Transfer Pricing Draft Guidelines

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

This appendix contains the first of a series of draft guidelines on the application of New Zealand's transfer pricing rules. The draft provides a general overview of the framework within which transfer pricing operates, including a discussion on documentation taxpayers should be looking to prepare if they are to evidence compliance with the arm's length principle.

Transfer pricing is not an exact science. For this reason, the guidelines have been drafted as a practical guide, rather than as prescriptive rules. Inland Revenue does not propose to issue the final guidelines as a binding public ruling.

Inland Revenue welcomes submissions on the material in the draft guidelines. Please make these by 27 February 1998, addressed to:

General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Inland Revenue proposes to follow these guidelines in administering the transfer pricing rules until such time as final guidelines are issued. On matters not addressed in this draft, Inland Revenue will continue to follow the OECD guidelines.

This document is also available on the Internet. Visit Inland Revenue's website at **http://www.ird.govt.nz** and choose the Tax Information Bulletin section.
The document is listed as an appendix to TIB Volume Nine, No.10 (October 1997)

Inland Revenue
Te Tari Taake

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Preface

Introduction

1. This is the first of a series of guidelines to be released on New Zealand's transfer pricing rules, and contains a general overview of the framework within which transfer pricing practice operates. It aims 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, these 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.

3. Inland Revenue plans to issue subsequent guidelines to address more specific transfer pricing issues. These issues include:

- the detailed application of the acceptable transfer pricing methods
- the treatment of intra-group services, such as management fees
- the treatment of intangible property
- cost contribution arrangements
- the procedure for applying for an advance pricing agreement (APA)
- permanent establishments (application of section FB 2).

Relationship to OECD guidelines

4. Tax Information Bulletin Volume 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.

5. The issuing of New Zealand's transfer pricing guidelines does not fully supersede the use of the OECD guidelines for New Zealand transfer pricing practice. Consensus established between OECD member countries means that the OECD guidelines will be the relevant guidelines to consider if a transfer pricing issue is raised under New Zealand's double tax agreements. For this reason, the New Zealand guidelines follow closely the OECD model for the application of the various transfer pricing methods.

6. This raises the question of why New Zealand is drafting 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.

7. Inland Revenue will continue to follow the OECD guidelines on matters not addressed in this part of the guidelines.

Inland Revenue's approach to New Zealand guidelines

8. 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 judgment, which will often depend on taxpayers' individual circumstances. Prescriptive guidelines are therefore not considered to be a practicable option.

9. 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.

10. 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. Because of their international importance, the OECD guidelines should 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, such as documentation, the New Zealand guidelines should be read as paramount.

11. 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, which 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

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

13. 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.

14. 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 Inland Revenue. At the present time, such contact should, in the first instance, be made with one of the following people:

Mike Spelman (Auckland Corporates) 09 367-1351
Anton Nannestad (Auckland Corporates) 09 306-2034
Pat Horan (Wellington Corporates) 04 802-6048
Paul Cooper (Policy Advice Division) 04 474-7004

15. 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

16. This part of the guidelines applies only to the application of section GD 13 (as modified by section GC 1 where relevant). It therefore applies only to transactions between separate entities.

17. These 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. The OECD is currently undertaking work on this issue. New Zealand will issue guidelines on section FB 2 at a later date, and these are likely to draw on the guidelines to be developed by the OECD.

Terminology

18. 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.

19. 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.

20. 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.

21. 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.

Arm's length principle

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

22. 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.

23. 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.

24. 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.

25. 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.

26. 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.

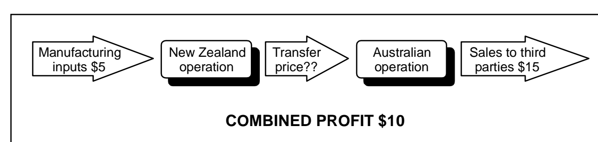
Importance of transfer prices to determination of tax base

27. 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.

28. 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.

29. 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).

30. 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.



31. 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.

32. 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:

	New Zealand Operation	**Australian Operation**
Transfer price $5.00		
Sales	$5.00	$15.00
Costs	($5.00)	($ 5.00)
Profit	$0.00	$10.00

33. 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:

	New Zealand Operation	**Australian Operation**
Transfer price $5.00		
Sales	$15.00	$15.00
Costs	($ 5.00)	($15.00)
Profit	$10.00	$ 0.00

34. 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

35. 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.

36. Tax Information Bulletin Volume Seven, 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 about which the legislative mechanics have been built.

37. 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."

38. 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.[1]

39. 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."

40. 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.

41. 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.

42. 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

1 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.

principle

43. 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.

Merit of arm's length approach for determining net income

44. 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.

45. 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.

46. 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

47. 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.

48. 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:

	New Zealand Operation	Australian Operation
Transfer price	$5.00	$10.00
Sales	$12.00	$15.00
Costs	($ 5.00)	($10.00)
Profit	$ 7.00	$ 5.00

49. 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.

50. 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.

51. 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.

Pricing methods: theoretical and practical considerations

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

52. 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.

53. 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.

54. 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.

55. 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.

56. 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.

57. 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.

58. The discussion in this chapter also builds a foundation that will be developed in subsequent guidelines, which will provide more detailed guidance and examples on the practical application of the pricing methods.

Description of transfer pricing methods

59. 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	(\$ 5,000)	
Gross profit	\$ 5,000	
Operating expenses	(\$ 3,000)	
Net profit	\$ 2,000	

Distributor Co:

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

60. 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.

61. 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.

62. 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.

63. 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.

64. 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.

65. 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.

66. 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.

67. 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.

68. 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. The methods are globally referred to by the OECD as the "transactional net margin method" (TNMM).[2]

69. 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.

Hierarchy of methods

70. 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.

71. 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.

72. The availability of data is likely to be very impor-

2. 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 (referred to there as the CPM), and the profit comparison method adopted by Australia (referred to there as the PCM). The term "comparable profits methods" used in section GD 13 (7)(e) would, in any case, be sufficiently broad to encompass all three approaches.

tant 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 134-42). 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

73. 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.

74. 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.

75. 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).

76. 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.

Applying the traditional transactional methods – an economics approach

77. The traditional transactional methods, in their purest form, are based on this scenario. 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 72.

78. 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.

79. 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.

80. 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.

81. 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.

82. 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.

83. 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, therefore, 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.

84. 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.

85. 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.

Real world constraints

86. 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.

87. 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.

88. 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.

89. The toaster scenario outlined in paragraph 72 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.

90. 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.

91. 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.

92. 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.

93. 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.

94. If an attempt to use the resale price method is made instead, the manufacturer should not expect to be able to pay only the same margin to the retailer to sell the product as it would have to pay 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.

95. 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

96. 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 also required an adjustment to be made to price the value of the manufacturer's improvement.

97. 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

98. 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.

99. 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.

100. 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".

101. 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. This compensation would arise in the form of the returns to any intangible it creates as a result of bearing the risk.

Legal ownership of and economic contribution to intangible property inconsistent

102. It is important to note, however, that the legal ownership of an intangible can differ from the economic contribution to its creation. Further, the OECD guidelines, at paragraphs 1.36 to 1.41, state that as a general rule, a taxpayer's structuring of a transaction should be

respected in determining the arm's length price. This means that in practice, the legal ownership of, rather than the economic contribution to, intangible property should be respected. This then leaves the question of how one should treat the contribution of a party to the value of intangible property if another party retains the legal ownership of that property.

103. Consider, for example, 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.

104. 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.

105. 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 that result in the creation of intangible value, they expect to also earn returns from that intangible.

Joint ownership of intangible property

106. 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.

107. 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?

108. 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.

109. 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

110. 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.

111. 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.

112. 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.

Residual profit split analysis

113. 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.

114. 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.

115. 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.

116. 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.

117. 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

118. 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.

119. 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.

120. 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.

121. 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.

Acceptability of profit split in other jurisdictions

122. 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.

Comparable profits methods

123. 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. The OECD refers to these methods collectively as the transactional net margin method (TNMM).[3]

124. 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	$ 600
Gross profit	$ 400
Less operating expenses	$ 250
Net profit	$ 150

125. Under the resale price method, the distributor's relevant margin is its gross margin of 40% (the ratio of

3. As noted previously, 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.

gross profit ($400) to sales to unrelated third parties ($1,000)).

126. 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% ($^{\$150}/_{\$1,000}$).

127. 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.

128. 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 be structurally very similar. 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.

129. 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.

130. 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.

131. 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 as to 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

132. 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.

133. 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

134. 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.

135. 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.

136. 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.

137. 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, taxpay-

ers should seek a practical solution that leads to a reliable measure of the arm's length amount.

138. 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

139. 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.

140. 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.

141. 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.

142. If, for example, 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 operations' perspective that is *prima facie* commensurate with that operations' 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

143. 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.

144. 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.

145. 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 the package as a whole, 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.

146. The OECD guidelines note, at paragraph 1.44, that a key principle to be followed in considering whether the transfer pricing should be determined for a combination of transactions or a package basis is that the transaction between related parties would need to be treated by the Revenue Authority in the same way that it would treat a similar deal between independent enterprises. Taxpayers should therefore be prepared to show that any package deal or combination of transactions reflects appropriate transfer pricing.

Use of ranges

147. 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.

148. 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.

149. 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. New Zealand will not be adopting this approach. 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.

150. 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

151. 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.

152. 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 will be more credible if they are supported by analyses under one or more secondary methods.

153. This does not mean that a taxpayer should go to the same level of detail to demonstrate a price under more than one method. 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

154. 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.

Principles of comparability

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 is a useful 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

155. 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.

156. 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.

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

158. 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.

159. 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

160. 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.

161. 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.

162. 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.

163. 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

164. 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, recourse will have to be made to one of the other pricing methods 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.

165. 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.

166. 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).

167. Functional analysis serves, therefore, 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.

168. 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.

169. 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

170. 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.

171. First, the functional analysis should provide those considering the transfer pricing policy of the multinational with a quick overview of the organisation, to assist them in familiarising themselves with its general operations. Second, the functional analysis should seek to identify the functions performed by each member of the multinational, and assess the importance of each function to the overall operations of the multinational.

Outline of multinational's operations

172. 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.

173. 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.

174. 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

175. 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

176. 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.

177. 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.

178. 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.

179. 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.

180. The same divergence of interests may not exist for related parties. It may be necessary, therefore, to evaluate whether or not 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.

181. 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

182. 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.

183. 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, therefore, to consider more specific functions performed within these general categories.

184. 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.

21. Warehouses finished product.
22. Ships product and provides insurance coverage.
23. Warrants product.

Relative contribution of various functions

185. 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.

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.

186. It is therefore 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.

187. 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.

188. 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.

189. 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 intangible 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.

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.

Treatment of risk

190. 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).

191. 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.

192. 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.

193. 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

194. 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.

195. 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 under 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.

196. 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.

197. 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.

198. 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.

199. 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.

200. 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.

201. 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

202. 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.

203. 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

Functions performed	Parent Co (country Y)	Sub Co (country Z)
Design and development of factory machinery	X	
Product planning development	X	
Purchase of raw materials	X	
Fabrication of clips	X	
Moulding of lead around clips	X	X
Boxing and packaging of completed wheel weights for shipment to customers	X	X
Warehousing of finished wheel weights in country Y	X	
Sales:		
• direct to large companies	X	
• through agents to others	X	
When orders received through agents:		
• issued shipping instructions	X	
• billed and collected	X	
Supply of technical service:		
• control of flow of raw materials	X	
• control of flow of finished products	X	
Payment of freight:		
• clips, raw materials from country Y to country Z		X
• completed weights from country Z to country Y	X	
Manufacturing of standard weights (large volume)	X	
Manufacturing of special weights (low volume)	X	
Manufacturing of wheel balancing machines	X	
Ownership and licensed user of patent for wheel balancing procedure	X	

204. 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.

205. 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.

206. 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

207. 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.

208. 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.

209. 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.

210. 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.

211. 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

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

- economic circumstances
- business strategies.

213. 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

214. 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.

215. 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.

216. 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 on the price.

217. 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.

218. 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

219. 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.

220. 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 to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

221. 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.

222. 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.

223. 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.

224. 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.

225. 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.

226. 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.

227. 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.

Materiality in a practical assessment of comparability

228. 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.

229. 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.

230. 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.

231. 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.

232. 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

233. 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 an 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 is a useful 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.

Practical application of arm's length principle

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

234. 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.

235. 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 a mandatory nor a prescriptive approach. The process adopted by a taxpayer will still depend on that taxpayer's individual circumstances.

236. 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).

Caveats to four-step process

237. 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 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.

238. Table 5 summarises the four-step process.

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

239. 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:

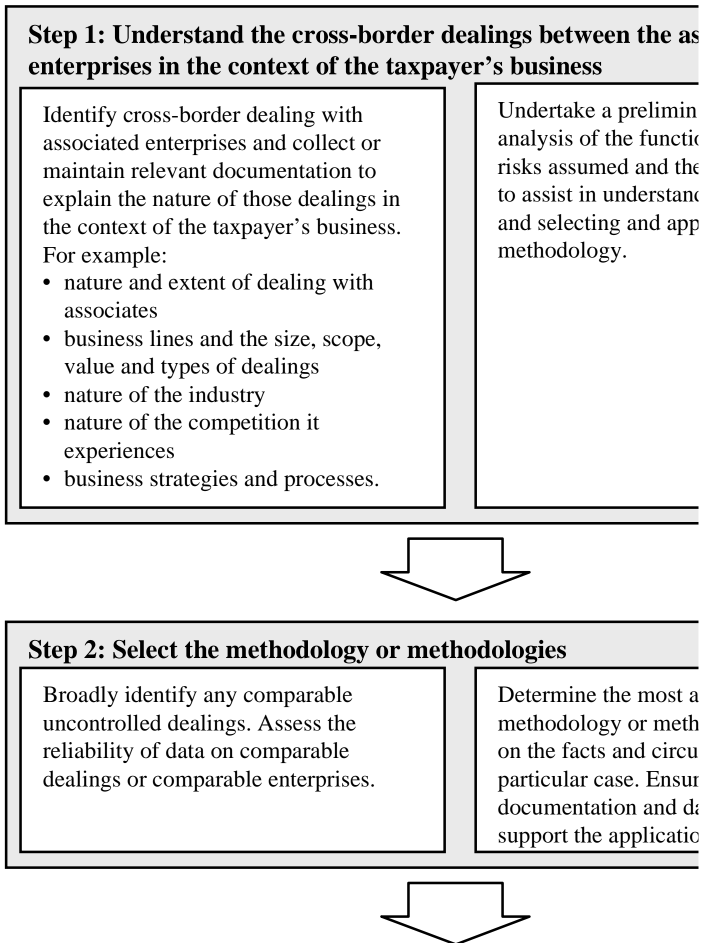
- how the international related-party dealings of the enterprise are undertaken
- the purpose or object of the dealings
- what the taxpayer obtains from its participation in the dealings, such as products, services, or strategic relationships
- the significance of the dealings to the taxpayer's overall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

240. 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

continued on page 28

Table 5: the four-step process

This is an illustration of the four-step process for setting or reviewing tr
process is properly undertaken, the taxpayer should have a lower risk of



functional analysis that might be needed for an analysis of comparability in applying the arm's length principle.

241. 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.

242. 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

243. 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.

244. 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.

245. It should be noted, however, that internal transactions may not provide reliable comparables if they do not occur on normal arm's length terms. For example, internal transactions are unlikely to provide reliable comparables for determining an arm's length price 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.

246. 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

247. 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.

248. 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).

249. 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

250. 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.

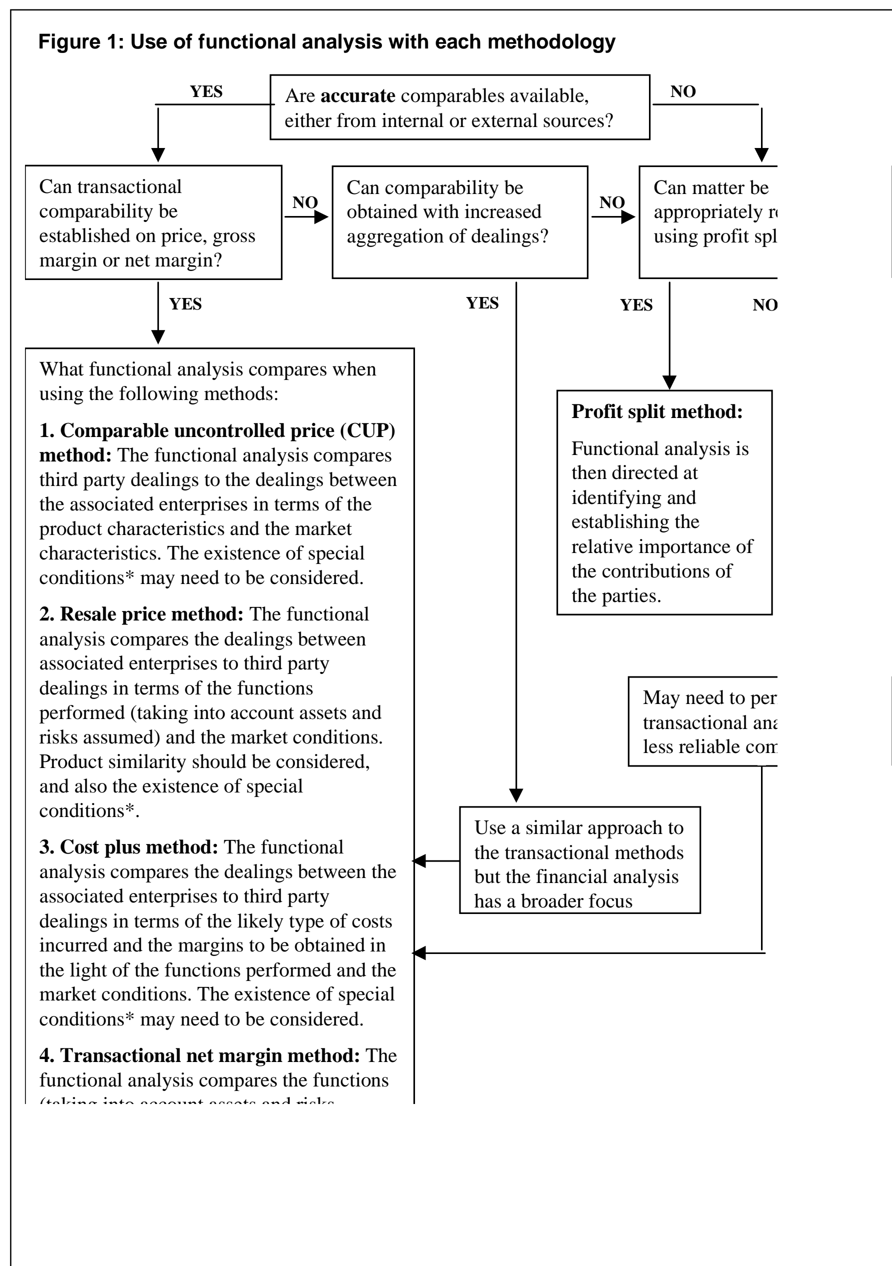
251. If a pricing method involving external benchmarking with independent enterprises is being used, the functional analysis assists in determining the comparability of the dealings of the multinational with uncontrolled dealings of the independent parties. The main purpose of this is to establish the 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.

252. 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

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

254. 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.



255. 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

256. 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 the ATO ruling TR 95/D22.

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

258. If taxpayers are concerned about whether their transfer pricing process will be acceptable to

Inland Revenue, they are encouraged to discuss the matter with their Account Manager in the Compliance Programme. Alternatively, taxpayers can contact one of the people identified in paragraph 13 of these guidelines. 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.

Documentation

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

259. 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.

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

261. 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.

262. 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.

263. 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.

264. Taxpayers are still required to comply with the arm's length principle. However, by documenting 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).

265. 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 seek 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.

266. 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.

267. 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.

268. 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.

269. 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.

270. 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.

271. 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.

272. 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.

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

Statutory requirements to maintain documentation

273. 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.

274. 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.

275. 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.

276. 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.

277. 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.

278. 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.

279. 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.

280. 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.

281. 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. Depending on the circumstances, Inland Revenue might even take the position that the stronger penalties are applicable.

Trade-off between compliance cost and tax risk

282. 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.

283. 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.

284. 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.

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

286. 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.

287. 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.

288. 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

289. 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.

290. 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).

291. 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.

Time for determining transfer prices

292. 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.

293. 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.

294. 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.

295. 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.

296. 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.

297. 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

298. 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.

299. 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.

300. 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.

301. 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

302. 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.

303. 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.

304. 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.

305. 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, thererfore, be obtained. Inland Revenue will, therefore, not generally accept such an argument from a taxpayer.

Retention of records

306. 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.

307. 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.

308. 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.

309. 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

310. 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.

311. 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.

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

Introduction

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

313. 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.

314. 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

315. 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.

316. 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.

317. 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.

318. 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

319. 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.

320. 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 transfer price	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

321. 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 exists

322. If a taxpayer seeks a binding ruling or Advance Pricing Agreement (APA), 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

323. 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 (although these factors 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.

324. 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 lead 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

325. 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.

326. 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.

327. 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.

328. 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

329. The two most important factors in Inland Revenue's appraisal of a taxpayer's risk rating will be the quality of a taxpayer's documentation 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.

330. 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.

331. 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.

332. 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 will take the form of a rebuttable presumption in favour of the adjustment

proposed by Inland Revenue.

Demonstration of more reliable measure of arm's length price

333. 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 will be an important factor here.

334. 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.

335. 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.

336. 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

337. 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.

338. 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.

339. 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.

340. However, if a taxpayer does not prepare adequate documentation, and provide it to Inland Revenue if requested, it will, at best, result in a poor risk rating. At worst, it is possible that Inland Revenue may attempt to invoke the non-co-operation provision. Neither approach is conducive to the efficient administration of the transfer pricing rules, from either the taxpayer's or Inland Revenue's perspective. Despite the options available, Inland Revenue's preference would clearly be for a co-operative environment in which transfer pricing issues might be readily resolved.

Conclusions on burden of proof rule

341. 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.

342. 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.

343. 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

344. 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.

345. In the context of a review of a taxpayer's volun-

tary 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.

346. 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.

347. 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

348. 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.

349. 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.

350. 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.

351. 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.

352. 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.

353. 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.

354. 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

355. 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 neces-

sary 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

356. 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.

357. 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

358. 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.

359. Inland Revenue does not rule out the possibility that non-publicly available information will be used in administering the transfer pricing rules, as the Tax Administration Act 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 hindsight

360. 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.

361. 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 that 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.

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

363. 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.

364. 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.

365. 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.

366. 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.

367. The use of hindsight 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.

368. 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 also help preclude the possible use of hindsight by Inland Revenue in an appraisal of the taxpayer's transfer prices.

Summary of general documentation

principles

369. 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, taxpayers should 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, arm's length transfer prices should be determined and documented for a transaction by the time taxpayers 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:
  - More extensive documentation should not be required than would exist to support any other business decision of a similar level of complexity and importance.
  - 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.