines themselves note that while an attempt should be made to establish the proper arm's length pricing, there may be practical reasons why a tax administration, exceptionally, might forgo accuracy in favour of practicability (paragraph 7.37). As indicated in the chapter on documentation, taxpayers should trade-off the risks and benefits in determining its transfer pricing policies. Taxpayers should, however, record the basis for any cut-off decision.

### **Summary**

570. This chapter has considered the following key points:

- There are two central questions to be addressed:

- Has a service been provided?
- If so, how should the arm's length price be determined?
- The central test of whether a service has been provided is whether the recipient of an activity receives something that an independent enterprise in comparable circumstances would have been prepared to:
  - pay for it, or
  - perform the service for itself in-house.
- The most common methods applied to services are the CUP and cost plus methods.
- When the cost plus method is applied, costs might be identified directly if a direct-charge approach is used, or indirectly using an appropriate allocation key.
- If a cost allocation is being used, taxpayers should seek to identify a realistic allocation of costs with due regard to considerations of materiality, and not for accounting perfection—the real test is whether a fair charge is determined for the services provided.
- In auditing the transfer prices adopted for intra-group services, Inland Revenue is most likely to focus on:
  - whether a service has been provided
  - if an indirect-charge approach is taken to applying the cost plus method, whether the allocation key used is appropriate, and
  - whether the approach adopted results in a double deduction through both an explicit and an implicit charge being made.

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## Cost contribution arrangements (CCAs)

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### Key Points

- A CCA is a contractual arrangement whereby the contracting parties agree to contribute costs in proportion to their overall expected benefits from the arrangement.
- To satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances.
- Difficulties can arise in measuring the value of a participant's contribution and the expected value of its benefits. Participants should ensure that any judgement made leads to commercially justifiable conclusions.

### Introduction

571. A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights. It also determines the nature and extent of the interest of each participant in those assets, services, or rights. It is a contractual arrangement under which a member's share of contributions should be consistent with its expected benefits from the arrangement. Each member is also entitled to exploit its interest in the CCA separately as an effective owner, rather than as a licensee—it does not need to pay a royalty or other consideration for that right (paragraph 8.3, OECD guidelines). There is no standard framework for a CCA—each arrangement will depend on its own unique facts and circumstances.

572. A CCA should be distinguished from the scenario where members of a MNE jointly fund a new entity which then develops and exploits intangible property in its own right. In that case, the new entity will own any intangible property that it creates, and would be expected to derive an arm's length return from the exploitation of that intangible. The return to the members funding the new entity would be based on the form of capital contributed (for example, interest paid on debt or dividends paid on equity), rather than by benefiting directly from the intangible property.

573. The OECD guidelines suggest that the most likely area in which CCAs will arise will relate to the development of intangible property. However, the guidelines note that CCAs may also be used for any joint funding activity, such as centralised management services or developing advertising campaigns common to the participants' markets (paragraphs 8.6 and 8.7).

574. There are a number of significant issues that have not yet been resolved by the OECD (paragraph 8.1, OECD guidelines). The OECD guidelines appear likely to be developed further, therefore, as member countries gain experience in applying the arm's length principle to CCAs.

575. There may also be an issue over whether CCAs will be acceptable in overseas jurisdictions. For example, some jurisdictions may limit the use of CCAs to the development of intangible property, while others may not recognise them at all. If a CCA is not recognised in an overseas jurisdiction, there is potential for double taxation to occur.

576. The purpose of this chapter is to provide an overview of the OECD guidelines on CCAs. The discussion is not, however, exhaustive of issues canvassed in the OECD guidelines. For example, the OECD guidelines contain a detailed discussion on documents that would be useful to

document adequately a CCA (paragraphs 8.41 to 8.43). If a taxpayer does intend entering into CCA, the OECD guidelines are essential reading before entering into the arrangement.

## **Applying arm's length principle to CCAs**

577. For a CCA to satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances (paragraph 8.8, OECD guidelines).

578. Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the CCA be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement (paragraph 8.9, OECD guidelines).

579. Applying the arm's length principle to CCAs, therefore, requires the determination of:

- the participants in the CCA
- each participant's relative contribution to the joint activity, and
- the appropriate allocation of contributions, based on each participant's expected benefits.

## **Identification of participants**

580. Because the concept of mutual benefit is fundamental to a CCA, a participant must have a reasonable expectation that it will benefit from the CCA activity itself. A participant must receive a beneficial interest in the property or services that are the subject of the CCA activity and have a reasonable expectation of being able to exploit that interest, directly or indirectly.

581. A member of the MNE that performs part of the CCA activity but does not stand to benefit from the outcome of the CCA activity cannot be a participant of the CCA. Instead, it should be compensated by way of an arm's length charge for the services it performs for the CCA. This principle is illustrated in example 13.

### ***Example 13***

582. Three members of a MNE marketing a product in the same regional market in which consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the MNE helps develop the advertising campaign, but does not itself market the product.

583. The fourth member will not be a participant in the CCA, both because it does not receive a beneficial interest in the services subject to the CCA activity and would not, in any case, have a reasonable expectation of being able to exploit any interest. The three participants in the CCA would, therefore, compensate the fourth member by way of an arm's length payment for the advertising services provided to the CCA.

## **Amount of participant's contribution**

584. As contributions are to be made to a CCA in proportion to expected benefits, it is necessary to be able to value each member's contribution. Following the arm's length principle, the value of each participant's contribution is the value that independent enterprises would have assigned to the contribution in comparable circumstances.

585. Contributions to a CCA could be monetary or non-monetary. Non-monetary contributions might include, for example, the use of a participant's existing intangible assets or the provision of services by a participant.

586. When the contribution is cash, its value can easily be quantified. There are, however, a number of difficulties in valuing non-monetary contributions that have not yet been fully resolved in the OECD guidelines. For example:

- Should cost or market value be used in valuing contributions?
- How should the value of property or services provided be apportioned when they are only partly applied in the CCA activity with the balance applied in the provider's other activities?

587. These issues will need to be resolved on a facts and circumstances basis. The key consideration, however, is to ensure that the valuation approach adopted is commercially justifiable, and that independent firms would have been prepared to accept the terms of the CCA given the valuations adopted.

### **Appropriateness of allocation**

588. While a participant's contribution must be consistent with its expected benefits if a CCA is to satisfy the arm's length principle, there is, however, no universal rule for estimating the expected benefits to be obtained by each participant in a CCA (paragraph 8.19, OECD guidelines). Possible techniques include (but are not limited to):

- Estimation based on anticipated additional income that will be generated or costs that will be saved as a result of entering the CCA.
- The use of an appropriate allocation key, perhaps based on sales, units used, produced or sold, gross or operating profits, numbers of employees, capital invested, or alternative keys.

589. Again, appraisal of the appropriateness of the cost allocations will be based on facts and circumstances. The key consideration, however, is to ensure the benefits estimated are consistent with the benefits that an independent firm might have expected to receive from the CCA.

### **Balancing payments**

590. Balancing payments may be required to adjust participants' proportionate shares of contributions (paragraph 8.18, OECD guidelines). If, for example, a participant's contribution exceeds its expected share of the benefits from the CCA, a payment should be made to that participant from the other participants so that its contributions and expected benefits are reconciled.

### **Tax treatment of contributions and balancing payments**

591. The tax treatment of contributions to a CCA will depend on the character of the payment. If the expenditure would be deductible if it were to be incurred outside the CCA, the expenditure will be deductible. If, however, the expenditure would be treated as capital expenditure if it were to be incurred outside the CCA, the expenditure will be non-deductible.

592. A balancing payment is treated as an addition to the costs of a payer and as a reimbursement (reduction) of costs to the recipient. If a balancing payment exceeds the recipient's deductible expenditures, the tax treatment of the excess payment will depend on what the payment is made for.

593. No part of a contribution or balancing payment in respect of a CCA will constitute a royalty for the use of intangible property, because each participant in the CCA receives a right to exploit intangible property arising from the CCA by virtue of being a participant in the CCA.

### **Conclusions on applying arm's length principle to CCAs**

594. The preceding discussion suggests that it may be difficult to locate comparable data on which to apply the arm's length principle to CCAs. Participants to a CCA may, therefore, need to depend on the exercise of "commercially justifiable" judgement in determining the value of the

contributions and the expected benefits of each participant. Each case will depend on its own facts and circumstances.

595. Taxpayers should ensure in particular that:

- valuations of non-cash contributions to a CCA are consistent for each party's contribution and commercially justifiable; and
- expected benefits are estimated in such a way that an independent enterprise would be prepared to use the outcome of the estimation as a basis for determining whether it would accept the terms of the CCA.

## **Structure of CCA**

596. Paragraph 8.40 of the OECD guidelines lists a number of conditions that a CCA at arm's length would ordinarily meet. These conditions, set out below, may provide a useful guide when formulating a CCA.

- (a) The participants would include only enterprises expected to derive mutual benefits from the CCA activity itself, either directly or indirectly (and not just from performing part or all of the activity).
- (b) The arrangement would specify the nature and extent of each participant's beneficial interest in the results of the CCA activity.
- (c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the beneficial interest in property, services, or rights obtained through the CCA.
- (d) The proportionate shares of contributions would be determined in a proper manner using an allocation method reflecting the sharing of expected benefits from the arrangement.
- (e) The arrangement would allow for balancing payments or for the allocation of contributions to be changed prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants.
- (f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the withdrawal of a participant and upon termination of the CCA.

## **Summary**

597. This chapter has considered the following key points:

- A CCA is a contractual arrangement whereby participants agree to share costs on the basis of expected benefits from the arrangement.
- To satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances.
- Difficulties can arise in measuring the value of a participant's contribution and the expected value of its benefits. Any judgements made in making these measurements should be commercially justifiable.

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## Changes from draft guidelines

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598. This chapter summarises the changes, other than minor editorial and renumbering changes, that have been made to the draft transfer pricing guidelines following consultation.

### Introduction

599. The introduction has been substantially redrafted to consolidate the prefaces to parts 1 and 2 of the draft guidelines. Some material has also been added on the Competent Authority procedure (paragraphs 26 to 30) and advance pricing agreements (APAs) (paragraphs 31 to 33).

600. The changes of substance reflected in the introduction are:

- The guidelines now fully endorse the positions set out in chapters 1 to 8 of the OECD guidelines (paragraph 7).
- References to releasing future guidelines on the detailed application of the transfer pricing methods have been removed. The OECD is developing further examples for publication in their transfer pricing guidelines.
- It is no longer anticipated that Inland Revenue will issue separate guidelines on the attribution of income and expenditure to a branch (section FB 2) (paragraph 39).

### Arm's length principle

601. No changes have been made to this chapter.

### Pricing methods: theoretical and practical considerations

602. The changes of substance in the chapter on pricing methods are:

- References to the transactional net margin method (TNMM), recognised in the OECD guidelines, have been redrafted to reflect that the approach is narrower than the “comparable profits methods” referred to in section GD 13(7)(e) (paragraphs 85; 87 to 89). Reference has also been removed to the profit comparison method (PSM), as the Australian Tax Office recognises this as identical to the OECD's TNMM.
- The discussion on the economics approach to applying the traditional transactional methods has been shifted to an appendix to the chapter (paragraphs 174 to 184). This recognises the concern expressed in submissions that the unconventional nature of the analysis could cause confusion if it remained in the main text of the chapter.
- The discussion on intangible property (paragraphs 113 to 124) has been updated to reconcile with the subsequently published chapter on intangible property. In particular, the text has been updated to emphasise that it is legal ownership that ultimately determines where returns to intangibles should accrue, while recognising that the party creating the intangible value would, at arm's length, still expect to be compensated appropriately for its contribution (paragraph 117).
- A paragraph has been added to distinguish the profit split method from global formulary apportionment (paragraph 128).
- The profit split method can be almost entirely subjective in its application, and this has the potential to impact significantly on the reliability of the prices determined using the method.

Two new paragraphs have been added to highlight that caution must be exercised when applying the method because of this reliability concern (paragraphs 139 and 140).

- The paragraph on evaluating package deals has been updated to reflect correctly the position in the OECD guidelines (paragraphs 164 and 165).
- To remove an apparent contradiction with paragraph 169, the sentence “New Zealand will not be adopting this approach” has been removed from paragraph 168.
- To remove any inference that Inland Revenue might expect taxpayers to perform analyses under more than one method, the word “will” has been changed to “may” in paragraph 171, and paragraph 172 has been redrafted. The draft guidelines were never intended to convey to taxpayers that they must prepare analyses under multiple methods—only that such further analyses might increase the credibility of their analysis.

## **Principles of comparability**

603. The changes of substance in the chapter on comparability are:

- The key points and the summary have had small drafting changes to reflect that in most cases, functional analysis will be an essential, rather than merely a useful, tool in performing a transfer pricing analysis. Paragraph 237 has been changed to similar effect, noting that Inland Revenue would expect in most cases to see a functional analysis as part of a taxpayer’s documentation.
- The words “whether charged for or not” have been added in paragraph 201, recognising that even if a function performed is not charged for, it might still be expected to provide a return if performed at arm’s length.
- The example of a functional analysis in table 4 has been simplified. It was considered that the example as previously drafted lost the key message of the importance of comparing functions, in favour of a less relevant focus on the nature of the process that might be followed.
- In paragraph 251, a short example has been added to draw out the relationship between the bearing of costs and risks on the one hand with the expectation of accruing any rewards from those costs and risks on the other.
- A short section has been added on the effect of Government policies on transfer prices, based on similar material included in paragraphs 1.55 to 1.59 of the OECD guidelines (paragraphs 258 to 260).

## **Practical application of arm’s length principle**

604. The changes of substance in the chapter on the practical application of the arm’s length principle are:

- A comment has been added in the introduction reflecting that the four-step process might be costly to apply, and that taxpayers should weigh up the costs of developing their transfer pricing policies against the risk of an audit and an adjustment (paragraph 268).
- The Australian draft ruling TR 95/D22 on which the chapter is based has been finalised as ruling TR 98/11 since New Zealand’s draft guidelines were published. Given that the draft transfer pricing guidelines have already been fairly well assimilated into New Zealand tax practice, it was not considered that there would be much benefit to attempting a wholesale review of the chapter to reflect the revised Australian analysis. A cross-reference to the final Australian ruling has, however, been added to the chapter.
- Paragraph 279 has been rephrased to reflect that while a third party arm’s length sale for the purpose of establishing an arm’s length price may not provide a reliable comparable, it does not

necessarily follow that it will be an unreliable comparable. There are broader factors to consider than merely that the transaction occurred.

## **Documentation**

605. The changes of substance in the chapter on documentation are:

- A new paragraph has been added to the introduction to recognise that preparing documentation may not necessarily entail a lot of work on the taxpayer's behalf, if based on working papers prepared in the course of following a process to determine arm's length prices (paragraph 294).
- When the draft transfer pricing guidelines were prepared, implicit in the notion of "good documentation" was a credible underlying analysis. In most cases, this implication was clear from the text. Changes have, however, been made in paragraphs 299, 365 and 369 to emphasise the importance of the credibility of the underlying analysis in Inland Revenue's assessment of whether a taxpayer's documentation is adequate.
- A footnote has been added to the discussion on the trade-off between compliance cost and tax risk, noting that tax risk should be measured in terms of the revenue at risk (paragraph 317).
- Comments suggesting that the level of transfer pricing documentation should be consistent with the amount that might be expected to support any other business decision of similar complexity and importance have been changed. The text now reflects the position in the OECD guidelines that the application of "prudent business management principles" relates to the extent to which one should undertake a transfer pricing analysis, rather than the extent to which documentation should be prepared (paragraphs 326 and 327, 405).
- Paragraph 368 has been redrafted to clarify what was intended by the term "rebuttable presumption" used in the draft guidelines.
- Paragraph 376 has been redrafted to reinforce Inland Revenue's preference that transfer pricing administration occur within a co-operative environment. This preference was not considered sufficiently well drawn out in the original text.
- References to the use of "hindsight" by Inland Revenue have been removed from paragraphs 403 and 404. The term was an unfortunate choice of words, not reflecting accurately the issues the paragraphs are attempting to expound.
- The second bullet in the summary to the chapter has been redrafted to reflect that, while it is reasonable to expect taxpayers to have documented their transfer prices by the time they file their return, preparing transfer pricing documentation is not a statutory requirement (paragraph 405).

## **Intangible property; Intra-group services; Cost contribution arrangements (CCAs)**

606. The only changes to the chapters on intangible property, intra-group services, and cost contribution arrangements (CCAs) are the deletion of the first paragraph, referring to Inland Revenue's endorsement of the OECD guidelines, from the introduction of each chapter. This is now dealt with in paragraph 7 in the Introduction.