

Transfer Pricing Draft Guidelines – Part 2

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

This appendix contains the second part of a series of draft guidelines on New Zealand's transfer pricing rules. The first part, issued in October 1997, contained a general overview of the framework in which transfer pricing operates. This part deals with the remaining issues covered in the OECD guidelines issued to date, namely intangible property, intra-group services and cost contribution arrangements (CCAs). Subsequent guidelines will deal with advance pricing agreements (APAs) and the application to branches of section FB 2 of the Income Tax Act 1994.

Inland Revenue welcomes submissions on the material in this part of the draft guidelines. Please make these by 31 March 2000, addressed to:

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Inland Revenue fully endorses the OECD guidelines in relation to issues dealt with in this part of the guidelines. This part should be read, therefore, as supplementing the OECD guidelines, rather than superseding them. On matters not addressed in draft guidelines issued to date, 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.

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Te Tari Taake

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*References in this table of contents are to paragraph numbers, not page numbers
All section references in these guidelines are to the Income Tax Act 1994*

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PREFACE

Introduction

1. This is the second part in the series of guidelines on New Zealand's transfer pricing rules. The first part, a draft of which was issued in October 1997, contained a general overview of the framework in which transfer pricing operates. This part deals with the remaining issues covered in the OECD guidelines issued to date, namely intangible property, intra-group services and cost contribution arrangements (CCAs). Subsequent guidelines will deal with advance pricing agreements (APAs), and the application of section FB 2 to branches.

Inland Revenue's approach to this part of guidelines

2. This part of the guidelines deals with material of a specialised nature covered in chapters 6 to 8 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (referred to in these guidelines as the "OECD guidelines"). Inland Revenue considers there to be little value to replicating the analysis of those guidelines here. Consequently, this part of the guidelines consists substantially of a summary of the key points made in the OECD guidelines (cross-referenced to relevant paragraphs in those guidelines), supplemented by Inland Revenue's views on those guidelines and comments on areas where it is considered that further clarification is useful. If more detail is required than is provided in this part of the guidelines, reference should be made to the OECD guidelines.

3. Inland Revenue fully endorses the material in chapters 6 to 8 of the OECD guidelines and proposes to follow the positions outlined in those chapters in administering New Zealand's transfer pricing rules. This part of the guidelines should, therefore, be read as supplementing the OECD guidelines, rather than superseding them. This applies for the domestic application of New Zealand's rules, as well as in relation to issues raised under New Zealand's double taxation agreements.

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

Scope

5. 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.

Application of section FB 2 to branches

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

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

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

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

9. The OECD is continuing to work on developing guidelines on the application of the arm's length principle to permanent establishments. Inland Revenue's guidelines will follow the OECD position, once it is finalised and published.

10. In the interim, Inland Revenue will continue to follow the OECD's current published position on the issue, set out in the loose-leaf version of the OECD's *Model Tax Convention on Income and on Capital* (November 1997), specifically, the:

- Commentary on Article 7 (Business Profits) in volume 1; and
- Report on the Attribution of Income to Permanent Establishments in volume 2.

Submissions on Part 1 of guidelines

11. Submissions have been received on Part 1 of the transfer pricing guidelines, released in draft as an appendix to Tax Information Bulletin Vol. 9 No.10 (October 1997).

12. Submissions have not identified any areas where a substantive revision of the draft will be required. It is proposed, therefore, that a further draft of Part 1 will not be prepared for release at this stage. Instead, it is planned to issue a final version later this year, incorporating the final version of the material included in this draft and on APAs.

INTANGIBLE PROPERTY

Key points

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

Introduction

13. Chapter 6 of the OECD guidelines discusses the application of the arm's length principle to intangible property. Inland Revenue fully endorses the position established in those guidelines. This chapter should, therefore, be read as supplementing, but not supplanting, the OECD guidelines.

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

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

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

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

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

17. A sound functional analysis (see paragraphs 164-211 in the draft of Part 1 of the guidelines) is an important first step in applying the arm's length principle to intangible property. Functional analysis can help identify:

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

18. The results of the analysis can identify those features of a transaction for which comparables ideally should be identified. It also better enables a check that the price determined is consistent with the true nature of the property being transferred. (Table 2, which contains a list of specific factors that can be particularly relevant in determining the nature of intangible property being transferred, is a key reference in this chapter.)

19. The most desirable way to determine the arm’s length price is through the direct application of reliable comparables. For example, the arm’s length price might be determined directly by reference to the transfer of similar intangible property in an uncontrolled transaction (a comparable uncontrolled price, or CUP), or by comparing the return to a manufacturing function incorporating equivalent intangible property (a cost plus approach). One possibility here is that if one of the parties to the transaction does not contribute any intangible property, that party might be used as the “tested party”, even if it is not the New Zealand party to the transaction (see paragraphs 134 to 138 in the draft of Part 1 of the guidelines). Alternatively, internal comparables (the transfer of the same property to an independent third party), if available, could prove a valuable source of information (see paragraphs 243 to 246 in the draft of Part 1 of the guidelines).

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

21. If comparables cannot be applied directly, recourse might be made to the profit split method, which requires a less rigorous application of comparables than the other methods. Alternatively, the intangible might be valued by reference to reliable projections of future cash flows attributable to that property. Comparables might

still be usefully applied in such an approach, possibly, for example, as support for the variables underlying the valuation.

22. One issue that taxpayers should be conscious of, and will need to address in their analysis, is the possibility that a double deduction might arise if a local operation, either directly or indirectly, is meeting the costs of maintaining intellectual property (generally an issue associated with marketing intangibles). If an independent party would not be required to maintain the intangible in a similar transaction, the local operation should not be paying the same price for the property being transferred as the independent firm, as well as meeting the maintenance expenditure.

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

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

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

Identifying types of intangible property

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

27. For example, the effectiveness of the promotion of a trade name (a marketing intangible) is likely to be a significant factor in determining its value (although the quality of the underlying product or service will also be important). This suggests that an important factor in assessing the value of a marketing intangible used in a

transaction will be how that intangible is maintained. For example, a marketing intangible may have a very limited life unless supported by current marketing expenditure (in other words, if current marketing is eliminated, its value will quickly evaporate). Such an intangible is likely to have little or no inherent value, and it would be inconsistent with the arm's length principle for the intangible to earn anything beyond a nominal return.

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

29. Table 1 summarises the general differences between the two types of intangibles.

Table 1: Distinguishing trade and marketing intangibles

<i>Trade intangibles</i>	<i>Marketing intangibles</i>
1. Tend to arise from risky and costly research and development.	1. Often cheap to create legally (such as trademarks and trade names) but very costly to develop and maintain value.
2. Generally associated with the production of goods.	2. Associated with the promotion of goods or services.
3. Use of a patented trade intangible may result in a monopoly for a product	3. Competitors are able to enter the same market if products are differentiated.
4. Any legal rights established (for example, a patent) are likely to have a limited life.	4. May have an indefinite life (if properly maintained).

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

- the value of any intangible property transferred within a MNE; and
- the amount of income attributable to intangible property and how:
 - the income should be allocated between the parties if ownership of the property is shared.

- one party to a transaction should be compensated if it contributes to the value of intangible property owned by the other party.

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

Applying arm's length principle

32. In principle, the arm's length standard applies to intangible property in the same way as for any other type of property – the methods in section GD 13(7) are applied to determine the most reliable measure of the arm's length price. As noted in paragraph 16, however, the arm's length principle can be difficult to apply in practice to controlled transactions involving intangible property, because:

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

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

34. When attempting to apply comparables to transfer pricing analyses involving intangible property, a key consideration is how reliable those comparables are in practice. Because of the special character of intangible property, it is possible that even apparently small differences between two items being compared could have a significant effect on their relative value. Consequently, a greater level of care is likely to be required in assessing comparability when intangible property is involved. It cannot be automatically assumed

that because two items of intangible property appear comparable outwardly, they are directly comparable. Detailed analysis will often be necessary to determine the extent to which the two items are truly comparable.

35. It is also important to consider both parties to the transaction (paragraph 6.14). One might, for example, perform an analysis that demonstrates, from a transferor's perspective, the price at which an independent party would be prepared to transfer property. However, this may not be the same price that an independent party would be prepared to pay, based on the value and usefulness of the intangible in its business. At arm's length, the transaction would not proceed at the price determined from the transferor's perspective. That price could not, therefore, be an arm's length price. (The asymmetry of the interests of the transferor and transferee is commented on further in paragraph 90, in the context of valuation-based approaches to determining the arm's length price.)

Ascertaining what the transaction involves

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

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

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

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

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

Ownership of intangible property

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

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

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

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

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

Factors in pricing

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

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

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

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

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

Table 2: Factors in determining nature of intangible property

- (a) The expected benefits from the intangible property, determined possibly through a net present value calculation.
- (b) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or non-exclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights might be exploited.
- (c) The stage of development of the intangible in the market in which the intangible is to be exploited, including, where appropriate:
 - the extent of any capital investment, start-up expenses or development work required; and
 - necessary governmental approvals, authorisations, or licenses required.
- (d) Rights to receive updates, revisions, or modifications of the intangible.
- (e) The uniqueness of the property and the period for

which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries, and the value that the process in which the property is used contributes to the final product.

- (f) The duration of the license, contract, or other agreement, and any termination or negotiation rights.
 - (g) Any economic and product liability risks to be assumed by the transferee.
 - (h) The existence and extent of any collateral transactions or on-going business relationship between the transferee and transferor.
 - (i) The functions to be performed by the transferee, including any ancillary or subsidiary services.
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49. Each of the factors in the table will influence the price for the intangible property. For example, if the transferee is to assume economic and product liability risks (paragraph (g)), the arm's length price for the property transferred will be lower (perhaps by way of a lower royalty rate) than if the transferor retained those risks.

Terms and conditions of transfer

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

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

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

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

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

Calculating arm's length price

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

56. First, in applying the traditional transactional methods (CUP, resale price and cost plus methods) or the comparable profits methods (including the transactional net margin method (TNMM)) to determine the arm's length price for a transaction involving intangible property, it will be very important to identify that the independent transaction used as a benchmark is truly comparable. If the independent transaction is not comparable, perhaps because an important functional difference has not correctly been identified, the analysis based on that comparable is likely to have no value. The principles of comparability applied to intangible property are discussed in paragraphs 61 to 70 below.

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

58. One option available to taxpayers is the use of the profit split method. This is discussed in paragraphs 71 to 78. A key feature of the profit split method is that it requires a less rigorous application of comparables than is required for analysis under the other methods. The downside of this, however, is that because the method tends to be more subjective in application than the other methods, it can increase the potential for disagreement between taxpayers and Inland Revenue over what transfer prices are appropriate.

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

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

60. It is likely that comparables might still play a part in a valuation-based approach. For example, comparables might be located to lend support to the assumptions underlying the valuation model applied. The use of comparables is not essential to this approach, but would be expected to increase the credibility of the analysis, if applied. Valuation-based approaches are discussed further in paragraphs 79 to 100.

Comparability

61. As noted in paragraph 56, it will be very important to identify that the independent transaction used as a benchmark is truly comparable when considering transactions involving intangible property. If the independent transaction is not comparable, perhaps because an important functional difference has not been correctly identified, the analysis based on that comparable is likely to have no value.

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

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

64. The second approach involves estimating the value of the brand name itself, with the price of the unbranded shoe and the extra value attributable to the brand name being determined separately. The OECD guidelines (paragraph 6.25) suggest the following as one approach that might be taken:

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

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

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

Example 1, adapted from the United States' section 482 regulations (1.482-4(c)(4), example 4), further illustrates considerations in identifying intangibles.

Example 1

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

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

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

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

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

Profit split method

71. As noted in paragraphs 57 and 58, taxpayers will, in many cases, face difficulties in identifying reliable comparables on which to base a sound transfer pricing analysis. The profit split method might then be a useful alternative approach for performing an analysis, particularly as it requires a less rigorous application of comparables than is required for analysis under the other methods.

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

In cases involving highly valuable intangible property, it may be difficult to find comparable uncontrolled transactions. It therefore may be difficult to apply the traditional transactional methods and the transactional net margin method, particularly where both parties to the transaction own valuable intangible property or unique assets used in the transaction that distinguish the transaction from those of potential competitors. In such cases the profit split method may be relevant although there may be practical problems in its application.

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

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

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

76. Second, in many cases, taxpayers will face difficulties in identifying reliable comparables on which to base a sound transfer pricing analysis. Taxpayers may then need to examine alternative approaches for performing an analysis. As paragraph 117 of the draft of Part 1 of the guidelines noted:

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

77. An important caveat should be noted in applying the profit split method. The subjective nature of the profit allocation between the parties means that the method might reasonably be considered the least reliable of the transfer pricing methods. Because of this, the method is perhaps less likely to be, or may not be, acceptable in foreign jurisdictions, particularly if an

alternative, more reliable, method can be applied. This has the potential to result in double taxation.

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

Valuation-based approach to intangible property

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

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

81. Paragraph 6.29 of the OECD guidelines is drafted with specific reference to intangible property for which valuation is highly uncertain at the time of transfer. Inland Revenue considers that the specific difficulties created by the size of the New Zealand market means that the approach could usefully have broader application here than a superficial reading of the OECD guidelines might imply, particularly for determining arm's length royalty rates. Taxpayers should be aware, however, that while Inland Revenue considers a broader ambit fully consistent with the tenor of the OECD guidelines, other tax administrations might not hold the same view.

Applying a valuation-based approach

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

83. Example 2 illustrates this principle, and offers valuable insights into how:

- an arm's length price for a transfer of intangible property might legitimately be estimated in the

absence of reliable comparables; or

- comparables might be applied in a non-traditional manner to support the assumptions underlying a valuation approach to intangible property.

Example 2

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

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

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

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

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

Observations on valuation approach

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

88. First, determination of the values for most of the variables applied in the NPV calculation (in particular, expected benefits and the appropriate discount rate) can be very subjective. Further, the arm's length principle

does not appear to apply NPV calculations directly. However, in appraising how independent firms have valued intangible property, the arm's length principle is implicitly testing what the market has established the variables in the NPV (or similar) calculation should be.

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

90. Second, it is important to consider both parties to the transaction (paragraph 6.14), a point noted in paragraph 35. Example 2 determined the maximum value the transferee would be prepared to pay for the intangible property – the price commensurate with the value and usefulness of the intangible property in its business, given its risk-tolerance preference. At arm's length, however, the transferor is unlikely to have access to the same information as the transferee, and may for example, based on its own perceptions of profit potential, be prepared to license the intangible property for a royalty of only \$500,000 per year. The parties might then be expected to negotiate a royalty somewhere between these two reservation prices.

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

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

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

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

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

Valuation highly uncertain at time of transaction

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

96. When the value of the intangible property is uncertain, the risks and rewards of transferring that property will typically be shared between the parties when it is transferred. A MNE might structure a transaction in a number of ways, depending on the level of risk, and the various types of risk, each of its members are to assume. For example, the initial owner of intangible property (see paragraphs 40 to 43) may choose to exploit that property with the following levels of market risk (paragraphs 6.29 to 6.31):

- **No risk:** The developer sells the entire results of its development for a fixed sum, with the purchaser then assuming the entire risk of the commercial success or failure of the intangible.

- **Complete risk:** The developer might manufacture and market the final product itself, using a contract distributor to get the product to the market.
- **Partial risk:** The developer might retain ownership, but license the use of that property to another entity in return for some form of royalty. Such an arrangement results in risk being shared between the developer (the licensor) and the other party (the licensee). The developer's royalty return depends on the level of sales by the other entity, and is subject, therefore, to market risk. The other entity's return will similarly be dependent on how well the product performs in the market. Royalties with periodic adjustments are a subset of this category.

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

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

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

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

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

Use of standard international royalty rate

101. One question that is often posed is whether a royalty rate established as arm's length in relation to one member of a MNE will be accepted automatically by Inland Revenue as also being arm's length in relation to New Zealand. This issue is discussed in the example 3.

Example 3

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

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

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

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

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

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

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

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

Marketing activities of enterprises not owning marketing intangible

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

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

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

- A distributor acting merely as agent and being reimbursed for its promotional expenditure would be entitled to compensation appropriate to its agency activity, but not to any share in returns attributable to marketing intangibles (paragraph 6.37).
- A distributor bearing the cost of its own marketing activity would expect to share in the potential benefits of those activities (paragraph 6.38). However, it is important to consider the rights of the distributor in determining whether any extra return is justified. For example:
 - The distributor may benefit directly from its investment in developing the value of a trademark from its turnover and market share if it has a long-term sole distribution contract

for the trademarked product.

- Unless a distributor bears expenditure beyond that which an independent distributor with similar rights would bear, there is no justification for it to receive an additional margin relative to an independent distributor.

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

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

Example 4

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

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

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

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

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

not be appropriate to stop with an analysis at the gross level. From Gizmo Co's perspective, charging inadequate consideration would reduce its gross margin relative to comparable firms. However, this is offset by the New Zealand subsidiary not charging explicitly for its services, which reduces the costs Gizmo Co would recognise in calculating its net profit.

Allocating return attributable to marketing intangibles

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

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

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

Summary

119. This chapter has considered the following key points:

- Intangible property poses some special difficulties in determining the arm's length price, particularly because of the complexity of some arrangements and the difficulties in identifying comparable transactions.
- If one party to a transaction does not contribute intangible property, the most straightforward analysis is likely to involve using that party as the

“tested party”, even if it is outside New Zealand.

- Two particular areas where sufficient care is often not taken are:
 - A local operation is meeting costs for maintaining intellectual property that an independent party would not be required to meet, while at the same time paying the same amount as the independent firm for property it acquires (a double deduction).
 - Analysis being based on what outwardly appear to be reliable comparables but that are not reliable, because the nature of intangible property (potentially high price variations for differences that superficially appear quite small) has not been considered adequately.
- In many cases (particularly using the profit split method), the analysis of intangible property may need to be based on a subjective judgement with limited recourse to reliable comparables. In exercising such judgement, taxpayers will need to be conscious that the final result should seek to ensure that each party to the transaction obtains a return that is broadly consistent with its functions performed, assets employed and risks assumed in relation to the transaction involving the intangible property.
- Valuing intangible property based on realistic projections of future benefits may be an appropriate response to the limited availability of comparables in the New Zealand market, particularly in relation to determining arm's length royalty rates.
- When dealing with marketing activities of firms that do not own the marketing intangible, it is important to ensure that their compensation is commensurate with what independent entities would have accepted given the rights and obligations under the arrangement.

INTRA-GROUP SERVICES

Key Points

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

Introduction

120. Chapter 7 of the OECD guidelines discusses the application of the arm's length principle in relation to intra-group services. Inland Revenue fully endorses the OECD position on intra-group services.

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

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

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

Key issues in intra-group services

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

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

Has a service been provided?

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

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

- If a service is performed to meet an identified need of one or more specific members of the group, an intra-group service would ordinarily be found to exist, because an independent party

would be willing to pay to have that need met (paragraph 7.8).

- “Shareholder activities” performed because of an ownership interest in a group member (such as meetings of the shareholders of the parent company of the group) would not justify a charge to the recipient company, because the group members do not need the activity (paragraph 7.9).
- An incidental benefit derived by a group member from an activity performed for another group member does not mean that it has received a service, because independent enterprises would not be willing to pay for the activities giving rise to the benefit (paragraph 7.12).
- An “on call” service may be an intra-group service to the extent that it would be reasonable to expect an independent enterprise in comparable circumstances to incur ‘standby’ charges to ensure the availability of the services when the need for them arises (paragraph 7.16).

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

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

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

Determining an arm’s length charge

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

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

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

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

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

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

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

Applying a pricing method

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

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

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

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

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

139. When applying the cost plus method, it is important to ensure that the functions for which a margin is being determined are comparable. If the MNE provides only an agency function, it would not be appropriate to use the mark-up added by an independent distributor as an unadjusted comparable. Having said that, the reliability of the cost allocation is likely, in practice, to be a more material issue than the reliability of the mark-up adopted. In this regard, taxpayers may find the administrative practice set out in paragraphs 166 to 176 of some assistance.

Profit element

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

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

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

Determining the cost base for cost-plus method

142. Paragraph 7.23 of the OECD guidelines notes that:

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

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

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

services.

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

146. If taxpayers are in any doubt over an appropriate cost allocation, they may find it useful to discuss the allocation they propose with their account manager in Inland Revenue. Alternatively, they could contact Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340.

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

Global formula approach

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

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

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

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

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

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

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

Time expended

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

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

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

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

Income producing units

156. Corporations in the business of leasing plant and equipment are generally able to identify the generation of income from the utilisation of specific units. Expenditure incurred in producing the income can also be more readily identified. Once it is determined what assets the New Zealand operation is leasing out, as compared to the leasing of assets by the worldwide group, centralised costs might be allocated based on the number of units being utilised. This principle is illustrated in example 5.

Example 5

157. A New Zealand shipping company charters ships that it owns. In allocating head office costs incurred by a foreign parent, it is likely to be appropriate to make an allocation of head office costs relating to chartered vessels over the number of chartered vessels worldwide.

However, it is not likely to be appropriate to allocate head office charges of the group's entire shipping operations over the number of ships operated and leased. This type of allocation does not recognise that different types of ships have different costs – for example, support vessels for oil exploration and production platforms as contrasted with roll-on roll-off freighters.

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

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

Support vessels in New Zealand	x	Allocation expenditure
Support vessels worldwide whether working or not		

Gross profit allocation basis

160. There will be situations where allocating costs on the basis of gross revenue will not be appropriate. This may be through an inability to make like comparison of the turnover of the various members of a group, because the mix of activities is not consistent throughout the group and some activities may require greater support than others. For example, one member's gross turnover may be distorted by a high turnover activity, conducted only by that member, that generates little, if any, profit and requires relatively less assistance to administer (for example, a lease that is sub-leased or a contract that is sub-contracted).

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

Other methods

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

Pitfalls and potential audit issues

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

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

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

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

Administrative practice for services

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

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

168. The administrative practice applies to:

- Non-core services. These services refer to activities that are not integral to the profit-earning or economically significant activities of the group. They include activities that are supportive of the group's main business and are generally routine but are not similar to activities by which the group derives its income; and
- Services with costs below a *de minimis* threshold. This will apply when the total direct and indirect costs of supplying services to New Zealand or foreign associated enterprises, as appropriate, is not more than \$100,000 in a year. The practice

applies to all intra-group services supplied or acquired where the relevant cost limit is not exceeded.

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

170. The criteria for the administrative practices are set out in Table 3.

Table 3: Criteria for administrative practices for services

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

171. To accommodate the varying requirements of other jurisdictions and lessen the possibility of double taxation, taxpayers may instead use the following alternative prices for non-core services in the preparation of their tax returns, if relying on the Commissioner's application of the administrative practice. A transfer price of up to cost plus 10% of relevant costs would be accepted for non-core services supplied by associated enterprises resident in a particular foreign country where it is established by the taxpayer's group that it is the practice of that country to require that price for the services for its tax purposes, and to accept such prices (or mark-ups) for similar services supplied by New Zealand companies to associated enterprises resident in that country (ie, that the other country does or would be expected to accept symmetrical mark-ups for such services). Therefore, the New Zealand group may use different prices in respect of services acquired from associated enterprises in different countries, but none that exceed cost plus 10% of relevant costs.

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

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

Caveat to administrative practice

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

175. To rely on the administrative practices, the taxpayer (whether a supplier or recipient of services) must maintain documentation to establish the nature and extent of services supplied/acquired and to address the issues (as far as is relevant) considered in calculating the relevant total costs. If the taxpayer wishes to use a mark-up other than 7.5% (see paragraphs 171 and 172), documentation of other countries' practices to support

that choice should be kept. Further, a record of the relevant group companies should be retained.

176. If taxpayers require further information on the application of the administrative practice, they should contact their account manager, or Keith Edwards, the National Advisor (Transfer Pricing), on (09) 367-1340.

Practical solutions

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

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

Summary

179. This chapter has considered the following key points:

- There are two central questions to be addressed:
 - Has a service been provided?
 - If so, how should the arm's length price be determined?
- The central test of whether a service has been provided is whether the recipient of an activity receives something that an independent enterprise in comparable circumstances would have been prepared to:
 - pay for it; or
 - perform the service for itself in-house.
- The most common methods applied to services are the CUP and cost plus methods.
- When the cost plus method is applied, costs might be identified directly if a direct-charge approach is used, or indirectly using an appropriate allocation key.
- If a cost allocation is being used, taxpayers should seek to identify a realistic allocation of costs with due regard to considerations of materiality, and not for accounting perfection – the real test is whether a fair charge is determined for the services provided.

- In auditing the transfer prices adopted for intra-group services, Inland Revenue is most likely to focus on:
 - whether a service has been provided;
 - if an indirect-charge approach is taken to applying the cost plus method, whether the allocation key used is appropriate; and
 - whether the approach adopted results in a double deduction through both an explicit and an implicit charge being made.

COST CONTRIBUTION ARRANGEMENTS (CCAS)

Key Points

- A CCA is a contractual arrangement whereby the contracting parties agree to contribute costs in proportion to their overall expected benefits from the arrangement.
- To satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances.
- Difficulties can arise in measuring the value of a participant's contribution and the expected value of its benefits. Participants should ensure that any judgement made leads to commercially justifiable conclusions.

Introduction

180. Chapter 8 of the OECD guidelines discusses the application of the arm's length principle in relation to cost contribution arrangements (CCAs). Inland Revenue fully endorses the position established in those guidelines.

181. A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights. It also determines the nature and extent of the interest of each participant in those assets, services, or rights. It is a contractual arrangement under which a member's share of contributions should be consistent with its expected benefits from the arrangement. Each member is also entitled to exploit its interest in the CCA separately as an effective owner, rather than as a licensee – it does not need to pay a royalty or other consideration for that right (paragraph 8.3). There is no standard framework for a CCA – each arrangement will depend on its own unique facts and circumstances.

182. A CCA should be distinguished from the scenario where members of a MNE jointly fund a new entity which then develops and exploits intangible property in its own right. In that case, the new entity will own any intangible property that it creates, and would be expected to derive an arm's length return from the exploitation of that intangible. The return to the members funding the new entity would be based on the form of capital contributed (for example, interest paid on debt or dividends paid on equity), rather than by benefiting directly from the intangible property.

183. The OECD guidelines suggest that the most likely area in which CCAs will arise will relate to the development of intangible property. However, the guidelines note that CCAs may also be used for any joint funding activity, such as centralised management services or developing advertising campaigns common to the participants' markets (paragraphs 8.6 and 8.7).

184. There are a number of significant issues that have not yet been resolved by the OECD (paragraph 8.1). The OECD guidelines appear likely to be developed further, therefore, as member countries gain experience in applying the arm's length principle to CCAs.

185. There may also be an issue over whether CCAs will be acceptable in overseas jurisdictions. For example, some jurisdictions may limit the use of CCAs to the development of intangible property, while others may not recognise them at all. If a CCA is not recognised in an overseas jurisdiction, there is potential for double taxation to occur.

186. The purpose of this chapter is to provide an overview of the OECD guidelines on CCAs. The discussion is not, however, exhaustive of issues canvassed in the OECD guidelines. For example, the OECD guidelines contain a detailed discussion on documents that would be useful to document adequately a CCA (paragraphs 8.41 to 8.43). If a taxpayer does intend entering into CCA, the OECD guidelines are essential reading before entering into the arrangement.

Applying arm's length principle to CCAs

187. For a CCA to satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances (paragraph 8.8).

188. Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the CCA be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement (paragraph 8.9).

189. Applying the arm's length principle to CCAs, therefore, requires the determination of:

- the participants in the CCA;
- each participant's relative contribution to the joint activity; and

- the appropriate allocation of contributions, based on each participant's expected benefits.

Identification of participants

190. Because the concept of mutual benefit is fundamental to a CCA, a participant must have a reasonable expectation that it will benefit from the CCA activity itself. A participant must receive a beneficial interest in the property or services that are the subject of the CCA activity and have a reasonable expectation of being able to exploit that interest, directly or indirectly.

191. A member of the MNE that performs part of the CCA activity but does not stand to benefit from the outcome of the CCA activity cannot be a participant of the CCA. Instead, it should be compensated by way of an arm's length charge for the services it performs for the CCA. This principle is illustrated in example 6.

Example 6

192. Three members of a MNE marketing a product in the same regional market in which consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the MNE helps develop the advertising campaign, but does not itself market the product.

193. The fourth member will not be a participant in the CCA, both because it does not receive a beneficial interest in the services subject to the CCA activity and would not, in any case, have a reasonable expectation of being able to exploit any interest. The three participants in the CCA would, therefore, compensate the fourth member by way of an arm's length payment for the advertising services provided to the CCA.

Amount of participant's contribution

194. As contributions are to be made to a CCA in proportion to expected benefits, it is necessary to be able to value each member's contribution. Following the arm's length principle, the value of each participant's contribution is the value that independent enterprises would have assigned to the contribution in comparable circumstances.

195. Contributions to a CCA could be monetary or non-monetary in nature. Non-monetary contributions might include, for example, the use of a participant's existing intangible assets or the provision of services by a participant.

196. When the contribution is cash, its value can easily be quantified. There are, however, a number of difficulties in valuing non-monetary contributions that have not yet been fully resolved in the OECD guidelines. For example:

- Should cost or market value be used in valuing

contributions?

- How should the value of property or services provided be apportioned when they are only partly applied in the CCA activity with the balance applied in the provider's other activities?

197. These issues will need to be resolved on a facts and circumstances basis. The key consideration, however, is to ensure that the valuation approach adopted is commercially justifiable, and that independent firms would have been prepared to accept the terms of the CCA given the valuations adopted.

Appropriateness of allocation

198. While a participant's contribution must be consistent with its expected benefits if a CCA is to satisfy the arm's length principle, there is, however, no universal rule for estimating the expected benefits to be obtained by each participant in a CCA (paragraph 8.19). Possible techniques include (but are not limited to):

- Estimation based on anticipated additional income that will be generated or costs that will be saved as a result of entering the CCA.
- The use of an appropriate allocation key, perhaps based on sales, units used, produced or sold, gross or operating profits, numbers of employees, capital invested, or alternative keys.

199. Again, appraisal of the appropriateness of the cost allocations will be based on facts and circumstances. The key consideration, however, is to ensure the benefits estimated are consistent with the benefits that an independent firm might have expected to receive from the CCA.

Balancing payments

200. Balancing payments may be required to adjust participants' proportionate shares of contributions (paragraph 8.18). If, for example, a participant's contribution exceeds its expected share of the benefits from the CCA, a payment should be made to that participant from the other participants so that its contributions and expected benefits are reconciled.

Tax treatment of contributions and balancing payments

201. The tax treatment of contributions to a CCA will depend on the character of the payment. If the expenditure would be deductible if it were to be incurred outside the CCA, the expenditure will be deductible. If, however, the expenditure would be treated as capital expenditure if it were to be incurred outside the CCA, the expenditure will be non-deductible.

202. A balancing payment is treated as an addition to the costs of a payer and as a reimbursement (reduction) of costs to the recipient. If a balancing payment exceeds the recipient's deductible expenditures, the tax treatment of the excess payment will depend on what the payment is made for.

203. No part of a contribution or balancing payment in respect of a CCA will constitute a royalty for the use of intangible property, because each participant in the CCA receives a right to exploit intangible property arising from the CCA by virtue of being a participant in the CCA.

Conclusions on applying arm's length principle to CCAs

204. The proceeding discussion suggests that it may be difficult to locate comparable data on which to apply the arm's length principle to CCAs. Participants to a CCA may, therefore, need to depend on the exercise of "commercially justifiable" judgement in determining the value of the contributions and the expected benefits of each participant. Each case will depend on its own facts and circumstances.

205. Taxpayers should ensure in particular that:

- valuations of non-cash contributions to a CCA are consistent for each party's contribution and commercially justifiable; and
- expected benefits are estimated in such a way that an independent enterprise would be prepared to use the outcome of the estimation as a basis for determining whether it would accept the terms of the CCA.

Structure of CCA

206. Paragraph 8.40 of the OECD guidelines lists a number of conditions that a CCA at arm's length would ordinarily meet. These conditions, set out below, may provide a useful guide when formulating a CCA.

- (a) The participants would include only enterprises expected to derive mutual benefits from the CCA activity itself, either directly or indirectly (and not just from performing part or all of the activity).
- (b) The arrangement would specify the nature and extent of each participant's beneficial interest in the results of the CCA activity.
- (c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the beneficial interest in property, services, or rights obtained through the CCA.
- (d) The proportionate shares of contributions would be determined in a proper manner using an allocation method reflecting the sharing of expected benefits from the arrangement.
- (e) The arrangement would allow for balancing payments or for the allocation of contributions to be changed prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants.
- (f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the withdrawal of a participant and upon termination of the CCA.

Summary

207. This chapter has considered the following key points:

- A CCA is a contractual arrangement whereby participants agree to share costs on the basis of expected benefits from the arrangement.
- To satisfy the arm's length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances.
- Difficulties can arise in measuring the value of a participant's contribution and the expected value of its benefits. Any judgements made in making these measurements should be commercially justifiable.

