Transfer pricing regime

Sections GD 13 and FB 2, Income Tax Act 1994

Introduction

A new transfer pricing regime has been enacted to improve the measurement of taxpayers' net New Zealand-sourced income, and to reduce the scope for manipulation of cross-border transfer prices to reduce New Zealand tax liabilities.

The new transfer pricing rules are principally contained in section GD 13. In short, this section requires cross-border transactions between related parties that would otherwise deplete the New Zealand tax base to be reported for tax purposes at arm's length terms. An anti-avoidance provision will allow the section to also apply to certain other non-arm's length transactions. Cross-border income and expenditure apportionment for branches (mainly relevant to New Zealand branches of non-resident companies) is dealt with separately in new section FB 2.

The new transfer pricing regime is consistent with the international consensus developed between OECD countries on transfer pricing. It is also consistent with the approach used in all of New Zealand's double taxation agreements.

Later this year Inland Revenue will issue guidelines containing a detailed explanation of how to apply the new transfer pricing provisions. These guidelines will be based on the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Transfer Pricing Guidelines), and will be developed in consultation with interested parties. Until New Zealand's guidelines are issued, Inland Revenue will be following the OECD guidelines in applying the regime.

Background

Multinational groups can manipulate their worldwide tax position by paying inadequate or excessive consideration for the transfer of goods, services, intangible property and loans between their constituent members. For example, a multinational has an incentive to sell into a high tax country at high prices, as this reduces the profit earned in that country. Similarly, a multinational has an incentive to sell into a low tax country at low prices, as this increases profits earned in that country. The overall effect is that the multinational can minimise its total tax by manipulating its cross-border prices, thereby shifting its profits to the jurisdictions that impose the lowest tax cost.

An effective transfer pricing regime is one that prevents multinational groups from manipulating their intra-group prices to reduce their New Zealand tax liabilities. New Zealand's former transfer pricing rules, contained in the now repealed section GC 1, were deficient in this regard. For example, the control test which had to be satisfied before the provision could apply was inadequate, allowing the rules to be easily circumvented.

Internationally, the common approach to the problem of transfer pricing has been to require multinational groups to calculate prices for their intra-group transactions for tax purposes as if those transactions had been conducted on arm's length terms. New Zealand has looked to follow this internationally accepted "arm's length principle" in enacting the transfer pricing rules in new section GD 13.

Key features

- The regime generally applies to cross-border non-arm's length transactions between related parties that have the potential to deplete the New Zealand tax base.
- An anti-avoidance rule extends the regime to certain other non-arm's length transactions.
- The internationally accepted range of transfer pricing methods (as expressed in the OECD Transfer Pricing Guidelines) may be used to calculate the arm's length price. These are transaction-based methods (comparable uncontrolled price, resale price, cost plus) and profits-based methods (profit split and comparable profits).
- Each transfer pricing method will require reference to comparable uncontrolled prices and/or comparable profit margins.
- The method producing the most reliable measure of the arm's length price must be applied.
- The choice of transfer pricing method and its application must be made having regard to criteria including comparability, accuracy and completeness of the data, assumptions used, and sensitivity of results to deficiencies in the data and assumptions.
- The taxpayer's determination of the arm's length price will be upheld, unless either of the following applies:
    - The Commissioner can demonstrate a more reliable arm's length price.
    - The taxpayer does not cooperate with the Commissioner in the Commissioner's administration of the regime (such non-cooperation having a material effect on the Commissioner's administration), in which case the burden of proof will fall back on the taxpayer.
- In certain circumstances the rules allow compensating adjustments for a taxpayer who is subject to an adverse transfer pricing adjustment. The rules will also allow a substituted arm's length price to be used to calculate the tax of the other party to a transfer pricing arrangement.
- Companies may attach imputation credits retrospectively to non-cash dividends arising from transfer pricing arrangements. Imputation credits relating to

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tax paid on a transfer pricing adjustment may also be used to impute such dividends retrospectively.

- The Commissioner will issue guidelines on the detailed application of the transfer pricing rules in section GD 13 later this year. These guidelines will be based on the OECD Transfer Pricing Guidelines and will be developed in consultation with interested parties.
- New rules provide for the apportionment of cross-border income and related expenditure for branches, using the arm's length principle.
- Advance pricing agreements will be available as part of the binding rulings regime in order to increase taxpayer certainty. These agreements can be unilateral (involving only Inland Revenue) or multilateral (involving tax treaty partners willing to enter into such agreements).
- The new transfer pricing rules are consistent with New Zealand's double taxation agreements.

Application date

The new transfer pricing regime applies from the start of the 1996-97 income year. The new regime can apply to existing arrangements to the extent they affect income tax liabilities in the 1996-97 income year and subsequent years.

Scope of the regime (section GD 13 (2))

In order for the transfer pricing regime to apply to a transaction, the transaction must meet the following three conditions:

1. The arrangement must involve the supply and acquisition of goods, services or anything else.
2. The supplier and acquirer must be related parties.
3. The arrangement must be cross-border in character (i.e., not wholly within the New Zealand tax base).

These requirements are discussed in detail below.

1. Supply and acquisition of anything (section GD 13 (2)(a) and (13))

Section GD 13 applies to an arrangement involving the supply and acquisition of goods, services, money, other intangible property, or anything else. This means the description of the subject matter of a transfer pricing arrangement is all-encompassing.

Section GD 13 uses the term "arrangement" in relation to any transaction. "Arrangement" is widely defined in section OB 1 as meaning "any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect". This term underlies the all-encompassing nature of the transfer pricing regime with regard to what can be the subject matter of an affected transaction.

The terms "supply" and "acquisition" take their ordinary wide meaning. However, these ordinary meanings are supplemented by partial definitions in section GD 13 (13). "Acquisition" is defined to include obtaining the availability of anything, and "supply" is defined to include making anything available.

The references to "availability" in the "acquisition" and "supply" definitions were included to ensure that the new transfer pricing regime has its intended effect and ambit. The reference to "obtaining the availability" makes it clear that the regime applies to acquisition-type transactions by a New Zealand subsidiary from its non-resident parent (e.g., receiving a loan at an excessive interest rate or an intellectual property license at an excessive consideration (royalty)). Similarly, the "making available" reference makes it clear that the regime applies to supply-type transactions by a New Zealand subsidiary to its non-resident parent (e.g., a low interest loan or the licensing of intellectual property at an inadequate consideration).

Equity capital

The only exception to what can be included in the subject matter of a supply and acquisition is equity capital. The terms "acquisition" and "supply" in section GD 13 (13) specifically exclude the receipt or payment of consideration for the issue of shares (equity capital), unless the shares are fixed rate shares. (The term "fixed rate share" is defined in section OB 1.) The exception for equity capital (other than fixed rate shares) has been made because there is no requirement in the case of ordinary shares for any dividend to be paid by the recipient of the equity capital (the company) to its provider (a shareholder).

The continued inclusion of fixed rate shares in the types of transactions covered by the transfer pricing regime is necessary because such shares are analogous to, and highly substitutable with, loans. As loans are covered by the transfer pricing regime, it is appropriate that fixed rate shares are also covered. (Note that a New Zealand company that is deemed to have received an arm's length amount of dividend on a fixed rate share in an offshore subsidiary will not be entitled to an underlying foreign tax credit to offset the resultant dividend withholding payment liability. This is because section LF 2 (2)(c) provides for a nil underlying foreign tax credit if the share in respect of which a dividend is paid is a fixed rate share.)

2. Related party requirement (section GD 13 (2)(b))

The transfer pricing regime generally applies only to transactions between related parties. This is effected by requiring the supplier and acquirer to be associated persons. The associated persons definition in section OD 8 (3) is used for the purposes of the transfer pricing regime. Additionally, the proviso to section OD 8 (3)(a) (which provides that two companies are not associated if one is non-resident) does not apply. This associated persons definition is used for the purposes of most international tax provisions in the Income Tax Act.

3. Cross-border requirement (section GD 13 (2)(c))

The transfer pricing regime generally applies only to cross-border transactions. These are effectively defined to mean all transactions which have an international aspect (i.e., are not wholly domestic), and which therefore have the potential to reduce the New Zealand tax base. An arrangement involving a non-resident who has a New Zealand tax presence not amounting to a permanent establishment is not considered to be wholly domestic because New Zealand generally cannot tax the business profits of such persons if they are resident in a treaty country. (Section GD 13 actually uses the term "fixed establishment", although this is similar in meaning to the term "permanent establishment" used in New Zealand's double taxation agreements.)

The approach taken in the legislation is to include within the potential ambit of the transfer pricing rules all arrangements that are not wholly within the New Zealand tax base. Accordingly, cross-border arrangements include all of the following:

- An arrangement between two non-residents, unless each of the non-residents enters into the arrangement for the purposes of a business carried on by that person in New Zealand through a fixed establishment.
- An arrangement between a resident and a non-resident, unless the non-resident enters into the arrangement for the purposes of a business carried on by that person in New Zealand through a fixed establishment, and the New Zealand resident has not entered into the arrangement for the purposes of an offshore business carried on by that New Zealand resident.
- An arrangement between two residents, if either or both enter into the arrangement for the purposes of an offshore business. (It is necessary to include these arrangements, as they are not wholly domestic and allow for the potential manipulation of foreign tax credits and losses by New Zealand residents, with a resultant reduction in the New Zealand tax base.)

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The operative provisions in section GD 13 (3) and (4) will not apply to a transaction involving two non-residents which is wholly outside the New Zealand tax base. This is because these provisions can only apply to a "taxpayer", which is defined in section OB 1 to be a person chargeable with New Zealand income tax. As neither non-resident derives New Zealand-sourced income in respect of the transaction, section GD 13 cannot apply.

Section GD 13 (2)(c) applies to transactions between any type of persons. The regime therefore has a broader application than to merely transactions between companies, extending to transactions involving individuals and persons in their capacity as trustees of trusts and partners in partnerships.

Note that the limitation on the application requirements in section GD 13 (2) (notably the related party and cross-border requirements) do not apply if the specific transfer pricing anti-avoidance provision in section GC 1 is applicable to any arrangement (see page 10).

The following table summarises the 15 possible combinations of supply and acquisition arrangements involving residents and non-residents. The 12 types of arrangements which are covered by section GD 13 (2)(c) have a "yes" label while the three types of arrangements which are not covered have a "no" label. The subparagraph in section GD 13 (2)(c) which is relevant to a particular arrangement is also identified.

When section GD 13 (2)(c) applies

	Resident operating onshore	Resident operating offshore	Non-resident operating onshore through a fixed establishment	Non-resident operating onshore but not through a fixed establishment	Non-resident operating offshore
Resident operating onshore	No (c)(iii)				
Resident operating offshore	Yes (c)(iii)	Yes (c)(iii)			
Non-resident operating onshore through a fixed establishment	No (c)(ii)	Yes (c)(ii)	No (c)(i)		
Non-resident operating onshore but not through a fixed establishment	Yes (c)(ii)	Yes (c)(ii)	Yes (c)(i)	Yes (c)(i)	
Non-resident operating offshore	Yes (c)(ii)	Yes (c)(ii)	Yes (c)(i)	Yes (c)(i)	Yes (c)(i)

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Operative provisions (section GD 13 (3), (4), (5) and (12))

In short, the operative provisions of section GD 13 require the substitution of an arm's length amount in either of these situations:

- The taxpayer is paying an excessive consideration in respect of an acquisition.
- The taxpayer is receiving an inadequate consideration in respect of a supply.

The regime effectively only applies to transactions that deplete the New Zealand tax base.

The operative provisions apply automatically; they do not depend on the exercise of the Commissioner's discretion for their application. This is consistent with the principle of self-assessment. Also, a tax avoidance purpose is not a prerequisite to the application of the provisions.

Excessive consideration payable for acquisition (section GD 13 (3))

If the amount of consideration payable by a taxpayer for an acquisition exceeds the arm's length amount, an arm's length amount is deemed to be the amount payable by the taxpayer in substitution for the actual amount.

A substitution of an arm's length amount under section GD 13 (3) applies only in respect of the taxpayer's income tax liability. It does not affect the tax liability of the other party to the agreement, unless the other party has obtained an adjustment to its tax liability under section GD 13 (11) (see page 8). Section GD 13 (12) confirms that a transfer pricing adjustment affects only the taxpayer's income tax liability and does not affect the taxpayer's obligation to deduct withholding tax.

Example 1

A New Zealand subsidiary acquires a trademark license from its non-resident parent. If the New Zealand company's royalty payment to its parent in one year is $1.5m and the arm's length amount is $1m, an adjustment would be made under section GD 13 (3). The arm's length amount of $1m would be substituted and the New Zealand company's deduction for the royalty payment would accordingly be reduced by $0.5m.

This substitution does not affect the New Zealand company's non-resident withholding tax (NRWT) deduction obligations, and unless a consequential adjustment under section GD 13 (11) is obtained, the New Zealand company would still be required to deduct an amount of $0.15m NRWT, based on the actual royalty payment of $1.5m (assuming the non-resident parent is resident in a treaty country for which the NRWT rate is 10%).

Example 2

A New Zealand company purchases a capital asset from its non-resident parent for $15,000. If the arm's length amount for the asset was in fact $10,000, section GD 13 (3) would substitute this $10,000 amount so far as the New Zealand subsidiary's tax liability is concerned, and accordingly its cost base for depreciation purposes would be reduced by $5,000. However, the non-resident's tax position is not affected and accordingly it still derives a dividend of $5,000 under section CF 2 (1)(d) (property acquired by a company from any shareholder for excessive consideration). Section GD 13 (12) confirms that the New Zealand subsidiary's obligation to deduct NRWT in respect of this dividend is not affected by the application of section GD 13 (3).

Section GD 13 (3) applies for all purposes of the Income Tax Act in relation to the taxpayer's income tax liability. The flow-through effect for tax calculation purposes of the substitution of an arm's length amount is also illustrated in the case of trading stock; the transfer pricing adjustment may affect the value of any trading stock on hand at the end of the year and at the beginning of the following year.

Example 3

A New Zealand company in an income year purchases trading stock from its non-resident parent at a cost of $10 million. The arm's length amount of $7.5 million is substituted under section GD 13 (3) and therefore this amount represents the deduction under section BB 7 for the New Zealand company. Assume that:

- the New Zealand company recorded $4 million worth of trading stock on hand at the end of the year in its tax return, cost price being used for the purpose of section EE 1 (3) (all stock on hand is sourced from its parent); and
- the effect of the section GD 13 (3) adjustment can be apportioned on a straightline basis between stock on hand and the stock which has been sold, so that the value of any over-priced stock still on hand will be 25% ($1 million) less than the value of the stock on hand recorded by the New Zealand company; and
- the New Zealand company included an amount of $12 million in its income under section EE 1 (8) and (9) (being the excess of the stock on hand at the end of the year over the value of the stock on hand at the start of the year). This figure of $12 million was based on the $4 million over-priced stock on hand at the end of the year.

In this situation, the amount to be included in the income of the New Zealand company for the income year under section EE 1 will be reduced by $1 million in accordance with the second step above to $11 million.

The opening stock figure for the following year will be $3m ($4m, less the $1m stock adjustment).

Inadequate consideration received for supply (section GD 13 (4) and (5))

If the amount of consideration receivable by a taxpayer for a supply is less than the arm's length amount, section GD 13 (4) provides that the arm's length amount is deemed to be the amount receivable by the taxpayer in substitution for the actual amount. An adjustment under section GD 13 (4) applies for all purposes of the Income Tax Act in relation to the taxpayer's income tax liability, and may also affect the obligation of the taxpayer or the other party to the arrangement to make a withholding or deduction. The other party's own tax liability is not affected.

Example 4

A New Zealand subsidiary sells trading stock to its non-resident parent for a payment of $20,000. If the arm's length amount is in fact $30,000, section GD 13 (4) will substitute this amount for the purposes of calculating the subsidiary's tax liability. Accordingly the subsidiary is treated as having derived $10,000 additional income. The substitution of the arm's length amount under section GD 13 (4) does not affect the tax position of the parent which still derives a dividend under section CF 2 (1)(c) (property of a company transferred to a shareholder for inadequate consideration). Section GD 13 (12) confirms that the New Zealand subsidiary's obligation to deduct NRWT in respect of this dividend is not affected by the application of section GD 13 (4).

Section GD 13 (5) sets out certain circumstances where subsection (4) will not apply and is designed to ensure that that provision only applies if the transfer pricing arrangement would deplete the New Zealand tax base. Section GD 13 (5) is relevant to arrangements under which a non-resident is the supplier. In particular, section GD 13 (5) provides that subsection (4) will not apply if all of these conditions are met:

- The taxpayer (supplier) is a non-resident and did not enter into the arrangement for the purposes of a business carried on in New Zealand through a fixed establishment.
- The amount derived by the non-resident is interest, royalties, or an insurance premium.
- The amount is deductible in calculating the other party's net income.

Section GD 13 (4) will therefore not apply if the amount that would be increased is subject only to a form of NRWT and the New Zealand payer of the amount can claim an income tax deduction for the increased amount if it obtains a consequential adjustment under section GD 13 (11). Section GD 13 (5) ensures that section GD 13 (4) only applies if the combined tax of both parties to the arrangement would otherwise be reduced under the transfer pricing arrangement. Section GD 13 (5) would not apply if the payer was exempt from tax (meaning the payment was not deductible for tax purposes) and accordingly section GD 13 (4) would apply to deem the non-resident to have received an arm's length amount which would be subject to NRWT.

Example 5

A non-resident company (resident in a treaty country) licenses intellectual property to a New Zealand subsidiary. No royalty is paid by the New Zealand company for the use of the licence. The non-resident parent is the taxpayer in terms of section GD 13 (4). If an arm's length royalty of $100 was substituted for the nil payment, the New Zealand subsidiary could apply under section GD 13 (11) for a consequential adjustment, resulting in a deduction of $100 to the New Zealand subsidiary (for the deemed royalty payment) which has a greater tax cash value ($33) than the amount of tax ($10) that New Zealand could impose on the non-resident in respect of the $100 deemed royalty receipt. Section GD 13 (5) prevents section GD 13 (4) applying in this case. However, section GD 13 (5) would not apply if the New Zealand subsidiary was exempt from tax. In this case, no deduction to the New Zealand company could arise from a consequential adjustment under section GD 13 (11), and it would therefore be in New Zealand's interest to maximise the income of the non-resident parent by allowing GD 13 (4) to apply to deem it to have received an arm's length royalty payment.

An adjustment under section GD 13 (4) also applies for the purposes of the obligation of the other party to the arrangement to withhold or deduct from the amount receivable by the taxpayer. This will apply in the limited number of situations in which the non-resident is the taxpayer in terms of section GD 13 (4), and both of the following conditions are met:

- The taxpayer makes a supply for which the consideration is subject to NRWT
- The arrangement is not excluded from the transfer pricing regime by section GD 13 (5) (because, for example, the other party is tax exempt).

If an arm's length amount is substituted the other party to the arrangement will have an obligation to deduct NRWT from the substituted higher amount. Therefore, in the above example, assuming the New Zealand subsidiary was tax exempt (and therefore section GD 13 (4) is still applicable) the New Zealand subsidiary would have an obligation to deduct $10 of NRWT (assuming the relevant treaty rate is 10%).

An adjustment under section GD 13 (4) also applies for the purposes of the taxpayer's obligation to withhold or deduct from the amount receivable by that taxpayer. This reference is necessary to cater for the situation of a New Zealand company holding fixed rate shares in an

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offshore subsidiary for which the dividend paid is below an arm's length amount. Section GD 13 (4) would substitute an arm's length amount of dividend, giving the New Zealand company an obligation to deduct a dividend withholding payment under section NH 1 from this deemed amount.

Determination of arm's length amount (section GD 13 (6) to (9))

The preceding material has mainly described the provisions stipulating what transactions are affected by the transfer pricing regime. In short, these are generally cross-border, non-arm's length transactions between related parties that deplete the New Zealand tax base.

Transactions subject to the transfer pricing rules must be reported at arm's length terms for income tax purposes. Section GD 13 (6) to (9) stipulate how an arm's length amount of consideration is to be determined.

Section GD 13 (6) provides that the arm's length amount must be determined by using whichever one of the prescribed methods "will produce the most reliable measure of the amount completely independent parties would have agreed upon after real and fully adequate bargaining". This statement of the arm's length principle is consistent with the expression of this principle contained in the Associated Enterprises article (Article 9) of the *OECD Model Tax Convention on Income and Capital* (OECD Model Tax Convention), which is also found in all of New Zealand's double taxation agreements. The relevant part of this article reads:

> "Where ... 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".

The purpose of this part of the article is to give a brief overview only of the provisions relating to the determination of an arm's length amount. Guidance on the detailed application of these provisions (and other matters such as documentation requirements and advance pricing agreement procedures) will be provided by comprehensive guidelines to be issued by the Commissioner later this year. These guidelines will be based on the OECD Transfer Pricing Guidelines (published in July 1995), which represent the international consensus on the appropriateness and application of the arm's length principle in transfer pricing matters. New Zealand's guidelines will be developed in consultation with interested parties. (Until New Zealand's guidelines are issued, Inland Revenue will be following the OECD guidelines in applying the regime.)

Set out below are the transfer pricing methods prescribed in section GD 13 (7). These methods comprise the internationally recognised range of transfer pricing methods as expressed in the OECD Transfer Pricing Guidelines. The brief descriptions of the methods given are derived from these guidelines:

Comparable uncontrolled price (CUP) method

This method compares the price for property or services transferred in a controlled transaction (a transaction between associated enterprises) to the price charged for property or services transferred in an uncontrolled transaction in comparable circumstances. The price charged in the uncontrolled transaction forms the basis for the arm's length price determined under the CUP method.

Resale price method

This method is based on the price at which the product that has been purchased from an associated enterprise is resold to an independent enterprise. To determine the arm's length price, the resale price is:

1. reduced by the resale price margin, which is a margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (e.g., assets used and risks assumed), make an appropriate profit; and then
2. adjusted for other costs associated with the purchase of the product (e.g., customs duties).

Cost plus method

This method is based on the costs incurred by the supplier of property (or services) in a controlled transaction. The arm's length price is determined by adding an appropriate profit margin (measured by reference to margins computed after the direct and indirect costs incurred by a supplier of property or services in a transaction) to the costs incurred by the supplier, to make an appropriate profit in light of the functions performed (e.g., assets used and risks assumed) and the market conditions.

Profit split method

This method first identifies the combined profit to be split between the associated enterprises to a controlled transaction, and then splits those profits between the associated enterprises 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.

Comparable profits methods

These 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 (e.g., return on assets, operating income to sales, or other suitable financial ratios). They include what the OECD refers to as "transactional net margin methods". Note however, that these methods are internationally acknowledged to be the least reliable of the transfer pricing methods, and should generally be considered to be methods of last resort.

Choice and application of methods

The CUP, resale price and cost plus methods are referred to as transactional methods and the profit split and comparable profits methods as profits methods. The main distinction between transactional methods and profits methods is that transactional methods compare prices, while profits methods compare profits.

Section GD 13 (8) requires that the taxpayer's choice and application of a method to determine the arm's length amount must be made having regard to all of the following:

- 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 by the taxpayer
- the reliability of all assumptions
- the sensitivity of any results to possible deficiencies in the data and assumptions.

A key factor in determining an arm's length amount is comparability. This is because the application of the arm's length principle is generally based on a comparison of the conditions in the controlled transaction with the conditions in uncontrolled transactions (transactions between independent parties). Each of the prescribed transfer pricing methods requires reference to either comparable prices or comparable profit margins in comparable uncontrolled transactions.

The OECD Transfer Pricing Guidelines indicate that the main factors for determining comparability are:

- characteristics of property or services
- functional analysis (whether functions performed by parties to the controlled transaction are comparable to those performed by the parties to the uncontrolled transaction, considering also factors such as assets used and risks assumed)
- contractual terms
- economic circumstances
- business strategies.

The importance of each of these factors in establishing comparability in a particular case will depend on the nature of the controlled transaction and the transfer pricing method adopted.

The comparability standard requires controlled and uncontrolled transactions to be the same as or similar to each other, in order to provide the most reliable estimate of the arm's length price. A method will become a less reliable means for determining the arm's length price as the characteristics of the controlled and uncontrolled transactions become less comparable.

While inexact comparables are acceptable, material differences between compared transactions need to be taken into account. Adjustments will need to be made to account for any differences between the controlled and uncontrolled transactions that significantly affect the reliability of the price.

Although there is no formal priority of methods, the OECD Transfer Pricing Guidelines (on which the New Zealand guidelines will be based) incorporate a preference for transactional methods, as these methods produce the most reliable results if sufficient and accurate data exists. This is because transactional methods, by their very nature (they directly compare individual transactions), achieve a higher degree of comparability than profits-based methods. The profits-based methods, although recognised by the OECD to be consistent with the arm's length principle, allow only for an indirect comparison of individual transactions, and are generally regarded by the OECD as methods of last resort.

The arm's length amount determined under section GD 13 (6) to (8) should be treated as the "market value" amount where that term or an equivalent term is used elsewhere in the Income Tax Act (e.g., in section GD 1 (1) - market price or the true value).

Section GD 13 (9) provides that the taxpayer's determination of the arm's length amount, in accordance with subsections (6) to (8), will be upheld, unless either of the following applies:

- The Commissioner can demonstrate a more reliable arm's length amount in accordance with subsections (6) to (8).
- The taxpayer has not cooperated with the Commissioner in the Commissioner's administration of the transfer pricing regime and the non-cooperation has materially affected that administration, in which case the Commissioner will determine the arm's length amount in accordance with subsections (6) to (8).

This rule effectively places the burden of proof on the Commissioner to demonstrate that the taxpayer's determination of the arm's length amount (in particular, the taxpayer's choice of method and selection of comparable prices or profit margins) is incorrect and should not be applied.

However, the taxpayer is still required to determine the arm's length amount in accordance with subsections (6) to (8). Section GD 13 (8) effectively requires taxpayers to make reasonable efforts to assess adequately the comparables to a controlled transaction. A taxpayer is therefore required to make a reasonable determination of the arm's length price.

There are two main situations where the non-cooperation rule would apply so that the burden of proof reverts to the taxpayer:

- The taxpayer does not provide requested relevant information to the Commissioner.
- The taxpayer fails to comply in a material manner with the documentation requirements (necessary to support a taxpayer's prices in its controlled transactions) contained in Inland Revenue's transfer pricing guidelines.

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Collateral adjustments (section GD 13 (10) and (11))

The collateral adjustment provisions allow a person to make a downward adjustment to its tax liability that relates to and is a direct consequence of an upward transfer pricing adjustment to itself or another person.

The operative provisions in section GD 13 (subsections (3) and (4)) only apply if the New Zealand tax base is depleted, so section GD 13 also contains provisions allowing for compensating and consequential adjustments (collectively referred to as "collateral adjustments") in certain situations to give relief to taxpayers and other parties to arrangements which have been subject to an adverse transfer pricing adjustment. Compensating adjustments may be available for the taxpayer in an arrangement subject to the transfer pricing rules. Consequential adjustments may be available to the other party to the arrangement.

1. Compensating adjustments (section GD 13 (10))

In certain circumstances, a taxpayer who has been subject to an adverse transfer pricing adjustment is allowed a compensating adjustment for a transaction involving an inadequate payment for an acquisition or an excessive receipt for a supply ("favourable transaction"). Therefore, if a taxpayer conducts two related non-arm's length transactions, and section GD 13 (3) or (4) applies to only one of those transactions, a compensating adjustment may be allowed to provide relief in relation to the other transaction.

For a compensating adjustment to be allowed, the adverse transfer pricing adjustment under section GD 13 (3) or (4) must have occurred in the same income year as the favourable transaction or in the immediately preceding or succeeding income year, and involve the same other party. Either of the following conditions must also be met:

- The transaction giving rise to the adverse transfer pricing adjustment must involve the same subject matter as that in the favourable transaction.
- If the transaction involves different subject matter, the amount of consideration in the transaction giving rise to the adverse transfer pricing adjustment was deliberately set having regard to the pricing in the favourable transaction (commonly referred to as an "intentional setoff").

The restrictions on the availability of compensating adjustments were considered necessary to make the transfer pricing rules administratively manageable. The conditions mean that the favourable transaction must be directly related to the transaction giving rise to the adverse transfer pricing adjustment. It is therefore not possible to dispute the outcome of a particular adverse transfer pricing adjustment by seeking a series of compensating adjustments to unrelated transactions.

A common situation in which a compensating adjustment would be available would be if a fixed price is used to record transactions between related parties, but the market price in fact fluctuates during the period. Section GD 13 (10) allows the transactions that resulted in an overpayment of tax (inadequate payment for an acquisition or an excessive receipt for a supply) to also be adjusted to the arm's length amount in accordance with section GD 13 (6) to (8).

Example 6

A New Zealand subsidiary acquires in an income year a commodity from its non-resident parent. The contract provides for a set price notwithstanding that the market price of the commodity may vary during the year.

If the transfer pricing rules were applied in the absence of subsection (10), the price payable by the New Zealand subsidiary to the extent that it was greater than the arm's length amount would be adjusted downwards, but there would be no upwards adjustment if the price paid was less than arm's length.

Section GD 13 (10) would apply in this case to allow an upward adjustment to the less than arm's length prices paid by the New Zealand subsidiary. The conditions of section GD 13 (10) are satisfied as the arrangements are between the same parties and involve the same subject matter and have all taken place within the prescribed period.

The compensating adjustment mechanism can also apply if a taxpayer makes an acquisition for an excessive price but also makes a supply for an inadequate price, and the various conditions of subsection (10) are also satisfied (the arrangements take place within the three year timeframe and involve the same other party, and involve the same subject matter, or the consideration payable and receivable under the arrangements are linked).

Section GD 13 (10) would also be applicable if a taxpayer makes an acquisition for an inadequate price and makes a supply for an inadequate consideration, again so long as the various conditions in subsection (10) are met.

2. Consequential adjustments (section GD 13 (11))

The other party to an arrangement that was adjusted under the transfer pricing rules may request that the arm's length price also apply for tax purposes in relation to that other party. The application for a consequential adjustment must be made by the other party in writing within six months of when the taxpayer receives the assessment or determination reflecting the adverse transfer pricing adjustment. The consequential adjustment will apply if the Commissioner considers it is fair and reasonable to do so, having regard to any adjustment made under a double taxation agreement or any other matter. The consequential adjustment will apply for all purposes in relation to the application of the Income Tax Act to the other party, except for determining whether the other party has derived a dividend.

Unless the other party to an arrangement (typically a non-resident involved in an acquisition by a New Zealand taxpayer) seeks a consequential adjustment under section GD 13 (11), a transfer pricing adjustment will not affect the taxpayer's obligation to deduct withholding tax, something which is confirmed by subsection (12).

Example 7

A New Zealand company is licensed to use the trademark of its non-resident parent. If an excessive royalty of $150 (the arm's length amount being $100) was paid by a New Zealand company to its non-resident parent, the New Zealand company would be denied a deduction for the $50 amount of excess royalty under section GD 13 (3). Section GD 13 (11) allows the non-resident parent to request a consequential adjustment to reduce the amount of royalty income (subject to NRWT) it derives by the same amount. If an adjustment were obtained, the NRWT liability of the non-resident company would be reduced from $15 to $10 (assuming a 10% treaty rate applies). The New Zealand company's liability to deduct NRWT would be correspondingly reduced.

Interaction with dividend rules (sections CF 2 and ME 6)

The transfer pricing rules in section GD 13 work in conjunction with the non-cash dividend rules contained in section CF 2. As noted earlier, the arm's length amount is equivalent to the market value amount in section CF 2. For example, if a subsidiary sells trading stock to its non-resident parent for a less than arm's length amount, section GD 13 (4) would deem the sale price to be the arm's length price, thereby increasing the New Zealand company's gross income. In addition, section CF 2 (1)(c) would deem the difference between the actual sale price and the arm's length price to be a dividend to the non-resident parent. The combined effect of the transfer pricing and non-cash dividend rules is to increase the New Zealand subsidiary's profits from which a higher-than-declared dividend was paid. Consequential adjustments sought by the non-resident parent under section GD 13 (11) cannot affect the amount of dividend derived.

New section ME 6 allows a company that is subject to a transfer pricing adjustment to attach imputation credits retrospectively to a related non-cash dividend. (Fully imputed deemed dividends are subject to 0% NRWT rate under section NG 2 (1)(b)(ii) and are also excluded from the foreign investor tax credit regime.) This is subject to the condition that the company's imputation credit account remains in credit at the end of each imputation year between the end of the year in which the non-cash dividend was paid and the end of the imputation year before the year in which the company retrospectively attaches the imputation credits.

Income tax paid that is attributable to a transfer pricing adjustment is also allowed to be treated as being paid on the original date the related non-cash dividend was paid (thereby giving rise to imputation credits) to the extent necessary to fully impute the non-cash dividend.

Example 8

In the 1998-99 income year, the Commissioner makes a transfer pricing adjustment in respect of the 1996-97 income year. The adjustment results in extra tax of $165,000 being payable by the New Zealand company, and a non-cash dividend of $500,000 arising to its non-resident parent. The New Zealand company has a credit balance of $100,000 in its imputation credit account (ICA) at the end of each of the 1996-97 and 1997-98 imputation years.

The amount of imputation credit required to fully impute the $500,000 non-cash dividend is $246,269 ($500,000 x 33/67). The New Zealand company will be able to fully impute the dividend by:

- retrospectively attaching the $100,000 credit balance in its ICA at the end of the 1996-97 imputation year; and
- retrospectively attaching the remaining $146,269 required to fully impute the dividend by treating $146,269 of the payment of tax on the transfer pricing adjustment as having been paid in the 1996-97 (rather than the 1998-99) income year for ICA purposes.

Unwinding deemed dividends (section CF 2 (9A))

Section CF 2 (9A) operates independently of the transfer pricing adjustment provisions in section GD 13 and will not affect their operation. Section CF 2 (9A) allows for the unwinding of a dividend in certain circumstances. It allows the Commissioner to disregard the amount of a non-cash dividend arising from non-market value transfers of property between companies and shareholders if the company took reasonable steps to ascertain the market value of the property at the time of the transfer and the shareholder has subsequently paid the correct amount of consideration, or refunded any excess consideration.

Controlled foreign companies (sections CG 11 (8) and GD 13 (11))

A controlled foreign company (CFC) is treated as a non-resident company for the purposes of the normal

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application of section GD 13. Unless a CFC has a branch operation in New Zealand, it will not normally qualify as a taxpayer for the purposes of section GD 13 (3) and (4) (although it could qualify as the other party to a relevant transfer pricing arrangement).

However, section GD 13 is also relevant to the calculation of the branch equivalent income or loss of a CFC and the resultant calculation of the attributed foreign income or loss of New Zealand residents holding an income interest of 10% or greater in the CFC. This is because of the general rule for calculating branch equivalent income or loss set out in section CG 11 (1), which provides that the branch equivalent income or loss of a CFC is the net income or net loss that would be calculated in accordance with the Income Tax Act (including section GD 13) if the CFC were resident in New Zealand.

Section CG 11 (8) modifies the application of section GD 13 for the purpose of calculating the branch equivalent income or loss of a CFC. It provides that section GD 13 shall apply in determining the branch equivalent income or loss of a CFC only if a transaction has been entered into between a CFC and an associate of the CFC which has a purpose or effect of defeating the intent and application of the loss and foreign tax credit jurisdictional ring-fencing rules.

The application of the transfer pricing rules in section GD 13 in determining the branch equivalent income or loss of a CFC is therefore limited in effect to an anti-avoidance rule directed at transactions with associated parties (the associated persons definitions in both sections OD 7 and OD 8 (3) apply in determining whether a CFC and another person are associated). Such an anti-avoidance rule is necessary to protect the integrity of the loss and foreign tax credit jurisdictional ring-fencing rules which could otherwise be circumvented by CFCs shifting profits between jurisdictions through manipulative transfer pricing practices.

Any shareholder in a CFC is entitled to request a consequential adjustment to the tax position of a CFC which is the other party in a transfer pricing adjustment made to a New Zealand company. Section GD 13 (11) confirms that the consequential adjustment flows through to the calculation of the branch equivalent income or loss of the CFC and the resultant calculation of the attributed foreign income or loss of the New Zealand shareholders.

Example 9

A New Zealand company sells trading stock with an arm's length value of $150 to a Hong Kong subsidiary for $100. Section GD 13 (4) applies to substitute the arm's length amount so far as the New Zealand company's tax liability is concerned (increasing its gross income by $50). The New Zealand company may apply under section GD 13 (11) for the arm's length amount of $150 to apply in relation to the Hong Kong CFC. If the Commissioner agrees to the consequential adjustment, an increased deduction of $50 is allowed for the purposes of the calculating the branch equivalent income of the Hong Kong CFC. This flows through to the calculation of the attributed foreign income of the New Zealand company.

Transfer pricing anti-avoidance rule (section GC 1)

The main transfer pricing rule in section GD 13 normally applies only to cross-border transactions between related parties (these requirements being contained in section GD 13 (2)). Section GC 1 is a specific transfer pricing anti-avoidance provision which is designed to bolster the application of the general transfer pricing regime in section GD 13. Section GC 1 allows the operative provisions in section GD 13 to apply to a transaction even if the cross-border and related party requirements in section GD 13 (2) are not satisfied, if the transaction has been entered into with an avoidance purpose or effect.

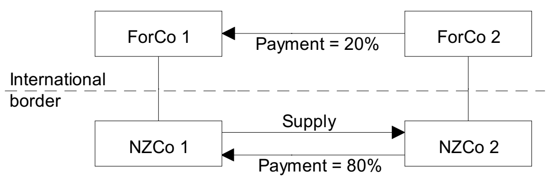
Section GC 1 allows section GD 13 to substitute arm's length prices for transactions which, taking into account related transactions and considered as a whole, have an in-substance, cross-border, non-arm's length nature, even though the individual transactions which are adjusted do not separately meet the cross-border or related party conditions in section GD 13 (2).

Section GC 1 contains a non-exhaustive number of circumstances that could result in an arrangement having an avoidance purpose or effect and therefore being subjected to a section GD 13 adjustment notwithstanding any of the requirements in section GD 13 (2). The circumstances listed are:

- a collateral arrangement involving an associated person not resident in New Zealand
- another collateral arrangement such as a market sharing arrangement, an arrangement not to enter a particular market, a back-to-back supply arrangement, or an income sharing arrangement.

The anti-avoidance rule will allow section GD 13 to apply to domestic transactions that are part of a broader agreement involving non-residents that have a character similar to that of cross-border transactions.

Example 10

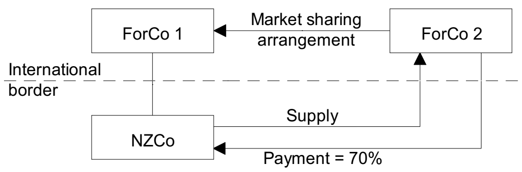


In this example, two unassociated company groups, comprising NZCo 1 and ForCo 1 in one group and NZCo 2 and ForCo 2 in the other group, have agreed that NZCo 1 will receive 80% of the arm's length price from NZCo 2 (which is in loss) for the supply of property in New Zealand. NZCo 1's offshore associate, ForCo 1, will receive the balance of 20% of the arm's length price from ForCo 2.

While, at first sight, the transaction between the two New Zealand companies appears to be wholly domestic, the transactions represent a transfer of New Zealand-sourced income from NZCo 1 to ForCo 1. As NZCo 2 is in loss, there is a deferral of New Zealand tax. Section GC 1 would apply in this case to protect the New Zealand tax base by allowing the application of section GD 13 (4) to the non-arm's length supply made by NZCo 1 to NZCo 2.

Section GC 1 will also allow section GD 13 to apply to cross-border transactions between parties that are not related but are acting in concert to avoid tax through manipulative cross-border transfer pricing.

Example 11



In this example, the group of ForCo 1 and NZCo has agreed with ForCo.2 that NZCo will only receive 70% of the arm's length price from ForCo 2 in respect of the supply made by NZCo to ForCo 2. In the absence of section GC 1, section GD 13 would not apply because the related party requirement is not satisfied. The group of ForCo 1 and NZCo have agreed to accept a less than arm's length amount on the supply because of a market sharing arrangement between ForCo 1 (which receives the benefit of the arrangement) and ForCo 2, which has the effect of redressing for ForCo 1 and NZCo the income imbalance resulting from the less than arm's length amount received on the export to ForCo 2. The New Zealand tax base is depleted because of the transfer of New Zealand-sourced income from NZCo to ForCo 1. Accordingly, section GC 1 would apply in this case to allow the application of section GD 13 (4) to the non-arm's length supply made by NZCo to ForCo 2.

Apportionment of income and expenditure for branches (section FB 2)

New section FB 2 effectively allows transfer pricing adjustments to be made in respect of:

- a single non-resident entity with a branch operation in New Zealand, to determine the New Zealand-sourced income of the entity (section FB 2 (1)); and
- a single New Zealand resident entity with an offshore branch or branches, to determine the net income sourced in each jurisdiction (section FB 2 (1A))

Section GD 13 is not applicable in a branch situation, as it only applies to transactions between separate legal entities. There are no inter-entity transactions in respect of a branch and its parent company to which section GD 13 could apply.

New Zealand branches of non-resident entities

The arm's length principle is applied in section FB 2 (1) to apportion gross income and expenditure between New Zealand and elsewhere in the case of a non-resident with a branch operation in New Zealand. This is achieved by apportioning the gross income and expenditure of the non-resident taxpayer in such manner as is necessary to produce an amount of net income or loss which the taxpayer might be expected to have if the taxpayer's activities in New Zealand were carried out by the taxpayer as a separate and wholly independent person undertaking only those activities and dealing at arm's length. The ambit of section FB 2 (1) is restricted to determining the New Zealand-sourced business income and contract income of non-residents. (Other types of income are covered by the source rules in section OE 4.)

Section FB 2 (1) states that the amount of gross income apportioned under the subsection to New Zealand is deemed to be derived from New Zealand. This "derived from New Zealand" reference ensures consistency of terminology with section OE 4, which stipulates the classes of income that are deemed to be derived from New Zealand, and section BB 3, which stipulates that all income derived from New Zealand is assessable for income tax.

The use of the arm's length principle in section FB 2 (1) is consistent with the arm's length approach commonly used in the Business Profits articles in New Zealand's double taxation agreements. These articles govern New Zealand taxation of the business profits of non-residents who are from treaty countries.

When conducting an apportionment in accordance with the arm's length principle under section FB 2 (1), no profit element or mark-up will be permitted for Head Office management or administrative expenses. This approach is consistent with the Business Profits articles in New Zealand's double taxation agreements and the OECD commentary on the Business Profits article (Article 7) in the OECD Model Tax Convention.

Note that any transfer pricing involving, for example, a non-resident company (with a New Zealand branch) and another non-resident (with no New Zealand branch) is dealt with by the inter-entity transfer pricing rules in section GD 13. Section FB 2 is only required to deal with intra-company income and expenditure apportionment involving the first non-resident.

Branches of New Zealand resident entities

New section FB 2 (1A) provides for gross income and expenditure to be apportioned among two or more countries, primarily for the purposes of determining foreign tax credit entitlements of New Zealand residents on foreign-sourced business and contract income. For foreign tax credit purposes it might be necessary to apportion gross income and expenditure among several foreign countries. Section LC 1 provides a credit for

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foreign tax paid in respect of income derived by a New Zealand resident for each country or territory from which the income is derived. The maximum credit allowed is the New Zealand tax payable in respect of the particular foreign income. Section FB 2 (1A) will therefore assist in determining the income from each jurisdiction for the purposes of determining the foreign tax credit entitlements of New Zealand residents (no foreign tax credit is available for income that is deemed to be derived from New Zealand).

Advance pricing agreements (Part VA, Tax Administration Act)

Advance pricing agreements (APAs) will be able to be negotiated with Inland Revenue on transfer pricing issues (involving both section GD 13, if different entities are involved, and section FB 2, in relation to cross-border income and expenditure apportionment for branches). An APA can be issued as a private binding ruling by the Commissioner under section 91E of the Tax Administration Act 1994, or under the Mutual Agreement articles in New Zealand's double taxation agreements.

Section 91E has been amended (new subsection (4A)) to allow a binding ruling to be given on questions of fact in relation to how section GD 13 or section FB 2 applies to particular persons and arrangements.

An APA issued under the binding rulings process will bind the Commissioner in the normal manner if it is complied with. An APA issued under a Mutual Agreement article in a double taxation agreement will similarly be binding if complied with (by virtue of section BB 11).

APAs can be either unilateral or multilateral. A unilateral APA is an agreement conducted with only one tax authority, while an agreement conducted with more than one tax authority is referred to as a multilateral APA. The key difference between a unilateral APA and a multilateral APA is that Inland Revenue cannot guarantee that a unilateral APA will be accepted by the country in which the other party to the transaction to which the unilateral APA applies is resident.

There are several advantages in obtaining an APA:

- It increases certainty of tax treatment for taxpayers.
- It reduces the risk of double taxation and also reduce the scope for international disputes between tax authorities over the source of income (if the APA is multilateral).
- It may prevent the occurrence of costly audits during the period for which the APA applies, thereby reducing compliance costs through the up-front agreement to a taxpayer's pricing approach in its controlled transactions.
- It reduces the likelihood of transfer pricing adjustments, which may result in tax penalties.

However, in deciding whether to pursue an APA, taxpayers will need to weigh these benefits against the costs of seeking one, such as financial and time costs. Taxpayers will also need to disclose all relevant information to Inland Revenue.

Inland Revenue's transfer pricing guidelines (to be issued later this year) will detail the process and documentation requirements for obtaining an APA.

Relationship with double taxation agreements

The issue of transfer pricing is addressed in New Zealand's double taxation agreements with other countries. In particular, two types of articles are relevant:

- The Associated Enterprises articles enable the profits of associated enterprises to be determined on an arm's length basis. These articles are based on Article 9 of the OECD Model Tax Convention.
- The Business Profits articles provide for the profits of a non-resident enterprise to be allocated to a New Zealand branch (permanent establishment) of the enterprise on an arm's length basis. These articles are based on Article 7 of the OECD Model Tax Convention.

Sections GD 13 and FB 2 allow treatment corresponding with these two articles to occur under New Zealand's domestic legislation. New Zealand's domestic transfer pricing provisions are generally consistent with New Zealand's double taxation agreements. In the event of any inconsistency, the double taxation agreement provisions will prevail in the normal manner.

If a transfer pricing dispute involved allocation of income with a treaty partner, the taxpayer could invoke the mutual agreement procedure in a treaty. In such a case, Inland Revenue would discuss the transfer pricing issue with the competent authority of the other country and an agreement would be sought between the competent authorities.

Consequential repeals (Tax Administration Act 1994, Student Loan Scheme Act 1992)

Several redundant references to the former section GC 1 of the Income Tax Act 1994, which contained the previous transfer pricing rules, have been repealed. These redundant references were contained in section 92 of the Tax Administration 1994 and section 16 of the Student Loan Scheme Act 1992.