Determination of the taxable income of certain persons from international transactions: Transfer pricing

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This research has not been previously accepted for any degree and is not being currently submitted in candidature for any degree.

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SUMMARY

Many intra-firm transactions are non-market transactions and therefore lack a market determined price. A transfer price is the price assigned to such non-market intra-firm transfers. Transfer prices are especially important for multinational corporations, since a parent company typically has subsidiaries or branches in other countries and transfers are often made between the component parts of the multinational.

As the world has become more internationally dependent, these transactions and the associated transfer prices have come under increased scrutiny. The fear often expressed by governments is that a multinational corporation may manipulate transfer prices in order to transfer profits from one country to another, and thereby affect various government policies. Most notably, transfer prices can affect the tax revenues of both the home and host country.

A general international consensus is that the appropriate transfer price is the 'arm's length' price. This is the price that would be charged by two unrelated parties. However, it is often difficult to find such a comparable transaction.

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Chapter One

1. Introduction

The term transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other.

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

For example, if a member of a multinational sells to a connected person resident in a specific country at a price which exceeds the market price, the profit which the multinational earns in that country is reduced. Similarly if the member of a multinational sells to a connected person resident in a country at a reduced price the profit the multinational earns in that country is increased.

Since South Africa's re-emergence in the international market, there has been a marked expansion of international trade and commerce, with wide-ranging changes in volume and complexity. An increasing proportion of this international activity is carried on between members of multinationals. As the globalisation of business activity continues to accelerate, protecting the South African tax base is vital to South Africa's wealth and development.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Exchange controls have historically provided some protection against the more significant manipulation of transfer prices to transfer profits to lower tax jurisdictions.

In anticipation of the relaxation of exchange controls and the envisaged adverse effect on the South African tax base section 31 of the Income Tax Act was introduced into the Act in 1955.

Section 31 enables the Commissioner to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement between connected persons. The Commissioner may adjust the consideration, for tax purposes, if the actual price is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm's length basis. The Commissioner may use the amount so determined, in the determination of the taxable income of either of the parties to the transaction.

The section therefore, provides a mechanism by which the Commissioner adopts the internationally accepted "arm's length principle" for taxation purposes as the basis for ensuring that the South African fiscus receives its fair share of tax. This is achieved by adjusting the consideration in the determination of taxable income based on the conditions which would have existed between unconnected persons under comparable circumstances.

Chapter Two

2. Section 31 of the Act

Sections 31 were introduced into the Act with effect from 19 July 1995 to counter transfer pricing practices which may have adverse tax implications for the South African fiscus. This section consists of a combination of transfer pricing and thin capitalisation provisions. The measures to combat transfer pricing schemes are in essence contained in section 31 (1) and (2). The provisions of section 31 (3) are more specifically aimed at countering thin capitalisation schemes.

Section 31 (1) defines the terms used in this section. Section 31 (2) empowers the Commissioner to adjust the consideration (for the purposes of the Act and the calculation of taxable income) in respect of international agreements to reflect an arm's length price for the goods or services supplied in terms of that international agreement.

The Commissioner may exercise his discretion in the following circumstance in relation to cross border transactions:

- Where the acquirer of the goods or services is a connected person in relation to the supplier of those goods or services (including the supply of goods and services to or by a permanent establishment which either such acquirer or supplier has in South Africa or which either such acquirer or supplier has outside South Africa); and
- The goods or services are supplied at a price other (greater or less) than the arm's length price.

Although the Act grants the Commissioner the power to adjust the consideration in respect of a transaction, the reality is that numerous transactions in respect of the same goods or services are entered into between the connected persons.

In practice the Commissioner will exercise his discretion in respect of all transactions entered into in respect of a product or service during any period. Such period could be a year or number of years of assessment.
In terms of sections 3 (4) of the Act, the Commissioner's decision is subject to objection and appeal.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Three

3. Tax Treaties

Article 7 of the OECD "Model Tax Convention on Income and on Capital" provides *inter alia* for the attribution of profits to a permanent establishment of an enterprise. Furthermore, Article 9 of the OECD Model Tax Convention stipulates that the arm's length principle must be applied to commercial and financial relations between associated companies residing in the contracting states. These principles are embodied in each of South Africa's tax treaties. Tax treaties cannot impose tax liability; they merely allocate existing tax liabilities between countries.

The "business profits" and "associated enterprises" articles in the tax treaties do not indicate priorities as to the methods to be used to determine the attribution of profits or an arm's length price. Therefore, the Commissioner hold the view that the treaties do not restrict or limit the application of Section31 of the Act, regardless of the method selected to determine an arm's length consideration. The Commissioner also takes the view that no inconsistency exists between domestic law and the tax treaties, as both embody the arm's length principle.

Paragraph 2 of Article 9 of the OECD Model Tax Convention provides that a contracting state must make an appropriate adjustment to the amount of tax it levies on profits, if the other contracting state has made an adjustment to the profits of a related enterprise.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Furthermore, the competent authorities of the contracting states may consult each other over the transfer pricing adjustments. Although South Africa's treaties generally incorporate such adjusting mechanisms, the wording of the relevant article in the treaties may not oblige South Africa to make a corresponding adjustment in all cases.

Although the provisions of section 31 of the Act are applicable to persons, which are separate legal entities, the contents of SARS will also apply to determine the arm's length consideration for income tax purposes of cross-border transactions conducted by –

- A person with a connected person;
- A person's head office with a branch of such person; or
- A person's branch with another branch of such person,

In the application of the tax treaties entered into by South Africa.

Chapter Four

4. Commentary on the Implementation Procedure of the OECD Guidelines for Multinational Enterprise.

Preface

1. The OECD *Guidelines for Multinational Enterprises* (the *Guidelines*) are recommendations addressed by governments to multinational enterprises. They provide voluntary principles and standards for responsible business conduct consistent with applicable laws. The *Guidelines* aim to ensure that the operations of these enterprises are in harmony with government policies, to strengthen the basis of mutual confidence between enterprises and the societies in which they operate, to help improve the foreign investment climate and to enhance the contribution to sustain- able development made by multinational enterprises. The *Guidelines* are part of the OECD *Declaration on International Investment and Multinational Enterprises* the other elements of which relate to national treatment, conflicting requirements on enterprises, and international investment incentives and disincentives.

2. International business has experienced far-reaching structural change and the Guidelines themselves have evolved to reflect these changes. With the rise of service and knowledge-intensive industries, service and technology enterprises have entered the international marketplace.

Source date accessed 20 October 2004
The OECD Guidelines for Multinational Enterprises
Available from: http://www.oecd.org

Large enterprises still account for a major share of international investment, and there is a trend toward large-scale international mergers. At the same time, foreign investment by small and medium-sized enterprises has also increased and these enterprises now play a significant role on the international scene.

Multinational enterprises, like their domestic counterparts, have evolved to encompass a broader range of business arrangements and organizational forms. Strategic alliances and closer relations with suppliers and contractors tend to blur the boundaries of the enterprise.

3. The rapid evolution in the structure of multinational enterprises is also reflected in their operations in the developing world, where foreign direct investment has grown rapidly. In developing countries, multinational enterprises have diversified beyond primary production and extractive industries into manufacturing, assembly, domestic market development and services.

4. The activities of multinational enterprises, through international trade and investment, have strengthened and deepened the ties that join OECD economies to each other and to the rest of the world. These activities bring substantial benefits to home and host countries. These benefits accrue when multinational enterprises supply the products and services that consumers want to buy at competitive prices and when they provide fair returns to suppliers of capital. Their trade and investment activities contribute to the efficient use of capital, technology and human and natural resources. They facilitate the transfer of technology among the regions of the world and the development of technologies that reflect local conditions. Through both formal training and on-the-job learning enterprises also promote the development of human capital in host countries.

5. The nature, scope and speed of economic changes have presented new strategic challenges for enterprises and their stakeholders. Multinational enterprises have the opportunity to implement best practice polices for sustainable development that seek to ensure coherence between social, economic and environmental objectives. The ability of multinational enterprises to promote sustainable development is greatly enhanced when trade and investment are conducted in a context of open, competitive and appropriately regulated markets.

6. Many multinational enterprises have demonstrated that respect for high standards of business conduct can enhance growth. Today's competitive forces are intense and multinational enterprises face a variety of legal, social and regulatory settings. In this context, some enterprises may be tempted to neglect appropriate standards and principles of conduct in an attempt to gain undue competitive advantage. Such practices by the few may call into question the reputation of the many and may give rise to public concerns.

7. Many enterprises have responded to these public concerns by developing internal programmes, guidance and management systems that underpin their commitment to good corporate citizenship, good practices and good business and employee conduct. Some of them have called upon consulting, auditing and certification services, contributing to the accumulation of expertise in these areas. These efforts have also promoted social dialogue on what constitutes good business conduct. The *Guidelines* clarify the shared expectations for business conduct of the governments adhering to them and provide a point of reference for enterprises. Thus, the *Guidelines* both complement and reinforce private efforts to define and implement responsible business conduct.

8. Governments are co-operating with each other and with other actors to strengthen the international legal and policy framework in which business is conducted. The post-war period has seen the development of this framework, starting, with the adoption in 1948 of the Universal Declaration of Human Rights.

Recent instruments include the ILO Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development and Agenda 21 and the Copenhagen Declaration for Social Development.

9. The OECD has also been contributing to the international policy framework. Recent developments include the adoption of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and of the OECD Principles of Corporate Governance, the OECD Guidelines for Consumer Protection in the Context of Electronic Commerce, and ongoing work on the OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations.

10. The common aim of the governments adhering to the *Guidelines* is to encourage the positive contributions that multinational enterprises can make to economic, environmental and social progress and to minimize the difficulties to which their various operations may give rise. In working towards this goal, governments find themselves in partnership with the many businesses, trade unions and other non-governmental organizations that are working in their own ways toward the same end. Governments can help by providing effective domestic policy frameworks that include stable macroeconomic policy, non-discriminatory treatment of firms, appropriate regulation and prudential supervision, an impartial system of courts and law enforcement and efficient and honest public administration. Governments can also help by maintaining and promoting appropriate standards and policies in support of sustainable development and by engaging in ongoing reforms to ensure that public sector activity is efficient and effective.

Governments adhering to the *Guidelines* are committed to continual improvement of both domestic and international policies with a view to improving the welfare and living standards of all people.

Concepts and Principles

1. The *Guidelines* is recommendations jointly addressed by governments to multi national enterprises. They provide principles and standards of good practice consistent with applicable laws. Observance of the *Guidelines* by enterprises is voluntary and not legally enforceable.

2. Since the operations of multinational enterprises extend throughout the world, international co-operation in this field should extend to all countries. Governments adhering to the *Guidelines* encourage the enterprises operating on their territories to observe the *Guidelines* wherever they operate, while taking into account the particular circumstances of each host country.

3. A precise definition of multinational enterprises is not required for the purposes of the *Guidelines.* These usually comprise companies or other entities established in more than one country and so linked that they may co-ordinate their operations in various ways. While one or more of these entities may be able to exercise a significant influence over the activities of others, their degree of autonomy within the enterprise may vary widely from one multinational enterprise to another. Ownership may be private, state or mixed. The *Guidelines* are addressed to all the entities within the multinational enterprise (parent companies and/or local entities). According to the actual distribution of responsibilities among them, the different entities are expected to co-operate and to assist one another to facilitate observance of the *Guidelines.*

4. The *Guidelines* are not aimed at introducing differences of treatment between multinational and domestic enterprises; they reflect good practice for all. Accordingly, multinational and domestic enterprises are subject to the same expectations in respect of their conduct wherever the *Guidelines* are relevant to both.

5. Governments wish to encourage the widest possible observance of the *Guidelines*. While it is acknowledged that small and medium-sized enterprises may not have the same capacities as larger enterprises, governments adhering to the *Guidelines* nevertheless encourage them to observe the *Guidelines* recommendations to the fullest extent possible.

6. Governments adhering to the *Guidelines* should not use them for protectionist purposes nor use them in a way that calls into question the comparative advantage of any country where multinational enterprises invest.

7. Governments have the right to prescribe the conditions under which multinational enterprises operate within their jurisdictions, subject to international law. The entities of a multinational enterprise located in various countries are subject to the laws applicable in these countries. When multinational enterprises are subject to conflicting requirements by adhering countries, the governments concerned will co-operate in good faith with a view to resolving problems that may arise.

8. Governments adhering to the *Guidelines* set them forth with the understanding that they will fulfill their responsibilities to treat enterprises equitably and in accordance with international law and with their contractual obligations.

9. The use of appropriate international dispute settlement mechanisms, including arbitration, is encouraged as a means of facilitating the resolution of legal problems arising between enterprises and host country governments.

10. Governments adhering to the *Guidelines* will promote them and encourage their ' use. They will establish National Contact Points that promote the *Guidelines* and act as a forum for discussion of all matters relating to the *Guidelines*.

The adhering Governments will also participate in appropriate review and consultation procedures to address issues concerning interpretation of the *Guidelines* in a changing world.

General Policies

Enterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. In this regard, enterprises should:

1. Contribute to economic, social and environmental progress with a view to achieving sustainable development.

2. Respect the human rights of those affected by their activities consistent with the host government's international obligations and commitments.

3. Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice.

4. Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees.

5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues.

6. Support and uphold good corporate governance principles and develop and apply good corporate governance practices.

7. Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate.

8. Promote employee awareness of, and compliance with, company policies through appropriate dissemination of these policies, including through training programmes.

9. Refrain from discriminatory or disciplinary action against employees who make bona fide reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the *Guidelines* or the enterprise's policies.

10. Encourage, where practicable, business partners, including suppliers and sub- contractors, to apply principles of corporate conduct compatible with the *Guidelines.*

11. Abstain from any improper involvement in local political activities.

Disclosure

1. Enterprises should ensure that timely, regular, reliable and relevant information is disclosed regarding their activities, structure, financial situation and performance. This information should be disclosed for the enterprise as whole and, where appropriate, along business lines or geographic areas.

Disclosure policies of enterprises should be tailored to the nature, size and location of the enterprise, with due regard taken of costs, business confidentiality and other competitive concerns.

2. Enterprises should apply high quality standards for disclosure, accounting, and audit. Enterprises are also encouraged to apply high quality standards for non- financial information including environmental and social reporting where they exist.
   The standards or policies under which both financial and non-financial information are compiled and published should be reported.

3. Enterprises should disclose basic information showing their name, location, and structure, the name, address and telephone number of the parent enterprise and its main affiliates, its percentage ownership, direct and indirect in these affiliates, including shareholdings between them.

4. Enterprises should also disclose material information on:
   a) The financial and operating results of the company.
   b) Company objectives.
   c) Major share ownership and voting right.
   d) Members of the board and key executives, and their remuneration.
   e) Material foreseeable risk factors.
   f) Material issues regarding employees and other stakeholders.
   g) Governance structures and policies.

5. Enterprises are encouraged to communicate additional information that could include:
   a) Value statements or statements of business conduct intended for public disclosure including information on the social, ethical and environmental policies of the enterprise and other codes of conduct to which the company subscribes. In addition, the date of adoption, the countries and entities to which such statements apply and its performance in relation to these statements may be communicated.

b) Information on systems for managing risks and complying with laws, and on statements or codes of business conduct.

c) Information on relationships with employees and other stakeholders

Employment and Industrial Relations

Enterprises should, within the framework of applicable law, regulations and prevailing labour relations and employment practices:

1. a) Respect the right of their employees to be represented by trade unions and other bona fide representatives of employees, and engage in constructive negotiations, either individually or through employers' associations, with such representatives with a view to reaching agreements on employment conditions;

b) Contribute to the effective abolition of child labour.

c) Contribute to the elimination of all forms of forced or compulsory labour.

d) Not discriminate against their employees with respect to employment or occupation on such grounds as race, colour, sex, religion, political opinion, national extraction or social origin, unless selectivity concerning employee characteristics furthers established governmental policies which specifically promote greater equality of employment opportunity or relates to the inherent requirements of a job.

2. a) Provide facilities to employee representatives as may be necessary to assist in the development of effective collective agreements.

b) Provide information to employee representatives which are needed for meaningful negotiations on conditions of employment.

c) Promote consultation and co-operation between employers and employees and their representatives on matters of mutual concern.

3. Provide information to employees and their representatives, which enables them to obtain a true and fair view of the performance of the entity or, where appropriate, the enterprise as a whole.

4. a) Observe standards of employment and industrial relations not less favorable than those observed by comparable employers in the host country.

   b) Take adequate steps to ensure occupational health and safety in their operations.

5. In their operations, to the greatest extent practicable, employ local personnel and provide training with a view to improving skill levels, in co-operation with employee representatives and, where appropriate, relevant governmental authorities.

6. In considering changes in their operations which would have major effects upon the livelihood of their employees, in particular in the case of the closure of an entity involving collective lay-offs or dismissals, provide reasonable notice of such changes to representatives of their employees, and, where appropriate, to the relevant governmental authorities, and co-operate with the employee representatives and appropriate governmental authorities so as to mitigate to the maximum extent practicable adverse effects. In light of the specific circumstances of each case, it would be appropriate if management were able to give such notice prior to the final decision being taken. Other means may also be employed to provide meaningful co-operation to mitigate the effects of such decisions.

7. In the context of bona fide negotiations with representatives of employees on conditions of employment, or while employees are exercising a right to organize, not threaten to transfer the whole or part of an operating unit from the country concerned nor transfer employees from the enterprises' component entities in other countries in order to influence unfairly those negotiations or to hinder the exercise of a right to organize.

8. Enable authorized representatives of their employees to negotiate on collective bargaining or labour-management relations issues and allow the parties to consult on matters of mutual concern with representatives of management who are authorized to take decisions on these matters.

Environment

Enterprises should within the framework of laws, regulations and administrative practices in the countries in which they operate, and in consideration of relevant international agreements, principles, objectives, and standards take due account of the need to protect the environment, public health and safety, and generally to conduct their activities in a manner contributing to the wider goal of sustainable development. In particular, enterprises should:

1. Establish and maintain a system of environmental management appropriate to the enterprise, including:

   a) Collection and evaluation of adequate and timely information regarding the environmental, health, and safety impacts of their activities.

   b) Establishment of measurable objectives and, where appropriate, targets for improved environmental performance, including periodically reviewing the continuing relevance of these objectives; and

   c) Regular monitoring and verification of progress toward environmental, health and safety objectives or targets.

2. Taking into account concerns about cost, business confidentiality, and the protection of intellectual property rights:

a) Provide the public and employees with adequate and timely information on the potential environment, health and safety impacts of the activities of the enterprise, which could include reporting on progress in improving environmental performance; and

b) Engage in adequate and timely communication and consultation with the communities directly affected by the environmental, health and safety policies of the enterprise and by their implementation.

3. Assess, and address in decision-making, the foreseeable environmental, health and safety-related impacts associated with the processes, goods and services of the enterprise over their full life cycle. Where these proposed activities may have significant environmental, health or safety impacts, and where they are subject to a decision of a competent authority, prepare an appropriate environmental impact assessment.

4. Consistent with the scientific and technical understanding of the risks, where there are threats of serious damage to the environment, taking also into account human health and safety, not use the lack of full scientific certainty as a reason for postponing cost-effective measures to prevent or minimize such damage.

5. Maintain contingency plans for preventing, mitigating, and controlling serious environmental and health damage from their operations, including accidents and emergencies; and mechanisms for immediate reporting to the competent authorities.

6. Continually seek to improve corporate environmental performance, by encouraging where appropriate, such activities as:

a) Adoption of technologies and operating procedures in all parts of the enterprise that reflect standards concerning environmental performance in the best performing part of the enterprise.

b) Development and provision of products or services that have no undue environmental impacts; are safe in their intended use; are efficient in their consumption of energy and natural resources; can be re-used, recycled, or disposed of safely.

c) Promoting higher levels of awareness among customers of the environmental implications of using the products and services of the enterprise; and

d) Research on ways of improving the environmental performance of the enterprise over the longer term.

7. Provide adequate education and training to employees in environmental health and safety matters including the handling of hazardous materials and the prevention of environmental accidents as well as more general environmental man- agreement areas, such as environmental impact assessment procedures, public relations and environmental technologies.

8. Contribute to the development of environmentally meaningful and economically efficient public policy for example by means of partnerships or initiatives that will enhance environmental awareness and protection.

Combating Bribery

Enterprises should not directly or indirectly offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage. Nor should enterprises be solicited or expected to render a bribe or other undue advantage.

In particular, enterprises should:

1. Not offer, nor give in to demands, to pay public officials or the employees of business partners any portion of a contract payment. They should not use sub-contracts, purchase orders or consulting agreements as means of channeling payments to public officials, to employees of business partners or to their relatives or business associates.

2. Ensure that remuneration of agents is appropriate and for legitimate services only. Where relevant, a list of agents employed in connection with transactions with public bodies and state-owned enterprises should be kept and made available to competent authorities.

3. Enhance the transparency of their activities in the fight against bribery and extortion.

   Measures could include making public commitments against bribery and extortion and disclosing the management systems the company has adopted in order to honour these commitments. The enterprise should also foster openness and dialogue with the public so as to promote its awareness of and co-operation with the fight against bribery and extortion.

4. Promote employee awareness of and compliance with company policies against bribery and extortion through appropriate dissemination of these policies and through training programmes and disciplinary procedures.

5. Adopt management control systems that discourage bribery and corrupt practices, and adopt financial and tax accounting and auditing practices that prevent the establishment of "off the books" or secret accounts or the creation of documents which do not properly and fairly record the transactions to which they relate.

6. Not make illegal contributions to candidates for public office or to political parties or to other political organizations. Contributions should fully comply with public disclosure requirements and should be reported to senior management.

Consumer Interests

When dealing with consumers, enterprises should act in accordance with fair business, marketing and advertising practices and should take all reasonable steps to ensure the safety and quality of the goods or services they provide.

In particular, they should:

1. Ensure that the goods or services they provide meet all agreed or legally required standards for consumer health and safety, including health warnings and product safety and information labels.

2. As appropriate to the goods or services, provide accurate and clear information regarding their content, safe use, maintenance, storage, and disposal sufficient to enable consumers to make informed decisions.

3. Provide transparent and effective procedures that address consumer complaints and contribute to fair and timely resolution of consumer disputes without undue cost or burden.

4. Not make representations or omissions, nor engage in any other practices, that are deceptive, misleading, fraudulent, or unfair.

5. Respect consumer privacy and provide protection for personal data.

6. Co-operate fully and in a transparent manner with public authorities in the prevention or removal of serious threats to public health and safety deriving from the consumption or use of their products.

Science and Technology

Enterprises should:

1. Endeavour to ensure that their activities are compatible with the science and technology (S&T) policies and plans of the countries in which they operate and as appropriate contribute to the development of local and national innovative capacity, political parties or to other political organizations. Contributions should fully comply with public disclosure requirements and should be reported to senior management.

2. Adopt, where practicable in the course of their business activities, practices that permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights.

3. When appropriate, perform science and technology development work in host countries to address local market needs, as well as employ host country personnel in an S&T capacity and encourage their training, taking into account commercial needs.

4. When granting licenses for the use of intellectual property rights or when otherwise transferring technology, do so on reasonable terms and conditions and in a manner that contributes to the long term development prospects of the host country.

5. Where relevant to commercial objectives, develop ties with local universities, public research institutions, and participate in co-operative research projects with local industry or industry associations.

Competition

Enterprises should, within the framework of applicable laws and regulations, conduct their activities in a competitive manner. In particular, enterprises should:

1. Refrain from entering into or carrying out anti-competitive agreements among competitors:
   a) To fix prices.
   b) To make rigged bids (collusive tenders).
   c) To establish output restrictions or quotas; or
   d) To share or divide markets by allocating customers, suppliers, territories or lines of commerce.

2. Conduct all of their activities in a manner consistent with all applicable competition laws, taking into account the applicability of the competition laws of jurisdictions whose economies would be likely to be harmed by anti-competitive activity on their part.

3. Co-operate with the competition authorities of such jurisdictions by, among other things and subject to applicable law and appropriate safeguards, providing as prompt and complete responses as practicable to requests for information.

4. Promote employee awareness of the importance of compliance with all applicable competition laws and policies.

Taxation

It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations.

This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle.

Chapter Five

5. The Arm's Length Principle

The first and overriding principle is that transactions between connected persons are to be conducted at arm's length. This simply means that the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.

Paragraph 1 of Article 9 of the OECD Model Tax Convention deals with the arm's length principle as follows:

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

- The problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.

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Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

- South Africa has adopted the arm's length principle, which is the international norm.

  The Commissioner is of the opinion that application of this internationally accepted principle will minimise the potential for double taxation.

- Other than tax considerations, factors such as governmental regulations (for example price or exchange controls) may distort the prices charged between connected persons. These factors are recognised by the OECD Guidelines and the Commissioner. This Practice Note intends to provide broad guidelines about the business and economic concepts which serve to indicate what information, data and other evidence would support a contention that a transaction has occurred at arm's length.

- The determination of an arm's length consideration is not an exact science but requires judgement on the part of both the taxpayer and the Commissioner. Accordingly, taxpayers and the Commissioner need to approach each case, having due regard for the unique business and market realities applicable to each individual case.

- An arm's length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where, within that range, a specific arm's length price will lie

New Zealand's approach to Arm's length principle

Introduction

Coverage of guidelines

These guidelines on New Zealand's transfer pricing rules aim to provide taxpayers with an appreciation of what they will need to do if they are to demonstrate to the Commissioner of Inland Revenue that they have compiled with the arm's length principle in section GD13.

Specifically, the guidelines consider:

- The rationale behind New Zealand's adoption of the arm's length principle
- The conceptual framework on which application of the acceptable transfer pricing methods is based
- The general principles of comparability (including a discussion on functional analysis) which forms the foundation of transfer pricing analysis
- The factors taxpayers should consider in determining the extent to which documentation should be prepared and maintained in support of their determination of the arm's length price
- The treatment of intangible property
- The treatment of intra-group services, such as management fees, and
- Cost contribution arrangements (CCAs).

Source accessed 17 September

New Zealand Transfer Pricing Explored

Available from: http://www.taxpolicy.ird.govt.nz

The material in these guidelines was released for consultation in draft form in two parts. Part 1, released in October 1997, provided a general overview of the framework within which transfer pricing operates, including a discussion on documentation. Part 2, released in January 2000, dealt with intangible property, intra-group services, and CCAs.

No changes have been made to Part 2 following consultation, other than to update cross-references.
Some changes have been made to Part 1, but these do not affect substantive issues. A summary of the changes is set out in a short chapter at the end of these guidelines.

Relationship to OECD guidelines

Tax Information Bulletin Vol 7, No 11 (March 1996) describe New Zealand's transfer pricing legislation enacted in December 1995.

On page 1 of that publication, it was stated that until New Zealand's transfer pricing guidelines are issued, Inland Revenue will be following the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (referred to in these guidelines as the "OECD guidelines") in applying the transfer pricing rules.

There is however, no valid reason why Inland Revenue should not follow the OECD guidelines entirely in administering New Zealand's transfer pricing rules. The consensus established between OECD member countries means that the OECD guidelines will, for example, be the relevant guidelines to consider if a transfer pricing issue is raised under New Zealand's double tax agreements. Inland Revenue also does not differ substantively from the OECD's view on any point.

Inland Revenue, therefore, fully endorses the positions set out in chapters 1 to 8 of the OECD guidelines and proposes to follow those positions in administering New Zealand's transfer pricing rules.

Consequently, New Zealand's guidelines should be read as supplementing the OECD guidelines, rather than superseding them. This applies for the domestic application of New Zealand's rules, as well as in relation to issues raised under New Zealand's double taxation agreements.

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

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

Inland Revenue's approach to New Zealand guidelines

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

The second approach is to provide guidance on the factors that should be considered in determining whether an amount constitutes an arm's length price and how these factors might affect a transfer pricing analysis.

This is the approach adopted in these guidelines, and it is hoped that the result will achieve the aim of providing a practical guide to transfer pricing issues and the application of the arm's length principle.

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

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

Key messages

A number of important messages are reiterated throughout these guidelines.

Perhaps first and foremost, transfer pricing is not an exact science. These guidelines continually emphasize that transfer pricing is a matter of judgment.

("Judgment" is used here in the sense of establishing the extent to which a factor is significant in determining an arm's length price, as opposed to an intuitive feeling that a price is correct). This is the reason for preparing these guidelines as a practical guide, rather than as prescriptive rules for determining transfer prices.

Second, the transfer pricing rules will be administered most efficiently if taxpayers and Inland Revenue co-operate in resolving transfer pricing issues. The final key message is that taxpayers know their business best, and this should influence how they respond to the transfer pricing rules. Taxpayers know how their prices are set and what the economic and commercial justifications are for the actions they take, and this knowledge can be used to develop a strong transfer pricing analysis.

If taxpayers make conscientious efforts to establish transfer prices that comply with the arm's length principle, and prepare documentation to evidence that compliance, Inland Revenue is likely to determine *prima facie* that those transfer pricing practices represent a low tax risk, and the review of those practices is likely to be diminished accordingly. By contrast, taxpayers who give inadequate consideration to their transfer pricing practices are likely to receive closer attention from Inland Revenue. Documentation to evidence consistency, therefore, plays a key role in determining whether Inland Revenue is likely to review taxpayers' transfer pricing in greater detail. Inland Revenue considers it to be in taxpayers' best interests to prepare and maintain adequate documentation.

Scope of guidelines and application of section FB2 to branches

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

The guidelines do not apply to transactions within a single entity, such as between a parent company and its branch operation. Those transactions are subject instead to the apportionment rules in section FB2.

Inland Revenue has received several comments expressing concern that no guidance has been issued to date on the application of section FB2 to branches.

Section FB2 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.

The drafting of section FB2(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.

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

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

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

Mechanisms to reduce transfer pricing disputes

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

Competent Authority procedures

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

When a foreign tax administration has initiated or proposed a transfer pricing adjustment, taxpayers can be expected to seek assistance from the New Zealand Competent Authority, either to obtain corresponding adjustments or deductions in New Zealand, or to obtain assistance in presenting its case to the foreign tax administration.

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

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

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

Advance pricing agreements (APAs)

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

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

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

Inland Revenue has not established any formal processes for obtaining an APA, as each case may be different, depending on a taxpayer's specific facts and circumstances.

Terminology

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

The guidelines, also frequently refer to "controlled transactions" and "uncontrolled transactions".

A "controlled transaction" is one in which the ownership relationship between the parties is able to influence the transfer price set. In relation to section GD 13, a controlled transaction will be any transaction between associated persons. However, it is possible that the term could have a wider meaning to the extent that section GC1 applies.

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

Notice should also be taken of the term "related parties". Section GD 13 applies only to transactions between associated persons. However, because section GC1 can extend the application of section GD13 to non-associated parties in certain circumstances, the guidelines use the term "related parties" in preference to "associated persons" to encompass the potential application of both section GD13 and section GC1.

Future work

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.

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

Arm's length principle

Key points

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

Introduction

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

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

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

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

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

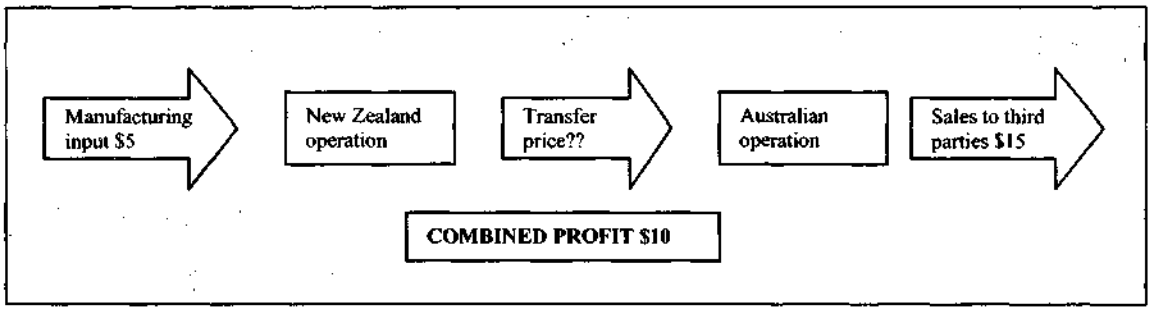
Importance of transfer prices to determination of tax base

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

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

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

Consider a multinational that has a manufacturing operation in New Zealand and a distribution operation in Australia. The cost of producing one unit of a product in New Zealand is NZ$5.00. The finished product is then sold in Australia for NZ$10.00.



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

At one extreme, the transfer price might be set equal to the cost to the New Zealand operation ($5.00).

The entire profit from each unit sold will then accrue to the Australian operation:

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

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

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

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

Arm's length principle in New Zealand law

New transfer pricing rules was enacted by the Income Tax Act 1994 Amendment Act (No. 3) 1995. The rules replaced the ones formerly found in section GC1 (section 22, Income Tax Act 1976). The new rules apply from the start of the 1996/97 income year.

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

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

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

Fundamentally, the arm's length principle is based on the notion that the operation of market forces results in a true return to the economic contribution of participants in transaction.

By seeking to remove the effect of the common ownership, the arm's length principle seeks to reduce a transaction within a multinational to one that reflects the conditions that would have existed had the pricing of the transaction been governed by market forces. In this way, the true return to economic contribution for each member of the multinational is determined.

The arm's length principle has been enacted into New Zealand legislation in section GD13 (6):

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

This rule does not say that an arm's length price will result if multinational sets its prices based on real and full internal bargaining. Rather, it recognizes that real and fully adequate bargaining between unrelated parties is a feature of the operation of market forces in a transaction. Section GD13 (6) therefore requires a multinational to adopt the price that may have arisen had its controlled transaction been governed by normal market forces.

The problem to be resolved is how a multinational should determine what price would have arisen if its transactions were subject to market forces.

The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an "uncontrolled transaction") should be used as a benchmark against which to appraise the multinational's prices (the "controlled transaction"). Any differences between the two transactions can then be identified and adjusted for. By adjusting the price adopted in the uncontrolled transaction to reflect these differences, and arm's length price can be determined for the multinational's transaction.

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

Reasons for adopting arm's length principle

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

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

Merit of arm's length approach for determining net income

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

Parties transacting at arm's length would be expected to endeavour to make efficient use of their resources. In doing this, firms seek to earn the full return to their economic activities. The arm's length principle used the behavior of an independent firm as the benchmark for what would be expected of a firm seeking to earn the true return from its economic contribution. By applying this benchmark to a multinational, the arm's length principle seeks to remove the effect of any ownership relationship between members of the multinational from the transfer price it adopts.

It is anticipated that this will result in each member of the multinational earning a return that is commensurate with its economic contribution and risk assumed.

The arm's length principle also results in abroad parity of tax treatment for multinationals and independent enterprises. This avoids the creation of tax advantages that would otherwise distort the relative competitive positions of either type of entity.

In so removing these tax considerations from economic decisions the arm's length principle promotes the growth of international trade and investment.

Minimization of double taxation

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

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

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

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

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

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

Practical application of arm's length principle

Key Points

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

  Taxpayers are encouraged to consider discussion their transfer pricing process with Inland Revenue if they are concerned about their acceptability to the Department.

Introduction

Previous chapters considered the theory behind the acceptable transfer pricing methods, and the principles of comparability that underpin all transfer pricing analysis. This chapter aims to work to determine their transfer prices.

Inland Revenue's view is that when taxpayers use the four-step process outlined in this chapter, it will help develop the reasoning and documentation needed to support their evaluation of their transfer prices.

However, the process outlined is neither mandatory nor prescriptive – the process can be costly and sometimes require expert assistance. The process adopted by a taxpayer will, therefore, still depend on those taxpayers individual circumstances. Taxpayers should weigh up the costs of developing a more comprehensive transfer pricing analysis against the risk that Inland Revenue will audit and adjust the taxpayer's transfer prices.

Caveats to four-step process

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

a) The approach outlined below assumes that the nature of the international dealings is fairly extensive and necessitates a thorough analysis. For enterprises with relatively simple and/or low value international dealings with related parties, the extent of any data collection and analysis may be minimal.

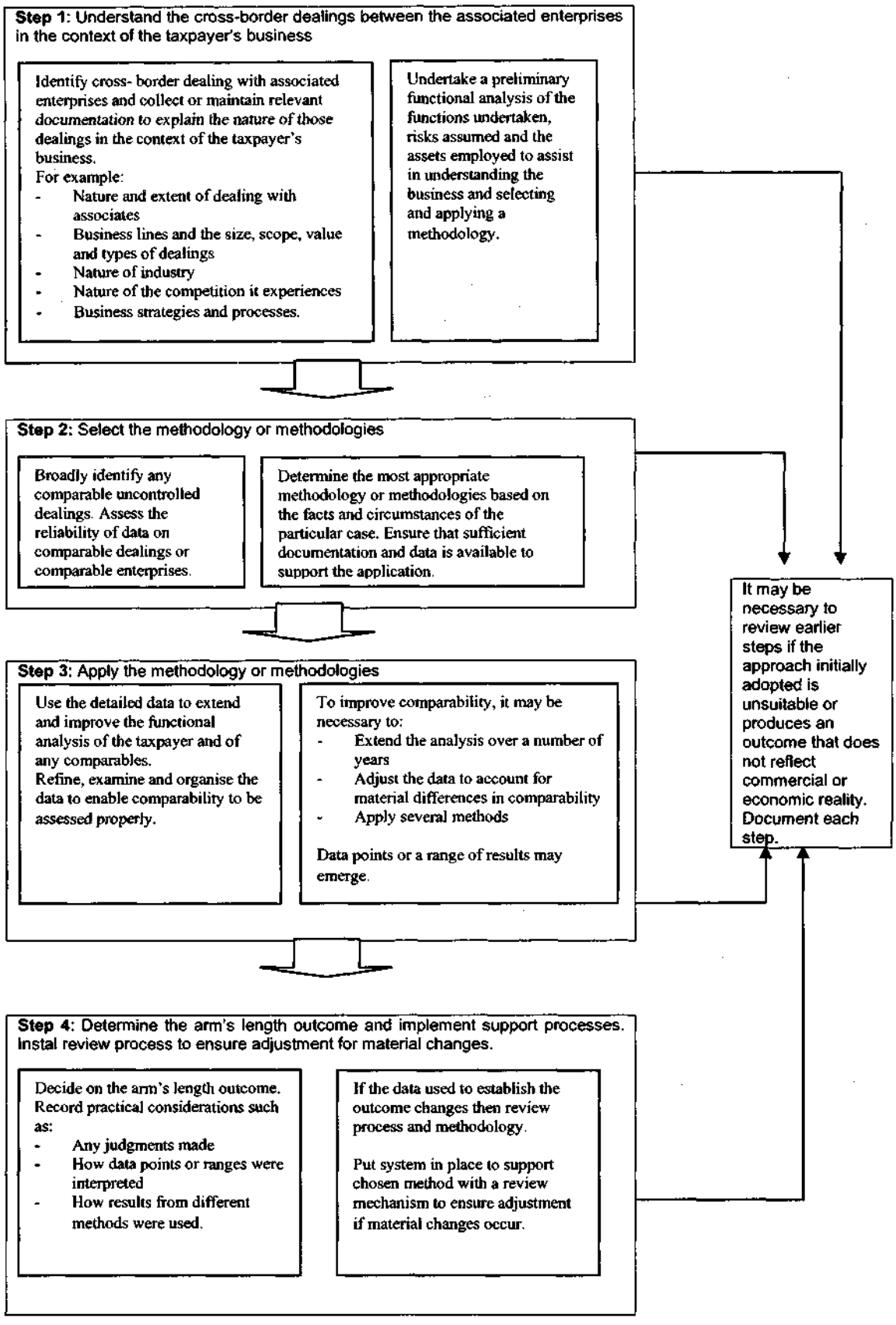
b) It may be possible in some cases to adopt either a pricing method or a specific price that has been developed and applied by a multinational on a global basis, after some confirmatory analysis and consideration of its suitability and reliability in relation to the New Zealand member of the multinational. However, the data used to support the pricing method will need to be carefully considered in terms of its relevance and reliability for New Zealand market conditions.

c) The analysis contained in this chapter complements the documentation created by enterprises in the normal course of their business dealings. Related parties need to show that their association has not inappropriately affected the nature and term of their deadlines.

This requires them to undertake more analysis and keep specific records to demonstrate the arm's length nature of their dealings in circumstances where independent enterprises could merely rely on their normal business records. This additional requirement cannot be eliminated without sacrificing the integrity of New Zealand's transfer pricing rules.

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

Figure 1


Step 1: Understand the cross-border dealings between the associated enterprises in the context of the taxpayer's business
Identify cross- border dealing with associated enterprises and collect or maintain relevant documentation to explain the nature of those dealings in the context of the taxpayer's business.
For example:
- Nature and extent of dealing with associates
- Business lines and the size, scope, value and types of dealings
- Nature of industry
- Nature of the competition it experiences
- Business strategies and processes.
Undertake a preliminary functional analysis of the functions undertaken, risks assumed and the assets employed to assist in understanding the business and selecting and applying a methodology.
Step 2: Select the methodology or methodologies
Broadly identify any comparable uncontrolled dealings. Assess the reliability of data on comparable dealings or comparable enterprises.
Determine the most appropriate methodology or methodologies based on the facts and circumstances of the particular case. Ensure that sufficient documentation and data is available to support the application.
Step 3: Apply the methodology or methodologies
Use the detailed data to extend and improve the functional analysis of the taxpayer and of any comparables.
Refine, examine and organise the data to enable comparability to be assessed properly.
To improve comparability, it may be necessary to:
- Extend the analysis over a number of years
- Adjust the data to account for material differences in comparability
- Apply several methods
Data points or a range of results may emerge.
Step 4: Determine the arm's length outcome and implement support processes. Instal review process to ensure adjustment for material changes.
Decide on the arm's length outcome. Record practical considerations such as:
- Any judgments made
- How data points or ranges were interpreted
- How results from different methods were used.
If the data used to establish the outcome changes then review process and methodology.
Put system in place to support chosen method with a review mechanism to ensure adjustment if material changes occur.
It may be necessary to review earlier steps if the approach initially adopted is unsuitable or produces an outcome that does not reflect commercial or economic reality. Document each step.

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

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

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

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

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

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

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

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

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

Location of comparables

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

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

The following examples illustrate these points:

Example 1:
A company is forced into bankruptcy and, as a result, sells all of its products to unrelated distributors for a liquidation price. Because those sales are not made in the ordinary course of business, they will not represent a valid comparable for transfer pricing purposes.

Example 2:

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

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

Step 2: Select the pricing method or methods

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

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

The application of these criteria will depend on the quality of the information available to the taxpayer. Thus at this stage of the process, the taxpayer will need to make an assessment of the quality of the data is has available. This assessment should be made for the purpose of determining which pricing method (or methods) is likely to provide the greatest consistency with the factors in section GD 13(8), and result in the most reliable measure of the arm's length price required under section GD13 (6).

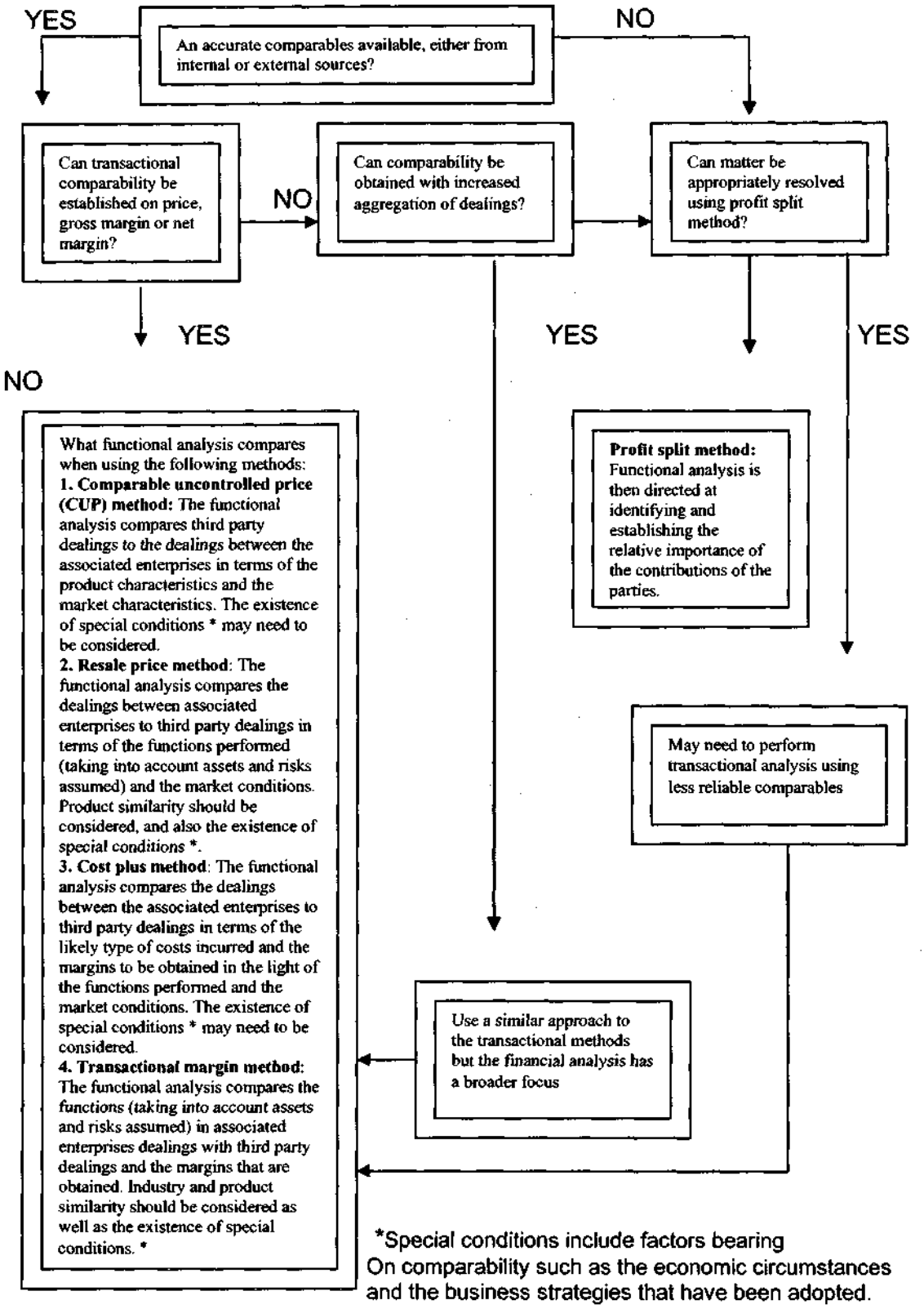
To this end, the information obtained in step 1 can assist with the:

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

Step 3: Application of the pricing method or methods

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

Figure 2: Use of functional analysis with each methodology



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

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

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

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

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

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

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

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 judgment made leads to commercially justifiable conclusions.

Introduction

A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights. It also determines the nature and extent of the interest of each participant in those assets, services, or rights. It is a contractual arrangement under which a member's share of contributions should be consistent with its expected benefits from the arrangement.

Each member is also entitled to exploit its interest in the CCA separately as an effective owner, rather than as a licensee-it does not need to pay a royalty or other consideration for that right (paragraph 8.3, OECD guidelines). There is no standard framework for a CCA-each arrangement will depend on its own unique facts and circumstances.

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.

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 centralized management services or developing advertising campaigns common to the participants' markets (paragraphs 8.6 and 8.7).

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

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 recognize them at all. If a CCA is not recognized in an overseas jurisdiction, there is potential for double taxation to occur.

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

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

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

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

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.

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 3.

Example 3

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.

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

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

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?

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

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

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

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

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

Tax treatment of contributions and balancing payments

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.

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.
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

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" judgment in determining the value of the contributions and the expected benefits of each participant. Each case will depend on its own facts and circumstances.

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

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 I payments) upon the withdrawal of a participant and upon termination of the CCA.

Summary

This chapter has considered the following key points:

- A CCA is a contractual arrangement whereby participants agree to shares 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 judgments made in making these measurements should be commercially justifiable.

Chapter Six

6. Principles of Comparability

Introduction

Comparability is fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable.

To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable.

Since precise calculations cannot be made and the application of any method involves elements of judgement, there is, depending on the circumstances of the particular case, a need to avoid making adjustments to account for minor or marginal differences in comparability.

The objective of comparability is to always seek the highest practical degree of comparability, recognising though that there will be unique situations and cases involving unique intangibles where it is not practicable to apply methods based on a high degree of direct comparability.

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South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

The practicable standard of comparability will be determined by the amount of data on which comparisons with uncontrolled situations and dealings in a particular case can be based. Comparisons with controlled dealings by other taxpayers cannot be regarded as arm's length comparisons.

The assessment of comparability can be affected, *inter alia*, by:

a. The characteristics of good and services;
b. The relative importance of functions performed;
c. The terms and conditions of relevant agreements;
d. The relative risk assumed by the taxpayer, connected enterprises and any independent party where such party is considered as a possible comparable;
e. Economic and market conditions; and
f. Business strategies

Characteristics of the property or services

Differences in the specific characteristics of property or services account, at least in part, for differences in their value in the open market. The OECD Guidelines, at paragraph1.19 mention a non-exhaustive list of features that may be relevant in comparing two products

Tangible property:	**Intangible property:**	**Services:**
Physical features	Form of the transaction	Nature of services
Quality and reliability	Type of property	Extent of services
Availability	Duration of protection	
Volume of supply	Degree of protection	
	Anticipated benefits from use	

The significance of the actual characteristics of a product or services being transferred in determining an arm's length price depends on the method applied in determining an arm's length price. For example, in applying the Comparable Uncontrolled Price (CUP) method, the actual characteristics of the goods or services are critical. On the other hand, when the Transactional Net Margin method is applied, the characteristics of the goods or services transferred are not nearly as important as the functions and risks undertaken by the relevant entities.

Functions undertaken

The compensation for the transfer of property or services between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account the risks assumed and the assets used. In determining whether two transactions are comparable, the functions and risks undertaken by the independent parties should be compared to those undertaken by the connected persons.

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

Most of the recommended transfer pricing methods (Cost Plus, Resale Price, Transactional Net Margin and Profit Split methods) focus on functions performed, risks assumed and assets utilised rather than on the goods or services being transferred.

When applying one of these methods in a transfer pricing analysis, the comparability of functions performed by the member of the multinational and the independent entity or entities to which it is compared is very important. In contrast thereto the CUP method is based on a direct comparison of the price charged for goods or services and the characteristics of the goods or services are therefore significant.

A practical way of evaluating functional comparability is to prepare a functional analysis. A functional analysis is a method of finding and organising facts about a business' functions, assets (including intangible property) and risks. It aims to determine how these are divided between the parties involved in the transaction under review.

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

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

A functional analysis will help to highlight where such significant functional differences may exist. However, it must be not that functional analysis is not a pricing method in its own right.

Rather, it is a tool assisting in the selection of a transfer pricing method and the proper determination of an arm's length price.

The extent to which functional analysis should be performed depends on the transactions at issue. For more involved transactions a functional analysis should address all of the following:

- An overview of the organisation, the overall structure and nature of the business undertaken by a member of a multinational.
- General commercial and industry conditions affecting the member of the multinational, and explanation of the current business environment and its predicted changes.
- Direct consideration of the transaction under review, the nature and terms of the transaction, economic conditions and property involved in the transaction, how the product or service that is the subject of the controlled transaction in question flows between the connected parties.
- Actual contractual terms of the transaction, because this may provide evidence about the form in which the responsibilities, risks and benefits have been assigned among those members.
- The functions undertaken by the relevant members of the multinational.
- The relative contributions of various functions: The number of functions performed by a particular member of a multinational is not decisive in determining whether that member should derive the greater share of the profit. It is the relative importance of each function that is relevant.
- An appraisal of risk. In the open market, this assumption of increased risk will be compensated for by an increase in the expected return. The risks assumed should therefore be taken into account in the functional analysis.
- It must also be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk.

The functions undertaken by an entity will, to some extent, determine the allocation of risks.

Economic circumstances

Arm's length prices may vary across different markets, even for transactions involving the same product or service. To achieve comparability, it is important to ensure that the markets in which the parties operate are comparable. Any differences must either not have a material effect on price, or be differences for which appropriate adjustments can be made.

The OECD Guidelines at paragraph 1.30, identify a number of factors relevant for comparing markets, including:

- Geographic location of the market;
- Size of markets;
- Extent of competition in the markets;
- Availability of substitute goods and services;
- Transport costs;
- The level of the market (retail or wholesale).

These factors may have particular relevance in the South African situation. Because South Africa is a small country, it may be difficult to obtain comparables from the South African market.

Business strategies

Business strategies are also relevant in determining comparability for transfer pricing purposes. Business strategies are a legitimate aspect of arm's length operations. The arm's length principle, therefore, acknowledges those strategies. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion and other factors which have bearing upon the daily conduct of business.

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

The important issue is how one should appraise whether a business strategy that temporarily decreases profits in return for higher long-term profits is consistent with the arm's length principle. The relevant question here is whether a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

The Commissioner may consider a number of factors in evaluating a taxpayer's claim of following a strategy that temporarily reduces profits in return for higher long-term profits, for example, whether:

- the conduct of the parties is consistent with the professed business strategy;
- the nature of the relationship between the parties to the controlled transaction justifies that the taxpayer bears the costs of the business strategy;
- there is a plausible expectation that the business strategy will produce a return sufficient to justify its costs, within a period of time that would be acceptable in an arm's length arrangement.

Acceptable Methods for Determining an Arm's Length Price

Introduction

Neither Section 31 nor the tax treaties entered into by South Africa prescribe any particular methodology for the purpose of ascertaining an arm's length consideration. Given that there is no prescribed legislative preference, the Commissioner would generally seek to use the methods that have been set out below.

The most appropriate method in a given case will depend on the facts and circumstances of the case and the extent and reliability of data on which to base a comparability analysis. It should always be the intention to select the method that produces the highest degree of comparability.

The choice of the most appropriate method should therefore be based on a practical weighting of the evidence, having regard to:

- the nature of the activities being examined.
- the availability, quality and reliability of the data,
- the nature and extent of any assumptions, and
- the degree of comparability that exists between the controlled and uncontrolled transactions where the difference would affect conditions in the arm's length dealings being examined.

In cases where there are no comparables or there is insufficient information to determine an arm's length outcome, the method to be used should be a method that produces a reasonable estimate of an arm's length outcome. Such estimate must be based on the facts in hand.

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South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

The application of the principles set out in this Practice Note may require the exercise of judgement.

After the identification of an independent benchmark or benchmarks against which the pricing of a multinational is to be compared, it needs to be established to what extent the functions of the members of a multinational are similar to or differ from those of the independent benchmark(s). An element of judgement is required to determine the extent to which these similarities or differences have a material effect on the transfer price adopted by the multinational.

As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Taxpayers will not be required to undertake an intricate analysis of all the methodologies, but should have a sound basis for using the selected methodology. This could entail providing reasons why secondary methods are not appropriate.
This section of the Practice Note considers the principles underlying each of the various transfer pricing methods. An understanding of these principles is useful for identifying the limitations of each method and applying the methods in practice.

The principle methods referred to in the OECD Guidelines

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

The standard transfer pricing methods recognised by the OECD Guidelines are:

- the comparable uncontrolled price method (CUP method);
- the resale price method (RP method);

- the cost plus method (CP method);
- the transactional net margin method (TNMM); and
- the profit split method.

The CUP, RP and CP methods are know as the traditional transaction methods and the TNMM and profit split method are referred to as transactional profit methods.

The Commissioner endorses the CUP, RP, CP, TNMM and profit split methods as acceptable transfer pricing methods, the most appropriate of these depending on the particular situation and the extent of reliable data to enable its proper application.

The hierarchy of methods

Section 31 does not impose a hierarchy for the transfer pricing methods. However, there is in effect a hierarchy, in that certain methods may provide a more reliable result than others, depending on the quality of available data and the taxpayer's circumstances.

The Commissioner acknowledges that the suitability and reliability of a method will depend on the facts and circumstances of each case. The most reliable method will be the one that requires fewer and more reliable adjustments.

It is essential to have an understanding of the commercial and economic reality underlying any particular transaction before beginning with a search for, and close examination of comparable transactions between unrelated enterprises in an application of the traditional arm's length methods.

As a general rule, the traditional transaction methods are preferred.

Of these methods the CUP method is preferred, as it looks directly to the product or service transferred and is relatively insensitive to the specific functions which are performed by the entities being compared.
The RP and CP methods look at valuing the functions performed. Because these methods examine gross margins, operating expenses are excluded and therefore the impact of relative cost structures should not be material.
In practice, the traditional methods may not be able to be applied, because of information constraints, particularly the lack of comparable uncontrolled transactions or published data on gross margins. Hence it may be necessary to resort to the transactional profits methods.

Of the transactional profits methods, the TNMM is reasonably objective because comparables are applied. Essentially, this is either the RP or CP with varying levels of operating expenses incorporated into the calculations.

In theory the TNMM is inferior to the RP or CP methods where sufficient information is available to apply all three methods, because comparing operating expenses requires a similar structure of business to be truly reliable. This presents a more difficult threshold than functional comparability.

Where a taxpayer has considered a number of methods, it may be appropriate to document the reasons for discarding some of those methods. The availability of data is likely to be very important in a taxpayer's choice of method. South Africa is a small market and under certain circumstances this means reliable comparables may be difficult for taxpayers to locate.

The CUP method

Description

In applying the CUP method, a direct comparison is drawn between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction, in comparable circumstances.

It therefore primarily focuses on the goods being transferred or service being rendered, but also takes into account broader business functions and economic circumstance.
Differences between the two prices may indicate the existence of non-arm's length conditions and that the price in the controlled transaction may need to be substituted for the price in the uncontrolled transaction.

Application

The CUP method is the most direct and reliable way to apply the arm's length principle where it is possible to locate comparable uncontrolled transactions. A comparable uncontrolled price can be determined by reference to similar products or services transferred under similar circumstances by the taxpayer to an independent party (internal comparable) or by reference to similar products or services transferred under similar circumstances by one independent party to another (external comparable).
The two transactions being compared will only be truly comparable if there are no differences between the two transactions that will have a material effect on the price, or if reasonably accurate adjustments can be made to eliminate the effect of differences that may materially affect the price.

It is important to keep in mind that two transactions will not be comparable merely because the product or service transferred is comparable. Regard should also be had to the effect on price of broader business functions and economic circumstances other than just the product comparability.

Listed below are examples of where adjustments may be necessary when comparable products or services are transferred between independent parties or the taxpayer and an independent third party:

(a) terms of transactions may differ (for example, credit terms)
(b) volumes transferred may differ significantly e.g. sell 10 tonnes to an independent party vs. 1000 tonnes to a connected person
(c) sell FOB to a connected person and at CIF to an independent party

Certain adjustments could be very difficult to effect, such as differences in –

(a) the quality of the products

(b) geographic markets

(c) market levels

(d) amount and type of intangible property involved

Practical problems

It is usually very difficult to find a transaction between independent enterprises which is sufficiently similar to a controlled transaction, without differences which have a material effect on price.

Where differences exist between the controlled and uncontrolled transactions, or between the enterprises undertaking those transactions, it may be difficult or impossible to determine reasonably accurate adjustments to eliminate the effect on price.

Example 4

A South African enterprise, A, manufactures crocodile leather shoes and travel bags. The shoes are sold to a French subsidiary, B, which sells the shoes to unconnected exclusive boutiques. The credit terms to B are 90 days. A also sells the shoes to two independent distributors in France, C and D. The credit terms to the independent parties are 30 days. C sells the shoes directly to end-users and D sells the shoes to expensive shoe shops in Oxford and Bond Street in London. A also sells the travel bags to an independent distributor in France.

Possible CUP's:

The travel bags sold to the independent distributor in France will not constitute a CUP because the product is not similar to shoes and the price is not comparable.

The shoes sold to C would also not qualify as a CUP because the level of the market is different. B is at a higher level in the distribution chain than C and it is unlikely to be possible to quantify this difference and make reliable adjustments.

The shoes sold to D may be a valid CUP if the Paris and London markets are comparable. It will, however, be necessary to adjust the price for the difference in credit terms.

The Resale Price method

Description

The resale price method is based on the price at which a product, which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller's selling and other operating costs, and to provide an appropriate profit, depending on functions performed, assets used and risks assumed by the reseller. The balance may be regarded as the arm's length price before other adjustments in respect of, for example, customs duties.

Application

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the entity obtains on items purchased and sold in comparable uncontrolled transactions, as well as by reference to the resale price margin obtained by one independent party selling to another.

Functional comparability is very important and it is essential that the functions performed by the independent entity are comparable to the functions performed by the member of the multinational selling to an independent enterprise. There should be no differences, which have a material effect on the price, for which reasonably accurate adjustments cannot be made.

In applying the resale price method, fewer adjustments are normally required for product comparability than under the CUP method. Minor product differences are less likely to have an effect on profit margins than on prices, as profit margins for similar functions tend to be equal, but prices for different products will be equal only to the extent that products are substitutes for one another. For example, a distributor performs the same function to sell toasters and blenders and is therefore likely to require the same profit margin, but blenders are not comparable in price to toasters.

Although broader product differences can be allowed in the resale price method, product similarity may still be important when applying this method, for example when high value intangibles are involved. All the other factors affecting comparability will have to be considered when applying the resale price method.

The resale price method focuses only on the external sale price to third parties and the gross margin required rewarding the function performed by the reseller. These factors are not overly sensitive to differences between the cost structure of a member of a multinational and an independent firm. Thus, if the member of the multinational operates a more efficient distributorship than the independent firm, this will result in a higher net profit percentage when the resale price method is used, and will not influence the gross profit percentage.

The resale price method is most appropriate where the reseller does not add substantially to the value of the product or does not posses valuable marketing intangibles.

Practical problems

- The biggest problem is to determine an arm's length resale price gross margin. It is usually very difficult to find a transaction between independent enterprises that is similar to a controlled transaction and where differences do not have a material effect on the margin.
- Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The items of cost taken into account to arrive at a gross margin may differ from company to company.
- The application of this method sometimes requires access to segregated product data.

Whilst this information may be available in respect of the controlled party being examined, it will usually not be available in respect of uncontrolled entities used as benchmarks.

Example 5

A South African company, manufactures pasta at its factory in Cape Town. Subsidiaries in Italy and Greece distribute the pasta in their relevant markets after packaging the pasta. The packaging is not a very complicated process since the pasta is shipped from South Africa in units of 500g wrapped in plastic. These individual packets are merely packaged in cardboard boxes by the subsidiaries.

Application of the resale price method:

A search on independent comparable distributors showed that these independent distributors obtain a gross profit margin of 37 per cent to 40 per cent. The only difference is that these distributors are not involved in packaging the pasta.

The effect of the additional packaging function on the gross profit margin earned by the subsidiaries should be evaluated. If material, an adjustment should be made. If not material, the subsidiaries would also be expected to earn a gross margin of between 37 per cent and 40 per cent.

The Cost Plus method

Description

The cost plus method requires estimation of an arm's length consideration, by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark-up should provide for an appropriate profit to the supplier, in the light of the functions performed, assets used and risks assumed.

Application

This method is best suited to situations where:

(a) services are provided,

(b) semi-finished goods are sold between connected parties,

(c) connected persons have concluded joint facility agreements or long-term buy-and-supply arrangements.

The mark-up should ideally be determined with reference to the mark-up earned by the same supplier in uncontrolled transactions. If this is not possible, the mark-up should be determined by using the mark-up earned in comparable transactions by an independent supplier performing comparable functions, bearing similar risks and employing similar assets to those of the taxpayer.

An uncontrolled transaction is comparable to a controlled transaction for purposes of the cost plus method if one of two conditions is met:

(a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or

(b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Fewer adjustments are needed for product comparability than under the CUP and the same comparability principles as discussed under the resale price method will apply to the cost plus method.

Practical problems

(a) The application of the cost plus method presents certain difficulties. In particular, the determination of costs, as some companies is more effective than others and will incur lower costs.

(b) In addition there may be circumstances where there is no discernable link between the level of costs incurred and a marked price.

(c) Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The types of cost included in cost to arrive at a gross margin may differ from company to company.

(d) The application of this method sometimes requires access to segregated product data. Whilst this information may be available in respect of the controlled party being examined, it will usually not be available in respect of the uncontrolled entities used as benchmarks.

Example 6

B, a South African holding company, is responsible for the development of all the software and the purchase of computer hardware to be used by its subsidiaries in Namibia and Botswana. It was clear from the beginning that there was a market for this kind of service in Africa. B also provides this service to other customers throughout Africa. The software and hardware required by each customer are unique and differ from the software developed and hardware supplied to the subsidiaries, but the functions and processes to provide these services are comparable.

Application of the cost plus method:

An analysis of the income and costs in respect of the services provided to the independent customers indicates that costs are recovered and gross profit of between 22 per cent and 25 per cent is achieved.

B should therefore charge its subsidiaries at cost plus between 22 per cent and 25 per cent for the performance of the information technology function.

Transactional Net Margin method (TNMM)

Description

The TNMM examines the net profit margin that a taxpayer realises from a controlled transaction, relative to an appropriate base, for example cost, sales or assets. This ratio is referred to as a profit level indicator.

The profit level indicator of the tested party is compared to the profit level indicator(s) of comparable independent parties.

Application

Although the TNMM is classified as a transactional profit method, it is more closely aligned to the CP and RP methods than to the profit split method. As with the CP and RP methods, the TNMM focuses on the functions performed by an enterprise. The difference is that the TNMM compares net profit rather than gross profit.
The TNMM is, however, considered less reliable than the traditional transaction methods. This is because the net margins which are used in the TNMM are very sensitive to the relative cost structures of the entities being compared, as they include operating expenses in their calculations.

For example, if a multinational operates a more efficient distributorship than the independent firm, the application of the TNMM would result in a lower net profit being determined for the distributorship than if the RP method were used. Thus, unless an adjustment could be made to reflect the relative efficiency of the firms being compared, use of the TNMM would not provide a reliable result.

In order to maximise the reliability of the TNMM, the member of the multinational and the independent firm being compared would need to be structurally similar. In practice, firms are structurally unique and comparisons of indicators between firms will tend to be less reliable than comparisons made at the gross margin level. For this reason the TNMM, along with the profit split method are considered to be methods of last resort in international practice.

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

The connected party (tested party) whose profit level will be compared to the profit level of the independent parties will usually be the party for which reliable data on the most closely comparable transactions can be identified. It is also usually the enterprise that is the least complex and that does not own valuable intangible property.

Practical problems

(a) The net margin of a taxpayer can be affected by factors that do not necessarily have an influence on price or gross margins, thereby reducing the reliance that can be placed on the results in applying the TNMM.

(b) Information about the taxpayer, required to apply the TNMM may not be available at the time of determining an arm's length price. It may, for example, not be possible to determine the net margin that will result from the controlled transaction.

(c) Information on the uncontrolled transaction may not be available.

(d) As with the CP and RP methods, the TNMM is a one-sided analysis, as it does not consider the effect of the determined price on the other party to the transaction. However, because operating expenses affect the calculations, the result for the TNMM is likely to be less reliable than that determined under the other methods.

It is important, therefore, to check that the profit resulting from applying the TNMM is consistent with what one may expect, based on first principles.

(e) It is often difficult to determine a transfer price once an appropriate margin has been determined.

Example 7

CCP is a manufacturer of dehydrated food. Its products are distributed by subsidiaries throughout Europe. CCP does not sell to independent distributors at all and no comparables could be located that would allow the application of the CUP, cost plus or resale price methods. The profit split method is not applicable and the only remaining method is thus the TNMM.

Research on comparable independent companies resulted in the determination of an arm's length range of 15 per cent to 18 per cent. This percentage is determined by expressing operating profit as a percentage of turn over. After adjustments were made for differences between CCP and the comparable independent companies, in respect of stock holding and debtors days outstanding, the range of arm's length margins is 17,5 per cent to 19 per cent.

The transfer price for the sale of the dehydrated food from CCP to its subsidiaries should thus be set at a level that will result in operating profit as a percentage of turnovers of between 17.5 per cent and 19 per cent.

The Profit Split method

Description

The first step in the profit split method is to identify the combined profit to be split between the connected parties in a controlled transaction. In general, combined operating profit is used, ensuring that both income and expenses of the multinational are attributed to the relevant connected person consistently.

That profit is then split between the parties according to an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Application

The profit split method is usually applied where transaction are so interrelated that they cannot be evaluated separately.

Under similar circumstances, independent enterprises may decide to set up a form of partnership and agree to some form of profit split.

Two alternative approaches to the profit split method are outlined in the OECD Guidelines. Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction. The combined profit is then allocated as follows:

- Under the residual profit split approach, each of the parties to the transaction is assigned a portion of profit according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.

- Under the contribution analysis approach, it is generally combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party to that combined gross profit.

However, the EOCD Guidelines notes that these approaches are not necessarily exhaustive or mutually exclusive. There may be alternative ways to split a profit to achieve a reliable arm's length result.
As is explained in the OECD Guidelines it may, in some circumstances, be appropriate to split gross profits (as opposed to operating profits) between the connected parties and then deduct the operating expenses incurred by or attributable to each relevant enterprise. The example used in the OECD Guidelines is the case of a multinational that engages in highly integrated worldwide trading operations involving various types of property. It may be possible to determine the enterprises in which expenses are incurred or attributed, but not to accurately determine the particular trading activities to which those expenses relate. In such a case it may be appropriate to split the gross profit from each trading activity and then deduct from the resulting overall gross profit the operating expenses incurred by or attributable to each enterprise.

The allocation of gross profit should be consistent with the location of activities and risks. Care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the activities performed and risks assume by the relevant entities.

Residual Profit Split Analysis

The residual profit split approach first provides both the parties to the transaction with a basic return, based on what independent firms would obtain for performing similar functions and undertaking similar risks. Applying other transfer pricing methods, such as a cost plus method or a resale price method, could also achieve this.

The residual profit remaining after the first stage division would be allocated among the parties, in accordance with the way in which this residual would have been divided between independent enterprises. Facts and circumstances that could influence the profit allocation in the second stage include the parties' contributions of intangible property and relative bargaining positions.

This requires a judgement about what factors contribute to the residual profit, and their relative contribution. For example, it may be determined that the process development and the marketing are the only relevant contributors to the residual profit and that each contributes 50 per cent to that profit. A 50:50 split of the residual profit between the manufacturer and the retailer would then be justified.

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

Contribution analysis

Multinationals are organisationally different from comparable domestic enterprises. Large integrated multinationals may have the benefit of cost savings attributable to the scale of their operations otherwise know as *economies of scale.*

Such savings are not necessarily available to independent enterprises. For example, the administration costs incurred by a multinational which both manufactures and retails toasters are likely to be less than the aggregated costs faced by two separate firms, one of which manufactures toasters, and the other of which retails them. In the absence of intangibles, the price determined under the cost plus method would then be higher than the price determined under the resale price method. This means that there would be a negative residual if the residual profit split approach were to be used.

Economies of scale are not an aspect which can readily be evaluated in a traditional arm's length analysis. However, it is an important factor that needs to be addressed when determining whether a multinational's transfer prices are consistent with the arm's length principle.

One approach to this problem may be to use the contribution analysis approach.

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

Practical problems

- The application of the profit split method relies on access to world-wide group data, which may be difficult to obtain.
- The allocation of profits is subjective

- This method may result in less reliable measure of the arm's length price than an analysis under one of the other methods.

Example 8

A, a South African manufacturer of mining equipment, acquired B, a company located in Namibia. B has an established distribution network in Namibia and the rest of Africa and has good contacts at mines in the region. A would not have been able to sell its product without involving B's contacts. Before the acquisition of the B, A and the company considered entering into a joint venture agreement and were negotiating a profit split of 40 per cent for A and 60 per cent for B.

Application of the profit split method:

There are not comparables which would allow the application of the CUP, resale price or cost plus methods. Based on the negotiations before the acquisition of B by A, it was decided to apply the profit split method to arrive at arm's length prices. Because of the importance of B's contacts and distribution network, and the other factors taken into account during the negotiation phase, it was decided that the transfer price at which the product should be sold to the B should be set at a level that will result in a 40:60 profit split if the relevant factors remain unchanged.

Chapter Seven

7. Interest and Penalties

Penalties

The penalty, additional tax and offence provisions applicable in the event of default or omission in the completion of the tax return or evasion of taxation are contained in sections 75, 76 and 104 of the Act and will also apply to default, evasion or omission relating to transfer pricing. The Act does not impose specific penalties in respect of non-arm's length pricing practices.

Interest

Sections 89 bis and 89 quat of the Act provides for interest on the underpayment of tax and will also apply if the underpayment of tax results from non-compliance with sections 31 of the Act.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Eight

8. Secondary Tax on Companies (STC)

Sections 64C of the Act provides that certain amounts distributed to a recipient by a company are deemed to be a divided declared by the company. Section 64C(3)(e) deems any amount adjusted or disallowed in terms of section 31 to have been distributed to a recipient by the company. The adjustment will therefore be subject to STC.

A "recipient" is defined as any:

- Shareholder of the company;
- Relative of such shareholder; or
- Trust of which the shareholder or relative is a beneficiary.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Nine

9. Burden of Proof

In terms of section 31, the discretion to adjust the consideration in respect of a transaction rests with the Commissioner. In the discharging of its burden of proof it is clearly in a taxpayer's best interests to:

- Develop an appropriate transfer pricing policy;
- Determine the arm's length amount, as required by section 31; and
- Voluntarily produce documentation to evidence their analysis.

Section 82 of the Act places the burden of proof regarding exemptions, non-liability for tax, deductions or set-offs on the taxpayer.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Ten

10. Advance Pricing Agreements (APA's)

APA's are described in detail in the OECD Guidelines. In short, this is a process whereby the setting of transfer prices in respect of controlled transactions may be agreed with tax administrators in advance of the transactions being undertaken and reported.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Eleven

11. 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

'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 (e.g., contract or product liability and environmental damages).

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.

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, 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.

Source date accessed 17 September
New Zealand Transfer Pricing
Available from: http://www.taxpolicy.ird.govt.nz

A sound functional analysis 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).

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.)

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. Alternatively, internal comparables (the transfer of the same property to an independent third party), if available, could prove a valuable source of information

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 GD3 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.

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.
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.

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.

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.

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

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.

For example, the effectiveness of the promotion of a trade name (a marketing intangible) is likely to b 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.

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.

Table 6 summarizes the general differences between the two types of intangibles.

Table 6: Distinguishing trade and marketing intangibles

Trade intangibles	*Marketing intangibles*
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).

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. This 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 t the value of intangible property owned by the other party

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

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

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

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

When attempting to apply comparables to transfer pricing analysis 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 bin 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.

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

Ascertaining what the transaction involves

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.

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.

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?

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

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.

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.
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.

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

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.

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

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.

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.

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

Table 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, authorizations, 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

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

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

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 benefit from the intangible.

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

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.

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

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

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.

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.

One option available to taxpayers is the use of the profit split method. 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.

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.

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

Comparability

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.

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.

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.

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

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

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

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

Example 9

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.

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.

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.

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 license agreement for the new drug might be closely comparable to the previous license agreement with the independent company, allowing the previous agreement to be used as a CUP.

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

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.

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.

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.

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.

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 judgment 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).

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.

An important caveat should be noted in applying the profit split method.

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

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

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.

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

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

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 realized (potential profits or cost savings) through the exploitation of that property. Example 10 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 10

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 utilize 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).

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

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

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.

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.

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.

Second, it is important to consider both parties to the transaction (paragraph 6.14, OECD guidelines). Example 10 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.

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.

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.

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.

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

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.

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 may choose to exploit that property with the following levels of market risk (paragraphs 6.29 to 6.31, OECD guidelines):

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

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

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

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

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.

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

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 11.

Example 11

A United States company licenses 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.

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

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.

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%

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.
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
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?

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

- A distributor acting merely as agent and being reimbursed for its promotional expenditure would be entitled to compensation appropriate to its agency activity, but not to any share in returns attributable to marketing intangibles (paragraph 6.37).
- A distributor bearing the cost of its own marketing activity would expect to share in the potential benefits of those activities (paragraph 6.38). However, it is important to consider the rights of the distributor in determining whether any extra return is justified. For example:

The distributor may benefit directly from its investment in developing the value of a trademark from its turnover and market share if it has a long-term sole distribution contract for the trademarked product.

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

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.

Example 12, adapted from examples 2 & 3 of the United States section 482 regulations at 1.482-4(f) (3) (iv), illustrates these principles further.

Example 12

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.

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.
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.

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.

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 recognize in calculating its net profit.

Allocating return attributable to marketing intangibles

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

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

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

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 appears to be reliable comparables but that is 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 judgment with limited recourse to reliable comparables. In exercising such judgment, 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.

Chapter Twelve

12. 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.

Source accessed 17 September
New Zealand Transfer Pricing Explored
Available from: http://www.taxpolicy.ird.govt.nz

Introduction

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

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.

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

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?

Each case must be tested on its own facts and circumstances (paragraph 7.7, OECD guidelines).

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

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 service when the need for them arises (paragraph 7.16).

The OECD guidelines also confirm that the provision of centralized 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 centralized services that are likely to be intra-group services because independent enterprises would be willing to pay for or perform them themselves:

- Administrative services:
  planning, co-ordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services.
- Financial service:
  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 the arm's length charge

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.

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.

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.

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

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).

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

Applying a pricing method

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

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.

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

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.

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.

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

Profit element

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).

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

Determining cost base for cost-plus method

Paragraph 7.23 of the OECD guidelines notes that:

> Any indirect-charge method should be sensitive to the commercial features of the individual case (e.g.. 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.

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.

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.

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.

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.
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

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

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

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.

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.

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:

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

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.

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.

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 categorization. In many cases, the gains in accuracy from further refining the service categorization 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.

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

Corporations in the business of leasing plant and equipment are generally able to identify the generation of income from the utilization 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, centralized costs might be allocated based on the number of units being utilized. This principle is illustrated in example 13.

Example 13

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 recognize 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.

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.

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

$$\frac{\text{Support vessels in New Zealand}}{\text{Support vessels worldwide whether working or not}} \times \text{Allocation expenditure}$$

Gross profit allocation basis

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).

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

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

One obvious issue for taxpayers is what needs to be done to minimize 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.

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

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

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

Administrative practice for services

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.

Inland Revenue is conscious, however, of the desirability of minimizing 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.

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.

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

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

	Services acquired from foreign associated enterprises		Services supplied to foreign associated enterprises	
	Administrative practice for non-core services	Administrative practice in *de minimis* cases	Administrative practice for non-core services	Administrative practice in *de minimis* cases
Applies to all services?	No	Yes	No	Yes
Restrictions on the application of the administrative practices	The total amount charged for the services is not more than 15% of the total accounting expenses of the New Zealand group companies Adequate documentation is maintained by the taxpayer	The total direct and indirect costs of providing the services is not more than $100,000 in the year Adequate documentation is maintained by the taxpayer	The total amount charged for the services is not more than 15% of the total accounting expenses of the New Zealand group companies Adequate documentation is maintained by the taxpayer	The total direct and indirect costs of providing the services is not more than $100,000 in the year Adequate documentation is maintained by the taxpayer
Acceptable transfer prices	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%

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 (i.e. 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.

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

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

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.

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% documentation of other countries' practices to support that choice should be kept. Further, a record of the relevant group companies should be retained.

Practical solutions

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.

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

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.

Chapter Thirteen

13. Cost Contribution Arrangements

Chapter VIII of the OECD Guidelines deals specifically with cost contribution arrangements. The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with connected persons involving cost contribution arrangements.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Fourteen

14. Effective Date

The provisions of section 31 apply only to goods and services supplied on or after 19 July 1995. The Practice Note applies in respect of such goods or services.

Source date accessed 11 July 2004

South African Revenue Services Practice Note No. 7

Date: 6 August 1999 Section 31 of the Income Tax Act, 1962 (the Act)

Chapter Fifteen

15. Conclusion

Taxpayers should make conscientious efforts to establish transfer prices that comply with the arm's length principle and prepare documentation to evidence that compliance.

Where such steps have been taken the Commissioner is likely to determine *prima facie* that the taxpayers' transfer pricing practices represent a lower tax risk and that the possibility of an in depth review of those practices is likely to be diminished accordingly. In contrast, taxpayers who give inadequate consideration to their transfer pricing practices are likely to receive greater scrutiny from the Commissioner.

The following is a summary of the broad guidelines suggested:

- Establish economic justification before the transaction is entered into;
- Be satisfied that the consideration is an arm's length consideration;
- Prepare and retain contemporaneous documentation to support the above matters and the assessment of market conditions at the time when the pricing decisions were made;
- Justify the choice of method; and
- Establish and consistently follow a systematic process for setting arm's length international transfer prices.

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