



***“THE REVIEW OF THE GLAXO DECISION
AND TOPICAL ISSUES IN TRANSFER
PRICING”***

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II. LIST OF ABBREVIATIONS

AAT	Australian Appeals Tribunal
ATO	Australian Tax Office
CAPM	Capital Asset Pricing Model
CPM	Comparable Profit Method
CMT	Cut Make and Trim
CRA	Canadian Revenue Agency
CSA	Cost Sharing Agreement
CUP	Comparable Uncontrolled Price
DCF	Discounted Cash Flows
DTA	Double Tax Agreement
EBIT	Earnings before Interest and Tax
EBITDA	Earnings before Interest and Tax Depreciation and Amortisation
FRS	Financial Reporting Standards
GAAP	Generally Accepted Accounting Practice
Glaxo	GlaxoSmithKline (Americas)
Glaxo UK	GlaxoSmithKline Plc
IFRS	International Financial Reporting Standards
IP	Intangible Property

IRC	Internal Revenue Code (United States)
IRD	Inland Revenue Department
IRS	Internal Revenue Services
ITA	Income Tax Act 2004
ITAA	Income Tax Assessment Act 1936 (Australia)
MAP	Mutual Agreement Procedure
MNC	Multinational Corporation
NZICA	New Zealand Institute of Chartered Accountants
OECD	Organisation for Economic Co-Operation and Development
PE	Permanent Establishment
PS	Profit Split Method
TAA	Tax Administration Act 1994
TNNM	Transactional Net Margin Method
WACC	Weighted Average Cost of Capital

III. ATTESTATION OF AUTHORSHIP

“I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.”

.....

Ranjit Singh

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V. ABSTRACT

Transfer pricing is an important business tool in the modern world. In the modern era of globalisation, it provides management with the opportunity to manipulate prices, pursuing the business objective of maximisation of profits. This in turn allows for increased distribution to the shareholders.

From a profit maximisation perspective, this concept is certainly tenable. However, businesses need to pay due consideration to the taxation implications of transfer pricing. While allowing for effective repatriation of profits from a high or low tax jurisdiction to a low or no tax jurisdiction, businesses need to be duly consider the taxation consequences if the revenue authorities establish that the tax base of their country is being depleted by such repatriations. In certain jurisdictions, the statutory powers allows for reconstruction with the existence of a mere suspicion of unacceptable price manipulation. Unlike New Zealand, the statutory framework imposes onerous obligations on the Commissioner to challenge the transfer prices by establishing that the adopted transfer pricing method is not comparable to arms length transactions.

Largely, transfer pricing involves a degree of price manipulation between a parent and a subsidiary. Against this background, multi-nationals need to balance this against the social obligations of the citizens of the country. The central issue behind almost all transfer pricing disputes between multinationals and revenue authorities is whether the prices charged is consistent with that of independent and un-associated parties. In saying this, it has to be recognised that certain transactions may have little to no comparable transactions, which constraints the search to substantiate the basis for the pricing. To make this concept workable, the transfer pricing rules in most jurisdictions operate on the basis of treating the parent and the subsidiary as separate entities. While this concept is theoretically sound, practically it is very difficult to “artificially” make the distinction for cross border transactions. Against this practical constraint, multinationals and revenue authorities reliance on commercial databases to corroborate the transfer prices certainly poses more questions. Effectively, the requirement to keep the transfer prices at arms length is discharged through utilisation of a database, designed for purposes other than transfer pricing.

VI. INTRODUCTION

A. Choice of Topic

It is abundantly clear that taxpayers go into business with the intention of minimising the taxes payable. To this end, they engage tax professionals with this objective in mind. With transfer pricing, arguably, the situation is complicated since the intra-company transactions are cross border, involving at least two tax jurisdictions. At the simplest level, one method of minimising taxes payable within a group is manipulating the “transfer price” of the goods/services of use of IP. The effects are even more noticeable when the income tax liability has been successfully “shifted” from a high tax jurisdiction to a low tax jurisdiction. On the contrary, the tax administrators are protecting the “depletion of their base, i.e. rightfully and legally collecting income tax on the profits derived in their country. This concoction stirred together has certainly captivated the attention of the writer to investigate the underlying issues further.

Interestingly, the driving motivation behind the choice of the topic is the writers’ passion. Further, the area of transfer pricing is complicated as there is no right answer. Moreover, invariably, the facts are different every time, imposing challenges. Transfer pricing undoubtedly involves a degree of manipulation. The question is to what extent is the manipulation acceptable by the tax administrators. The answer to this question, an unwritten law, appears to be that as long as the revenue administrators are satisfied that the transfer prices are within their tolerance range, it is accepted.

1.0. Purpose of Research

The purpose of this research is multi fold. Firstly, this research will confirm the substantial gap between the literature on transfer pricing, measured against its application. Further, the abstract concepts, to some extent are reconcilable. The approach of some tax administrators is certainly questionable. Secondly, it will demonstrate the problems associated with arms length principle and inherent complexities in its application.

2.0 *Limitations*

Since New Zealand does not have any cases of transfer pricing, the need arose to examine foreign tax cases in Australia, Canada and the United States and analyse their impact on the New Zealand framework. It is important to see the approach taken by the Courts in these respective jurisdictions.

Additionally, since the area of transfer pricing is enormous, secondary issues that arise are not analysed in any great depth. For example, one natural consequence under corporate restructuring is the issue of PE.

The analysis of the New Zealand statutory provisions are not subject to an in-depth analysis.

3.0. *Approach*

The compilation of this research project has been primarily based on an in-depth analysis of secondary data, including pertinent tax cases. The reference materials published by OECD were extensively utilised.

The research project has been deliberately broken into several parts. After setting the scene, Part VII 2 briefly looks at the history of transfer pricing provisions in New Zealand and the statutory framework, contained in Section GD13.

Part VIII proceeds on reviewing the fundamental approaches by the IRS and *Glaxo* in the *GlaxoSmithKline* transfer pricing case. It sets out the key transfer pricing issues and undertakes a critical analysis. The writer then attempts to apply it to the New Zealand statutory framework.

In the last 18 months, international corporate restructuring has exercised the minds of several revenue authorities, prompting the introduction of new legislation in countries like Germany. While there does not appear to be any noticeable activity in New Zealand, it is important to analyse the tax issues from a transfer pricing perspective. Part IX of this research project delves into the perplexities on corporate

restructuring.

Intellectual property represents a substantial component of almost all businesses. There are transfer pricing challenges when intellectual property needs to be valued, for a variety of reasons, including migration. Part X examines the critical issues from a valuation perspective that are involved when dealing with intangible property.

Common to all of the areas that are to be covered is the issue of arms length. This concept is universal and typically is at the core of the tax disputes between MNC and revenue authorities. Part XI undertakes a through examination of arms length, outlining the main problems with such a concept. Analogies are drawn from the review of selected tax cases, demonstrating the fundamental flaws with this concept.

VII. TRANSFER PRICING – INTRODUCTION

“Nuclear physics is much easier than tax law.

It’s rational and always works the same way.” (Jerold Rochwald)

A. Definition of TP

There are several definitions of transfer pricing (“TP”) but the simplest definition is the price an entity charges to an associated party for the provision of goods, services or use of an Intellectual Property (“IP”). Typically, the parent and the operating subsidiary are located in different countries, which create the undesired tension in transfer pricing. An alternative definition could be found in the decision in the *San Remo*¹ pasta case, where Hill J made the following observation:

“...transfer pricing or international profit shifting may involve artificially inflating the price of goods in a high tax country so that the profit can be taken in another lower taxed country. It will usually, although not necessarily involve the interposition of some entity in a tax haven, whether that be a no taxed haven, or a low taxed haven”

From a theoretical perspective, the determination of the transfer pricing should be straightforward. It requires a measurement of the entity’s financial health to determine the appropriate transfer pricing, valuing for risks, functions and assets of each of the associated parties. Practically, this approach is not straightforward, complicated by issues such as the expectation to establish arms length pricing despite the lack of comparable data.

The key issue in relation to transfer pricing is the conflicting motivation of the subsidiary and the host revenue authority. On one hand, the tax administrators are attempting to control the depletion of its tax base and taxing profits which rightfully should be taxed in their country. Conversely, the subsidiary is trying to, given the inherent difficulties with the transfer pricing legislation to extrapolate profits out of a high tax jurisdiction and get it taxed in a low tax jurisdiction.

¹ 99 ATC 5138, page 5140

B. History of TP in New Zealand

NZ introduced TP legislation in the early 1920's and broadly, this legislation was not subject to change until 1995. The problem with this old piece of legislation, Section GC1 of the Income Tax Act 1994 was that it did not set prescriptive boundaries the Commissioner could use to substitute consideration to what it considered was appropriate. Historically, NZ has only had one TP tax, referred to as the *Squibb*² case. The flaw with the old piece of legislation is arguably testament to the lack of TP cases in New Zealand.

Effective from December 1995, the new TP rules came into effect, which was broadly similar in principle to the TP guidelines issued by the OECD. IRD issued two sets of guidelines³, to assist taxpayers in understanding the new TP rules. The objectives of the new transfer pricing rules were⁴:

- Deter taxpayers from attempting to decrease their New Zealand tax liabilities by manipulating the level of income and
- Achieve the above objectives in a manner consistent with the Government's policy of minimising reducing compliance costs

The intention behind the new transfer pricing rules was of a narrow focus. Specifically, it was supposed to counteract cross border transactions which were not arms length and resulted in a depletion of the tax base.

C. Statutory Framework

Generally, cross border transactions between associated persons are subject to Section GD13 of the ITA 2004, which is attached under Appendix 1 of this research assignment. This section could be referred to as the “broad brush approach”, setting out minimum expectations of MNC undertaking cross border transactions.

² *Squibb v CIR*

³ TIB Vol

⁴ NZ Government Discussion Document – Proposed New Transfer Pricing and Source Rules, Chapter 7.2.1

This section gives the Commissioner of Inland Revenue statutory power to substitute the consideration exchanged between the associated parties to reflect arms length. As the reader will discuss later, the establishment of arms length is not as easy as one task at all and has been subject of considerable litigation internationally.

Section GD13(1) sets out the approach by IRD, effectively substituting transactions to arms length the effect of the cross border transactions results in a reduction to the taxable income.

Section GD13(1) reads as:

(1) Subject always to its express provisions, the purpose of this section is to require a taxpayer, who enters into a cross-border arrangement with an associated person for the acquisition or supply of goods, services, or anything else at a consideration which reduces the taxpayer's net income, to substitute an arm's length consideration when calculating the taxpayer's net income.

For transfer pricing rules to apply, there are three mandatory pre-conditions that have to exist. Firstly, one of the parties to the transaction has to be domiciled outside of New Zealand. Secondly, both these parties have to be associated. Thirdly, there has to be a supply of goods or services.

D. Transfer Pricing Methods

In arriving at an arms length amount, Section GD13 (7) sets out the method or a combination of methods that are to be used. The OCED refers to the first three methods as traditional methods⁵. The last two prescribed methods are commonly referred to by OECD as “transactional methods⁶”. These methods, which are unusual in nature, require an examination of the profits made between the associated parties. The adoption of these methods is subject to certain safeguards.

- Comparable Uncontrolled Price (“CUP”) Method
- Cost Plus Method
- Resale Price Method
- Profit Split Method

⁵ OECD Guidelines, paragraph 2.1, page II-3

⁶ Ibid, paragraph 3.2, III-1

- Comparable Profit Method

Notwithstanding the choice of methods, what is paramount is that the method chosen reasonably demonstrates arms length because if the IRD are able to demonstrate that a different method reliably demonstrates arms length pricing, the taxpayer could be subject to unnecessary questioning and more importantly, significant costs.

Further, the OCED guideline makes extensive references to “material differences” in the discussion on the transfer pricing methods. However, no definition has been provided to assist MNC, which have been explained through series of examples. Given the authoritative nature of this guideline and its preference to be paramount in most jurisdictions, the failure to define “material difference” can lead to disagreements.

In selecting the method for TP, taxpayers have to choose one or a combination of methods that:

“.....the most reliable measure of the amount completely independently parties would have agreed upon after real or effective bargaining”⁷

In arriving at the method that provides a reliable measure, taxpayers need to bear in mind the following⁸:

- Comparability of the uncontrolled transactions
- Completeness and accuracy of data used
- Reliability of assumptions
- Sensitivity of any results to possible deficiencies in the data and assumptions

These prescribed methods are largely based on the OECD guidelines⁹ with the exception of the Comparable Profits Methods, which was referred to in these guidelines but subsequently changed to Transactional Net Margin Method. It is

⁷GD13(6)

⁸ GD13(8)

important to note that while there is no statutory hierarchy of methods, implicitly, it is the CUP method is preferred. The caveat to this conclusion is Section GD13(8) which states:

The choice of method or methods for calculation and the resultant application of the method (or methods) must be made having regard to:

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

Quite clearly, the reference to degree of “comparability” in section (a) draws a natural inference of the preference towards the CUP method. Further, the adoption of the other transfer pricing, while not being statutorily discouraged preferred requires a demonstration that it was the appropriate methods giving the circumstances of the MNC.

⁹ OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrators

VIII. REVIEW OF GLAXO DECISION

A recent case that demonstrates the contentious nature of transfer pricing is *GlaxoSmithKline Holdings (Americas) Inc. & Subsidiaries v IRS*¹⁰. Apart from being notorious for being the largest transfer pricing tax case in history¹¹, it re-iterates the due diligence and care required when an MNC is going about assessing their transfer pricing risk. Although considerable litigation costs were incurred by both parties, a settlement was reached between IRS and *Glaxo*, totalling US\$4.3billion.

A. US Transfer Pricing Regime

It is appropriate that before analysing the key issues in this tax case, the United States transfer pricing regime is analysed.

The transfer pricing framework is contained in Section 482 of the IRC¹². The purpose of Section 482 is “to ensure taxpayers clearly reflect income attributable to controlled transactions and to prevent avoidance of taxes regarding such transactions¹³”. The key components of Section 482 are as follows¹⁴:

Best Method Rule:

The best method is the one that provides the most reliable measure of an arm’s length result.

Comparability:

Specific factors for determining comparability should be considered in applying and selecting different methods. Differences between controlled transactions and uncontrolled comparables should be adjusted for. Such adjustments will affect the reliability of the methods applied.

¹⁰ T.C., Nos.5750-04 and 6959-05

¹¹ (TD 8552) 59 FR 34971

¹² (TD 8552) 59 FR 34971

¹³ <http://www.irs.gov/irm/part4/ch11s01.html>, paragraph 4.11.5.2 (11-01-2004)

Arm's Length Range:

The final regulations recognize that the application of a method may produce a number of results from which a range of reliable results may be derived. A tax will not be subject to adjustment if its results fall within such arm's length range.

1.0 Facts

Glaxo UK was a worldwide leader in the manufacture of medication for six major diseases. It was headquartered in Ireland with an annual turnover of £23.2billion¹⁵. In 1992, the IRS served notification to commence a tax audit into *Glaxo*, looking at *inter-alia* twenty *Glaxo* Heritage Products. Of the twenty products under review, six of them made up 97% of the total transfer pricing adjustment. Of these 97%, Zantac represented 77% of this referred adjustment. In 1986, Zantac contributed substantively to *Glaxo's* status of being one of the “three leading pharmaceutical manufacturers in the world”¹⁶.

For the years ended 1989 – 1996 inclusive, *Glaxo* was the **distributor** of these Heritage products, which was discovered by *Glaxo UK*, who also patented these products.

Interestingly enough, both *Glaxo* and IRS had significant and fundamental disagreements in the pertinent facts. The respective interpretations are summarised as follows:

The IRS maintained the view that the substantial increase in the sales for *Glaxo* was attributed to the marketing strategies of the Zantac. Conversely, *Glaxo* maintained the view that being a pioneer drug, the value of Zantac should be allocated to the research and development, which was undertaken by the parent. Thus, this allowed IRS to treat *Glaxo* as a contract manufacturer, quite different to the licensee/licensor set up with *Glaxo UK*.

¹⁴ <http://www.irs.gov/irm/part4/ch47s03.html>, paragraph 4.61.3.2 (05-01-2006)

¹⁵ http://www.gsk.com/investors/eps06/annual_review_2006/index.htm

¹⁶ Fris Pim and Gonnet Sebastian: "Tax Planning International Transfer Pricing", BNA International, November 2006, page 3

Secondly, given this substantial investment in marketing of the products, it changed the role played by *Glaxo*. To this end, it implemented strategies aimed at growing the business, through a series of complicated strategies, analogous to a fully integrated business. On the other hand, the position of *Glaxo* was that it was a local distributor of drugs, acting consistently with the global strategies designed by *Glaxo* UK.

Thirdly, IRS argued that the increase in the number of employees in the sales department at *Glaxo*, disproportionate to the employees in the research and development department at *Glaxo UK*, represented the shift in enhancing the brand of Zantac, placing less reliance on the design and development. On this point, *Glaxo* argued that given the geographical area that had to be covered, it would require substantial sales representatives. Further and consistent with the group policy, the research and development is centralised, not de-centralised, employing experts in the area.

2.0. *Analysis of IRS Arguments*

The IRS advanced arguments, based on their interpretation of the facts as follows. The first argument, of major significance is that *Glaxo* should have withheld larger profits than what was accounted for. The basis for this argument is that *Glaxo*, through substantial marketing and sales contributed to the trade names and trade marks of the heritage products. Arising out of this, IRS asserted that this was sufficient to make *Glaxo* the “owner” of these trade marks and trade names for tax purposes, because of the associated know how under the IRS developer-assister rules in its transfer pricing regulations.

Under the developer –assister rules, the entity with the significant contribution to the development of the intangible property becomes the economic owner, regardless of the legal ownership. It is abundantly clear in the view of IRS that *Glaxo* contribution was significant than that of *Glaxo UK*. Generally, the starting in establishing the ownership of intangible property is to see who has legal ownership of the intangible asset. Economic ownership is secondary and applies to instances where

the intangible property cannot be legally registered.

The IRS challenged the royalties remitted under the distribution agreement that *Glaxo* had executed with *Glaxo UK*. It argued that the royalties reduced the entrepreneurial profits derived by *Glaxo*. It argued that the payments to *Glaxo UK*, in the form of royalties and purchases of these heritage products to *Glaxo UK* were excessive.

3.0. *Key Transfer Pricing Issues*

From the analysis undertaken, the key issues can be broken down as follows:

Firstly, whether *Glaxo* has adopted the correct transfer pricing method in its computation of cross border transactions with *Glaxo UK*?

Secondly, are the royalty payment and the purchase of these heritage products arms length transactions?

Thirdly, has the double tax agreement between USA and UK been applied in the manner which is consistent with its intention? Undoubtedly, the one of the intention stated in the introductory pages is that it is designed to facilitate cross border disputes between two jurisdictions.

4.0. *Key Messages*

The outcome of the *Glaxo* out of court decision has reinforced several key transfer pricing messages. Firstly, it has really questioned one of the fundamental reasons for having a double tax agreement. Certainly, the British revenue authorities maintained this view, arguing that the profits have already been taxed in UK, consistent with principles of the OCED guidelines. To this end, *Glaxo* requested relief from IRS pursuant to the Double Tax Agreement. This request was within the parameters of the double tax agreement between these two countries. Specifically, the double tax agreement states¹⁷:

¹⁷ United Kingdom/United States Dual Consolidated Loss Competent Authority Agreement

“..to resolve the issue regarding the interaction of the legislation and regulations referred to above, the competent authorities of the Contracting States agree that certain taxpayers may, subject to the terms and conditions of the competent authority agreement set forth in this document, elect to use, or relieve, losses in either the United States or the United Kingdom to the extent permitted by the rules of the Contracting State, as modified by this agreement”.

The comments of the lawyer represented nearly summarised the position of IRS¹⁸:

“The government’s position in the audit has been that the marketing in the US created success of Zantac”

The OECD has been an influential body, of which United States and UK are active members in the settlement of disputes arising out of cross border trading. The less than satisfactory approach by both parties to actively seek resolution to the dispute is against the spirit of the OCED guidelines on transfer pricing. In the prefatory comments of the OECD states¹⁹

“In order to minimise the risk of such double taxation, an international consensus is required on how to establish for tax purposes transfer prices on cross-border transactions”.

In relation to resolution of disputes:

”The Guidelines are intended to help tax administrations (of both OECD Member countries and non- Member countries) and MNEs by indicating ways to find **mutually satisfactory solutions** to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and MNEs and avoiding **costly litigation**”.

Further, the OCED goes on the state the following²⁰:

“These Guidelines are also intended primarily to govern the **resolution of transfer pricing cases in mutual agreement proceedings between OECD** member countries and, where appropriate, arbitration proceedings. They further provide guidance when a corresponding adjustment request has been made”

The motivation not to seek arbitration for a satisfactory outcome for both parties is beyond the comprehension of the writer. Perhaps, the quantum involved

¹⁸ Wall Street Journal:” *Glaxo* in the Major Battle with IRS over Taxes on years of U.S Sales”, June 11, 2002, comments by Mr Magee

¹⁹ OCED, Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrators, P-4

²⁰ Ibid, paragraph 17, P-5

played an important part. Possibly it can be attributed to the massive increase in sales of the drug in the US. Notwithstanding the reasons, the IRS “no nonsense” approach to transfer pricing has been evident in the *Eli Lilly*²¹ and *Bausch and Lomb*²² cases, which were both resolved after modest payments.

B. *Approach in New Zealand*

Under the New Zealand statutory framework, the IRD generally refers to the marketing and sales activities that enhance the value of an intangible property as “marketing intangible”. The OCED define marketing intangible as²³:

“An intangible that is concerned with marketing activities, which aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned”.

The important question is “how the marketer should be compensated for those services²⁴”. From this, two key considerations need to be addressed²⁵:

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

Marketing intangible possesses unique characteristics that distinguish them from non marketing intangibles or trade intangibles, including:

- Associated with the promotion of goods and services, for example the drug Zantac in *Glaxos* case
- Costs to get legal protection is cheaper, but its development and on going maintenance could be expensive
- Product differentiation is difficult as competitors can enter the market with

²¹ *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855 (7th Cir. 1988)

²² *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), aff'd, 993 F.2d 1084 (2d Cir. 1991)

²³ OCED Guidelines, page G-8

²⁴ IRD, Taxation Information Bulletin, Twelve, No1 (January 2000), paragraph 108.

²⁵ *Ibid*, paragraph 108

similar products

Ignoring the agreement between the parties, the entitlement to compensation is not straightforward. Clearly if the subsidiary is acting as an agent of the parent and obtaining reimbursement for marketing and advertising expenditure, no compensation is likely to flow from these sorts of set ups. If the subsidiary undertakes marketing and expenditure over and above that would be expected of an independent party, there may be an entitlement to some form of compensation. This benchmark, arguably, epitomises the core problem with the application of the transfer pricing rules. It poses real challenging questions, including:

- What “independent” companies are being used to establish if the compensation is reasonable or excessive? The issue of comparability of data, subject to adjustments for factors such as turnover, risks etc.
- What is the “arms length” to reasonably reimburse the subsidiary for the costs incurred in marketing the intangible property?

Once the entitlement to compensation has been established, the level of compensation is another transfer pricing minefield. The starting point would be a review of the agreement/supporting documentation between the parties, establishing the terms, obligations and rights. In this regard, the OECD provides illustrative examples²⁶ and guidelines in establishing the extent of the compensation. Inherent in these examples are the core issues of comparability and arms length price, further complicated by analysing the following questions²⁷:

- 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 – is it possible that its value in a particular market is wholly attributable to its

²⁶ Idem, paragraph 117

²⁷ Idem, paragraph 117

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?

Interpreting these questions another way, the key issue appears to be how to measure the increase in the value of intangible property. In this regard, there is no discussion, either by the IRD or OECD on establishing or more importantly measuring at what point the expenditure is deemed to have added value. This raises a whole series of inter-related questions, including:

- What are the methods to measure the “increase” in the value of the IP?
- How do we measure the increase reliably?
- Will the method adopted be accepted by revenue administrators?

The OECD provides authoritative guidance on arriving at arms length consideration²⁸. In analysing the comparable data to establish the “value added” to the intangible property, allowances for market share, geographical differences, sales volume and market share needs to be made. This path is complicated if the product is unique giving preferential market status, as seen with the *Zantac* drug. Amongst the arguments raised by IRS was that that this drug was a pioneer drug. This point is reconcilable as this drug revolutionised the medical fraternity, especially in the area of anti-histamines. Further, there were no threat of substitutes comparable to Zantac and given the size of *Glaxo UK*, this enabled a significant commitment to marketing and advertising. The success of this drug was significant and substantial to *Glaxo*. The OCED do acknowledge the inherent difficulties in determining whether or not the expenditures have contributed to the success of the product²⁹. Its guidelines discuss these concerns with reference to examples. Further, the guidelines discuss that a

²⁸ OCED Guidelines, page VI-9

²⁹ Ibid, page VI-15

“dominant market share may to some extent be attributable to the marketing efforts of the distributor”³⁰. Additionally, the “value and any changes will depend to an extent on how effectively the trademark is promoted in the particular market”³¹.

One issue seems to be abundantly clear from analysing the above. If an MNC has gone to the extent of undertaking some formal process of measuring such an increase, the revenue administrators will have little to no choice of accepting the findings.

There is so “silver bullet” to solve this problem, as is the case with the application of transfer pricing provisions. At the end of the day, it is the facts and circumstances that need to be thoroughly evaluated. The writer has reservations about this point as well as in the *Glaxo* case as the facts were interpreted differently by IRS and *Glaxo*. Interestingly, it puts a different perspective on what is a fact.

Additionally, the decision by IRS to reach an out of court settlement could have been implicitly motivated by the decision of the 9th Circuit in the *DHL*³² case, which reversed the decision of the US Tax Court. The facts of *DHL*, in so far as the identification of the “marketing intangible” are similar. *DHL* was one of the worlds leading courier networks³³ and in 1972 incorporated *DHLI* for the international aspect of the business. At all material times, despite the series of shareholding changes, *DHL* was privately owned. In 1974, an agreement was executed between *DHL* and *DHLI* to for the use of the trademark (*DHL*) for an initial period of 5 years (the agreement could be referred to as licensee and licensor set up). No royalties were payable in this initial period. The advertising, marketing, legal, registration costs etc incurred in the US were borne by *DHL* and similarly, *DHLI* bore the costs for these costs outside of the US. Given the continual deterioration of the courier business in the US, a decision was made to merge *DHL* and *DHLI* and as a result, the use of the *DHL* trademark was extended to 15 years, royalty free and “terminable only for cause”³⁴.

³⁰ Idem, paragraph 6.39, page VI-15,

³¹ Ibid, paragraph 6.39, page VI-15

³² *DHL Corporation v Commissioner of Internal Revenue*, United States Court of Appeal for the Ninth Circuit, No 99-71580, Tax Court No:26103-95

³³ Levy, Marc M and Ors: “DHL: Ninth Circuit sheds very little light on bright line test”, *Journal of International Taxation*, page 1

³⁴ Ibid, page 3

In 1990, *DHL* and *DHLI* sold their trademarks to a consortium represented by Japanese and German investors. Full controls of these trademarks were protracted.

The IRS argument was based around that *DHL* should have charged a royalty for the use of the trademark (*DHLI*) and issued assessments for the prior year's royalties.

The issue ultimately came down to who was the legal or beneficial owner of the *DHLI* trademark and arising from that, any royalties that would be payable. In reversing the decision of the Tax Court, the 9th Circuit held that DHLI was the beneficial/ economic owner of the trademark as it has expended considerable sums of money in building this trademark. The trial judge espoused the "bright line test" which notes that, every licensee or distributor is expected to expend a certain amount of cost to exploit the items of intangible property to which it is provided, it is whether the investment crosses the "bright line" of routine expenditure into the realm of non routine that economic ownership, likely in the form of a marketing intangible³⁵.

This disposed off the argument advanced by the IRS. Despite this case being argued on the old US TP regulations³⁶, one issue that was implicit in the decision, which is common to the area of marketing intangibles is the inherent difficulty in the identification and assessment of legal or economic (beneficial ownership)

C. Analysis of IAS 38 – Intangible Assets

Given the uncertainties surrounding the identification and recognition of marketing intangibles for transfer pricing, it is useful to consider an alternative and recognised approach to this issue, purely on the grounds to establish if they provide any more clarity and certainty in approach.

Given the shift to universal and a common set of financial reporting standards,

³⁵ Levy Marc M, Herksen and Ors: "The Quest for Marketing Intangibles", page 6

³⁶ The Regulations in 1968 were amended and replaced by the 1994 Regulations. The 1968 Regulations focussed on the legal ownership test. The 1994 Regulations introduced the beneficial/economic ownership test.

a good starting point is IAS 38 – Accounting for Intangible Assets.

IAS 38.12 defines an intangible asset as “an identifiable non-monetary asset without physical substance”. Further, it goes on to list three attributes of an intangible asset:

- Identification
- Control
- Future economic benefits

Importantly, the first point is of major relevance. IAS 38.21 says that an intangible asset is identifiable when it:

- Separable
- Arises from contractual or other legal rights

With reference to the heritage Products in the *Glaxo* case, it is rather difficult to clearly identify it. The separation aspect is equally challenging, conferring no extra certainty. It is conceivable that the intangible asset in question has arisen from the legal right granted by *Glaxo* UK to use. Interestingly, in the list of examples provided in IAS 38 of possible intangible assets, it includes “marketing rights”.

A further complication to this is that generally, internally generated intangible assets, arising from research and development are not classified as an asset.

This limited analysis has demonstrated to some extent that the whole area of marketing intangible is not straightforward, open to subjectivity and manipulation.

D. Form vs. Substance

From analysing the decision of *Glaxo* and attempting to apply it to the New Zealand statutory context, one issue that warrants further elaboration is form vs. substance. Factually, a whole of series of comprehensive agreements existed between *Glaxo US* and *Glaxo UK*.

A leading New Zealand authority in form vs. substance is the *Europa*³⁷ case, decided in the Privy Council. It re-affirmed the principle enunciated in the *Duke of Westminster*³⁸ case. Further, the IRD published a draft interpretation guide on this aspect³⁹. While the facts of the *Europa* case are irrelevant to set out, they were complicated, inter-twined through a whole series of agreements, which resulted in obtaining deductions under s.11 [now s.DA1] of the ITA 2004. The Privy Council ignored the subsidiary benefits that flowed from the series of inter-related arrangements, instead approaching the issue on the strict analysis of the legal rights acquired by the taxpayer, as set out in the agreement.

Hypothetically applying this principle to the facts in *Glaxo*, it would seem that the road for the Commissioner to succeed would be difficult, for the several reasons. Firstly, legally binding agreements exist between *Glaxo* and *Glaxo UK*. There have been no questions about the validity, genuineness or enforceability of these agreements, which could be slightly complicated by the fact that the parties are associated. There would be the tendency to be relaxed around some matters, which could be different if the contract was between two independent parties. Prima facie, *Glaxo* is remitting royalty payments, *inter-alia* to *Glaxo UK*, consistent with the terms of the agreement. In return, *Glaxo US* is getting exclusive use of the trademark associated with the heritage products.

Secondly, if *Glaxo* has added value to the intangible property owned by *Glaxo UK*, consistent with the principles laid down in the *Europa* case, this could be argued as incidental and subsidiary to the contract that exists between these parties. This issue added to the uncertainties with lack of arms length comparables really makes the Commissioners' approach more challenging. In this regard, it is important to note that the statutory transfer pricing provisions are part of the specific anti avoidance provisions.

E. Definition of Documents

³⁷ *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* - [1976] 1 NZLR 546

³⁸ 1935) 19 T.C. 490

³⁹ IRD, Draft Interpretation Statement IG9702[d], June 1997

Another peculiarity with the US transfer pricing regulations and New Zealand is that there is no statutory definition of “documents”, despite having a statutory expectation of demonstrating that the transfer pricing are arms length. The caveat to this point is the Section 22 of the Tax Administration Act. This administrative provision deals with general and broad record keeping issues and it was contemplated that this provision was sufficiently strong in its application to transfer pricing. This provision is further buttressed by Section 3 of the Tax Administration Act which covers the general requirement to maintain books and documents.

Instead, Inland Revenue approach this issue by setting out its minimum expectations. Without detracting from the clear and understandable reasons for having documentary evidence, this approach by IRD is deliberate. By this, the writer means that, statutorily, if IRD provided a list of documents and evidence it expects to see during transfer pricing reviews, this sets the benchmark for the nature of records that are to be maintained. On the other hand, there are significant costs associated in preparing these documents and having annual reviews if any changes need to be incorporated. Further, if there were important documents, not included under the definition of “documents”, the taxpayer does not have a legal obligation to provide it to IRD. The onus of proof further exacerbates this issue for IRD.

Notwithstanding, it is always in the best interests of taxpayers to have transfer pricing documentation, for several reasons, including arousing suspicion of unacceptable levels of manipulation.

With application to the US transfer pricing provisions, the crucial consideration is the onus of proof. The taxpayers have to provide all necessary and relevant documentation that extinguishes the concerns raised by IRS.

F. OECD – Arbitration Post Glaxo

In February 2007, the OECD released a document⁴⁰ designed to counteract situations where countries involved in cross border disputes are unable to reach resolution

⁴⁰ Improving the Resolution of Tax Treaty Disputes

according to MAP outlined in the treaty. It is quite possible that one of the underlying drivers behind this was the *Glaxo* case, which was long, protracted and costly for both parties. The MAP as it previously stood “did not *require* the countries to come to a common understanding of the treaty, but *only* that they endeavour to agree⁴¹”. The unintended consequence is “unrelieved double taxation or taxation not in accordance with the Convention...⁴²”. Despite being clear in its intention from a theoretical perspective, the MAP was flawed from a practical perspective as it did not set out all the necessary steps in the resolution of disputes. This had a detrimental effect on taxpayers as they did not see the MAP as a viable alternative in the resolution of cross border disputes. Further, from a tax administrator’s perspective, the MAP was not an attractive proposition as it did not outline all the necessary steps.

⁴¹ Ibid, page 4

⁴² Ibid, page 4

IX. CORPORATE RESTRUCTURING

A. Introduction

Another issue that has attracted lots of unnecessary attention in transfer pricing circles amongst the tax administrators is the issue of Corporate Restructuring (“CR”). Internationally, there has been an increase in CR. For example a survey in Canada of 140 companies established that 87% went through restructuring⁴³. This survey has demonstrated the shift to countries with cheap labour.

Typically, there are a combination of factors that could motivate a MNC to undertake restructuring. Broadly, these could be broken down into internal and external factors. The internal factors include centralization of decision making, optimisation of working capital, efficiency gains from low cost labor and increased manufacturing efficiencies. The external factors include reaction to global competition, threat of cheap substitutes and changing customer demands.

In the modern era of increased competition and globalisation, MNC’s are driven to restructure to maintain a competitive edge and to protect the erosion of its profits. Tax savings through relocation are important in the overall contribution to maintaining competitive edge and more importantly, these savings can amount to a significant amount which could be invested to grow the business.

Inescapably, the revenue authorities will probably become suspicious about the motives regarding CR, possibly maintaining the view that tax considerations were the primary driver for such a move. From a tax administrator’s point of view, any tax planning that involves the reduction of taxes, or alternatively the depletion of the tax base by moving profits offshore would be acceptable if the appropriate tax consequences have been carefully addressed.

Notwithstanding the inability of IRD to tell taxpayers how to run their

⁴³ Carolyn Kwan:” Restructuring in the Canadian Economy”, Working Paper 2002-8

business⁴⁴, it is in the interest of taxpayers that the decision to restructure is based on sound economic reasons and if tax was the main or incidental driver, the necessary due diligence and supporting documentation are carried out.

B. OECD on CR

Since CR is a significant strategic decision, important to any MNC, its taxation consequences are equally important. In this matter, the OECD has been an active body, leading the way in the identification of the associated taxation issues. Given the relative newness of CR, there appears to be more questions than answers. An example of this is the working party⁴⁵ created by the OECD to discuss eventuating taxation issues. In fact, the OECD is performing a delicate balancing exercise. On one hand the tax administrators “want to tackle “abusive” transactions or those which lack economic substance⁴⁶”. On the other hand, the OECD wants to develop “transfer pricing and treaty analytical framework to deal with bona fide restructurings that is clear as possible...⁴⁷”. Empirical evidence analysed by the OECD strongly suggest that the “stripping out” of functions, intangible assets and risks which were previously integrated in local operations⁴⁸” and transferring them to centralised or specialised units was done to be maintain a competitive edge. From a tax perspective, tax administrators would undoubtedly notice a reduction in the profits and ultimately a reduction in the taxes payable.

In the area of transfer pricing, the main concern expressed by the OECD is main concern is “whether the reattribution of profits is consistent with the arm’s length principle..... how the arm’s length principle applies to business restructurings⁴⁹”.

⁴⁴ Refer Ronpibon Tin case - HCA 15; (1949) 78 CLR 47 (6 June 1949)

⁴⁵ http://www.oecd.org/document/20/0,3343,en_2649_37989760_34535252_1_1_1_1,00.htm– 2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring , last accessed 31 March 2008

⁴⁶ http://www.oecd.org/document/11/0,3343,en_2649_33753_38087051_1_1_1_1,00.html– Approval of the Mandate – Background Information, last accessed 31 March 2008 , page 1

⁴⁷ Ibid, page 1

⁴⁸ http://www.oecd.org/document/53/0,3343,en_2649_33753_38093109_1_1_1_1,00.html

⁴⁹ Ibid, page 1

Transfer pricing is not the only area that requires detailed consideration in the area of the CR. There are consequential offshoots, in areas such as Permanent Establishment (“PE”)⁵⁰ and the attribution of profits to the PE⁵¹, which are beyond the scope of this research project.

The OECD has outlined several important transfer pricing risks when MNC are undertaking CR, which were discussed by the members. They are⁵²:

- How to determine arm’s length remuneration of a stripped entity and of its principal?
 - Should the testing be done only the complicated party between the stripped entity and the principal?
 - Should the testing be undertaken on both parties?
 - What is the impact of the declining royalty for the restructured entity?
- How to account for group synergies and efficiency gains?
 - How do we compare the alternative economic position?
 - What are the consequences of doing nothing?
 - Does the allocation of the group synergies still have to take place if the arms length prices do not capture it?
 - Does the resulting profit/loss of the restructured entity be allocated to the rest of the members of the group?
- Whether the arm’s length principle applies differently to an arrangement between associated enterprises depending upon whether or not it replaces an existing arrangement?
 - Is the restructuring an arms length transaction?
- Indemnification/payment upon conversion, e.g. for a transfer of intangibles or “loss of profit potential”
 - Under what circumstances is the payment liable to be made?

⁵⁰ Article 5 of the OECD Model Tax Convention

⁵¹ Article 7 of the OECD Model Tax Convention

⁵² <http://www.oecd.org/dataoecd/24/38/38791320.pdf>, last accessed 31 March 2008

- Is the payment an arms length transaction?
- How to calculate the payment for the conversion/indemnification?

C. Permutations of CR

Typically, the types of CR could be broadly classified as follows:

1.0. Converting from fully fledged manufacturer to contract manufacturer

Under this category, the manufacturing entity in the group is converted to a contract manufacturer for a number of reasons. Typically, the IP associated with the product manufactured is held and owned by the fully fledged manufacturer. The contract manufacturer owns the manufacturing know-how and has the provision to provide this service. Firstly, where a strategic decision has been made by the group to centralise all the valuable IP to permit efficient development and maintenance. Secondly, where current or existing products are being deleted in favour of new products and the development of the IP associated with this new product has taken place without consulting the contract manufacturer.

The tax risk with the change to a contract manufacturer is that the profitability is dictated by the transfer pricing policy of the group. Previously assumed functions, prior to the conversion (logistics, supply procurement, design, invoicing etc) and risks (foreign exchange, credit risks, inventory obsolescence etc) are no longer borne.

The arms length pricing would be equivalent to that of an independent contract manufacturer adjusted for risks assumed, assets used and functions performed. Since the entity is only performing manufacturing activities. It is fair to assume that it does not bear any risks in the development (for e.g. research and development) of the IP or its customers. On this basis, the contract manufacturer would be entitled to a mark up, consistent with the groups' policy on the total cost of the manufacturing and other operations.

Further, profits arising out of the use of the IP (such as brands, designs) will not be taxable in the country (which previously imposed tax) as it is not the legal or beneficial owner of the IP, which is now held offshore. The effect of this is that it will lead to a decline in the profits in that country. Arguably, the tax base would be depleted in such an approach, which could be easily quantified by reference to previous years taxes paid.

From a transfer pricing perspective, the tax authorities may assert that a deemed disposal of the IP has taken place, supported by the decline in the profitability in that country. They may seek to levy taxes based on the profits foregone. To rebut such a position, it is important that all the relevant supporting documentary evidence are maintained.

Further, the level of mark up charged for the contract manufacturing may also be under scrutiny. In the search for independent manufacturing comparables it is very critical that appropriate adjustments are made. In this context, it needs to be noted that independent parties (for e.g. sub-contractors or CMT) generally are not entitled to a share of profits arising from the IP. For example, if prior to the conversion the group had an efficient manufacturing chain, which really has not changed, (merely relocating the IP and changing ownership) an adjustment needs to be made to incorporate the routine intangibles. A detailed analysis of the functions would isolate these sorts of issues.

2.0. Converting from contract manufacturer to consignment manufacturer

Typically, this involves further streamlining the manufacturing operations by changing to a consignment manufacturer. The effect of such restructuring leads to a reduction in working capital and the total net assets. The term consignment manufacturer means that the manufacturer does not have legal title to the raw materials used in the manufacturing process. It is contracted by someone to manufacture (say for example the parent or subsidiary in the group) and bases its charges on labour, profit component and factory overheads to manufacture the product. The consignment manufacturer will thus be entitled to a “cost plus” with a

mark up, which will be dictated by the parent.

In the analysis of transfer pricing, under this set up, the risks borne by the consignment manufacturer is significantly reduced and could be classed broadly into the procurement of materials and holding inventory (deterioration, valuation etc). All other risks, assets and functions are borne by the parent. The question ultimately is whether the price charged for the consignment manufacturing is analogous to arms length pricing?

In establishing the extent to which this conversion has an impact on profitability, it is important to first appreciate what has changed for the contract manufacturer. After all, the contract manufacturer will be seeking to make a profit after recovering its costs.

Having eliminated one of the major assets (inventory) which is rather difficult, it is conceivable that the services provided by the contract manufacturer is one of service provider rather than contract manufacturing.

3.0. Closure of manufacturing operations

Under this arrangement, as the name suggests, the MNC eliminates the production in a jurisdiction and “shifts” it to another jurisdiction, still producing the same product that was manufactured in the closed factory. In other words, the “profit potential” is completely withdrawn from one country and relocated somewhere else, where the production is “ramped up”. The revenue authorities will thoroughly check to establish the “actual” reason(s) for the closure.

In reviewing the transfer pricing exposure, the MNC needs to be careful as the closure could have triggered a deemed disposal of the IP. There are other tax considerations that need to be carefully analysed.

The first issue relates to the deductibility of the restructuring costs. Essentially, the dispute will revolve around the blurry distinction between revenue and

capital expenditure and analysis of the key judicial precedents in the *BPAustralia*⁵³, *Fullers*⁵⁴ etc. Given that this expenditure is abnormal and once off, it would appear that this expenditure will be on non-deductible.

Secondly, the issue of stock write offs needs to be thoroughly analysed. This issue could be significant depending on the amount of stock that needs to be written off. The MNC may decide to recover some of its costs and sell the stock at a discounted price. This will have a direct impact on the net profit and could expect IRD scrutiny.

Thirdly, there may be penalties or damages may be payable for the early surrender of a lease and the termination of a contract. The deductibility of lease surrender payments are subject to the capital/revenue distinction.

Fourthly, there could be losses that could eventuate from the disposal of fixed assets, which will attract the attention of the revenue authorities

Fifthly, there may be “exit taxes” or “conversion taxes” imposed by the country being exited. The basis the imposition could stem for the determination that the exit has triggered a deemed transfer of assets. In arriving at a conclusion as to whether or not the deemed transfer has eventuated, the following significant and fundamental questions need to be addressed:

- Firstly, has the transfer set off a conversion (or taxable) gain?
- Secondly, how does one quantify the value of the taxable gain?

In relation to the first question, the approach would vary from jurisdiction to jurisdiction. For example, the German tax authorities approach to this issue from the point of view of “loss of profit potential⁵⁵”. Essentially, the approach is predicated on

⁵³ BP Australia Ltd v FCT[1965] HCA 35

⁵⁴ Fullers Bay of Islands Limited v Commissioner of Inland Revenue (2006) 22 NZTC 19,716 Court of Appeal, CA 264/04.

⁵⁵ Ernst and Young:” Business Restructuring – Three Taxation Issues” – International Tax services,

the basis that the stripping of functions amounts to loss of profits because, ordinarily, if it wasn't for the restructuring, the profits would be subject to income tax in Germany.

The approach to the second issue involves the utilisation of modern financial statistical methods (WACC, CAPM, DCF etc)⁵⁶. Notwithstanding the election of method, the key issue is establishing the arms length price for the conversion gain. As a starting point, the MNC will need to research and compare data from independent entities and similarly restructured entities. If comparable data has been located, a further issue is whether or not any compensation was made for the transfer of the assets. Further, business restructurings are generally unique and specific in nature.

Despite the above concerns, the following factors should be included in the analysis of comparable data:⁵⁷

- Duration and termination considerations of existing written inter-company agreements
- Actual or beneficial ownership of IP
- Historical conduct of the parties and consistency with the substance of the inter-company transactions

D. IP Migration

Ideally, MNCs undertaking tax planning would relocate their intangible properties before they prove to be a valuable asset. This optimum global positioning ensures the consistent return on operating efficiencies and more importantly, the non imposition of any possible taxes that may arise out of the restructuring. This was not the case in the *Merck*⁵⁸ case. While the facts are not fully available, the following findings of facts are noted:

June 2007, page 8

⁵⁶ Ibid, page 10

⁵⁷ Ibid, page 11

⁵⁸ *CRA v Merck Frosst Canada (Merck)* , full citation not available as the CRA has issued not assessments

- CRA commenced a review of Merck's taxation returns for the years ended 1998 to 2004 inclusive;
- CRA initiated re-assessments for certain adjustments involving inter-company transactions and issued a notice of assessment on October 10, 2006 for a sum totalling \$US1.4billion and \$US360million interest.
- The assessments relate to the asthma drug Singulair, which was developed in Quebec and its patent was held by Merck. At the back of reported sales of US\$950million in just the second quarter of 2006⁵⁹, Merck made a decision to transfer the parent to Barbados.

The statutory authority for raising the assessments was Section 247(2)(b) of the Canada Income Tax. Essentially, Section 247 gives the CRA the legal authority to substitute the considerations paid to reflect arms length. The outright sale of the patent is one of the methods available to MNC's to migrate intangible properties.

E. Cost Contribution Agreements (CCA) or Cost Sharing Agreement (CSA)

Many of the issues in the identification of which entity has economic ownership of the IP could be remediated through a CSA. Essentially, a CSA is a "framework amongst business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights⁶⁰". The most frequent example of a CCA is the joint agreement to develop an IP⁶¹. Under this arrangement, each party receives a separate share in the rights in IP and are permitted to exploit it in the agreed geographical area. The right to exploit the IP may constitute legal ownership or alternatively, it could be agreed that the parties to the agreement are all economic or beneficial owners and there is only one legal owner of the IP.

Theoretically, A CSA should minimise transfer pricing exposure as it sets out the responsibilities and interest from the beginning.

⁵⁹ Hill, Dale C and Ors; "Moving Intellectual Property Offshore in a Transfer Pricing Setting", Tax Notes International, page 684, November 12, 2007

⁶⁰ OECD Guidelines, page VIII-2

⁶¹ Ibid, page VIII-3

The IRD has provided its analysis in the administration of a CCA⁶². Given the inherent difficulties associated with the various permutations of a CCA, the IRD⁶³ and the OECD⁶⁴ acknowledge that the following issues that have yet to be resolved, as follows:

Firstly, which method should be used in the measurement the value of the contributions to the CCA⁶⁵? Does one use the actual costs or market value of these costs?

Secondly, how does one measure or adjust for any subsidies or tax incentives that have been provided by the Government. Further, how does one search for independent comparable data to commence the benchmarking process? In this regard, the question that needs to be posed is “...what independent enterprises would have done in similar circumstances⁶⁶”

Thirdly, the tax treatment of the contributions for e.g. research and development by the parties is to be treated in the same way as if the payment was made outside the CCA and subject to the normal general rules under the applicable jurisdiction, i.e. the research and development are subject to the normal deductibility rules in the Income Tax Act 2004. However, the income or the expected benefits may not accrue immediately and it may be spread over a term. This creates the apparent mismatch between the expenditure incurred and prospect of income.

All these factors need to be considered in arriving at the arms length pricing. If the CCA is not consistent with the ALP, one party would have received excessive benefits relative to their contributions, and consequently, an adjustment needs to be effected to reflect arms length. The benchmark is “what an independent party would have received or paid”, adjusted for the differing facts.

⁶² IRD: Taxation Information Bulletin, Volume 12, No 10 (October 2000).

⁶³ Ibid

⁶⁴ OECD Guidelines, page VIII-1

⁶⁵ OECD Guidelines, page VIII-6

⁶⁶ Ibid, page VIII-7

Notwithstanding the clear intention behind executing a CSA, this did not stop the IRS in re-allocating the costs in a CSA in the *Xilinx*⁶⁷ case. *Xilinx* was in the business of researching, manufacturing, marketing and disposing of circuit components. It entered into a CSA with its Irish subsidiary to develop IP. The terms of the CSA were nothing extraordinary, and required a percentage contribution by each party for the total research and development. As part of the employee package, *Xilinx* issued various types of share (stock) options to these employees. *Xilinx* did not include the costs associated with the issuing and/or exercising of the share options in its research and developments costs.

The IRS issued assessments using the transfer pricing provisions⁶⁸ on the basis that when the share options are exercised, the total costs to be shared should be inclusive of the difference between the market value and the “cost” to the employees of these shares. Further, the exclusion of the share options was inconsistent with the application of the ALP, i.e. independent parties would include the difference between the cost and the market price. Moreover, the IRS did not provide any comparable data to support its approach. The reasoning was as follows⁶⁹:

“it was unnecessary to perform any comparability analysis to determine....whether parties at arms length would share...[referring to the share options].

Further, “the identification of costs and the corresponding adjustments to the cost pool under the cost sharing arrangements should be determined without regard to the existence of uncontrolled transactions⁷⁰”

In disposing off the IRS arguments, the Tax Court provided an excellent analogy in the application of the ALP and the CSA. Notwithstanding the statutory burden in transfer pricing cases being on the taxpayers, the Tax Court re-iterated the importance of comparable data

⁶⁷ *Xilinx Inc. and Subsidiaries v Commissioner of Internal Revenue*, United States Tax Court, 125 T.C No.4

⁶⁸ Regulations 1.482-01(a)(1)

⁶⁹ *Xilinx Inc. and Subsidiaries v Commissioner of Internal Revenue*, United States Tax Court, 125 T.C No.4 , page 27-28

⁷⁰ *Ibid*, page 28

F. Approach by Inland Revenue

The IRD has not issued any formal discussion document or interpretation guidelines on this matter. The approach currently is similar to the position of the OECD, where there are more questions to which answers are sought. Essentially, the IRD has outlined two major concerns in relation to the restructuring of supply chains⁷¹:

- The economic substance underlying the purported low risk operations such as contract manufacturers and limited risk distributors; and
- The consistent return of routine profits

The economic substance behind the restructuring has to be genuine, of “real significance and not paper only⁷²”. While no express guidance has been provided on what is “real significance”, it could be analogous to circumstances where there has been a major structural change, resulting in changes to functions, risks, assets, which are clearly reflected in the contracts.

If an MNC undertakes restructuring activities in New Zealand, the IRD will be challenging activities where there are “costs associated with a penetration strategy⁷³” and extraordinary regional charges that are disproportionate to the scale of the local market.

In understanding the nature and basis of the restructuring, Inland Revenue would require responses to the following questions⁷⁴:

1. What is the fundamental basis for restructuring?
 - Is the restructuring consistent with the group wide restructure?
 - Is the restructuring a “regional restructure?”

⁷¹ Nash, John: “Transfer Pricing”, New Zealand Institute of Chartered Accountants, NZ Tax Conference 2005

⁷² Ibid, page 16

⁷³ Ibid, page 16

⁷⁴ <http://www.ird.govt.nz/aboutir/newsletters/corporates-contact/2007/large-enterprises-2007-12.html>

- Is the restricting a one-off/ domestic?
2. Has a three-step functional analysis been carried out before and after the restructuring?
 - Has the functional analysis identified any disposals and acquisitions?
 3. What compensation has been received for the transfer of tangible assets, liabilities and the transfer of intangible properties?
 4. Does the acquirers of the functions, assets and risks have the capacity, working capital and human capabilities to support the acquisition?
 5. Does the stripped entity provide functions that were previously provided as part of its business activity as a service to the restructured entity?
 6. Is the stripped entity compensated for all functions, assets and risks including those that were not specifically transferred and can still be regarded as profit drivers?
 7. Does the restructured entity have a PE in New Zealand?
 8. Who has borne the restructuring costs and has any deduction being claimed on fixed life intangible property as a result of the restructure?
 9. Have valuations/due diligence exercises undertaken for the assets the transferred assets?
 10. What documentation is available to support the transfer pricing before and subsequent to the restructuring?

G. Approach by Australian Tax Office

Unlike New Zealand, the ATO has released a discussion document⁷⁵ which sets out its approach in dealings with cross border transactions involving CR. Currently, this document is being considered by the Transfer Pricing sub-committee, its contents are

embargoed and it is anticipated that this document will be released for general comments later this year. The hypothetical threshold question, critical in the reconciliation of the basis for the CR is “whether arm’s length parties would have entered into the restructuring arrangement⁷⁶”.

In this document, the ATO set out its main concerns in relation to CR, approaching them as two questions⁷⁷. The first question is “what is the commercial justification for the restructure”. Implicit in this is the inability of the ATO to dictate how the MNC should structure and conduct its business. In essence, the ATO are less likely to use its statutory powers to challenge the CR if the reasons are justifiable and commercially sound, involving the shifting of risks, assets and functions in a manner consistent with independent parties.

For there to be commerciality, there has to be apparent changes in the business, which will be measured by analysing the respective positions before and after the CR. Although both the ATO⁷⁸ and the IRD⁷⁹ generally follow the form over substance approach, the ATO will at look at the economic substance of the transaction between the restructuring and restructured entity. This analysis should provide meaningful information on the approach taken independent parties. Legally, this approach could be described as substance over form, or in the case of CR, a “quasi” form vs. substance. A logical conclusion is that an analysis involving the review of the commercial factors and economic substance would potentially satisfy the ATO. The caveat to this conclusion is that where inconsistencies exist between the legal form and the economic substance of the CR, the transaction is likely to attract scrutiny. To this end, the importance of clear documentary evidence cannot be overemphasised.

Secondly, should there be any compensation payments (also called

⁷⁵ ATO: “Business Restructuring”

⁷⁶ Ernst and Young: Tax Insights – Transfer Pricing”, August 2007

⁷⁷ Ibid, page 2

⁷⁸ see Cecil Bros. Pty. Ltd. v F.C. of T.(1964) 111 C.L.R. 430, 438

⁷⁹ see Europa Oil (N.Z.) Limited v Commr. of I.R. (No. 2); Commr. Of I.R. v Europa Oil (N.Z.) Limited. (No. 2) (1976) 2 NZTC 61,066, Privy Council, 13 January 1976

conversion/exit payments) required to be made as a result of the restructure? Principally, the rationale behind the compensation is to recognise the disposal or transferring of assets to another party. Generally, compensation would be required if the restructuring has been detrimental to the stripped entity. In establishing whether value has been transferred, the ATO will look beyond the sale and purchase agreement or its equivalent and assess the economic consequences of the disposal of the assets, risks and functions.

Conversely, no compensation is required if the CR has benefited the stripped entity. Understandably, given that the document is at the early stages, it is difficult to establish what the ATO would define, interpret and apply as “detrimental”. However, one area to consider is the commercial factors behind the CR.

If a prima facie case exists for compensation, the second question is how to calculate the figure. Notwithstanding the unique and differing facts in each CR, it is important that the legal basis for calculating the compensation payment is justifiable and transparent. One option is to calculate on the basis of the profits forgone in the country where the functions, assets and risks have been stripped. In saying this, one has to be mindful of the statutory burden of proof in Australia, which sits on the MNC.

X. INTANGIBLE PROPERTY

“Transfer pricing, source of income and determination of legal and economic ownership of group intangible assets represent the tax problems with which authorities around the world are now wrestling. Traditional methods of taxation, developed on a different technological era, will have to be adapted to take into account the changing nature of undertaking business in a virtually borderless world⁸⁰”.

Transfer pricing disputes involving sale or license of intangible property has increased from 24% in 1995 to 35% in 2007⁸¹. In 2007, the Coco-Cola brand was the top rated brand in the world⁸², valued at 65.3 billion dollars. Undoubtedly, transfer pricing involving intangible property would have to be one of the most difficult areas for MNC⁸³.

The root of most of the real issues with IP transfer pricing stems from its fundamental characteristics⁸⁴, i.e. its uniqueness. This uniqueness gives the IP its value and the competitive edge, which is why MNC's are not prepared to allow un-associated entities to exploit their IP.

Given that there are several issues in relation to IP and transfer pricing in general, the emphasis in this section is on the valuation aspect. The reference to valuation of IP covers all the broad permutations that permit a subsidiary to exploit the IP, which can be broken down into two categories and are consistent with the group's ownership strategies.

The first category refers to situations where the group's policy is to centrally own and control the IP. Typically referred to as the licensee and licensor set up, this set up allows for royalty payments for the exploitation of the IP or the right to use the IP. Alternatively, the group could own the IP on a distributed basis, where members in the group would have ownership on an agreed basis. The commonest example of

⁸⁰ P Anderson: “Australia” (1997) International Tax Review 9

⁸¹ Ernst and Young: “International Tax Survey – December 2007”, page 17

⁸² http://www.ourfishbowl.com/images/surveys/Interbrand_BGB_2007.pdf, page 13

⁸³ Burns, John : “Transfer Pricing and Intangible Property”, page 1

⁸⁴ Adams D Chris, Godshaw M Gerald: “Intellectual property and transfer pricing”, International Tax Review, London 2002, Iss 8

this is a CSA, which is discussed in Part IX of this research paper.

A. Intangible Property – Approach by OECD

The New Zealand transfer pricing statutory framework does not provide a definition of IP. However, the OCED provides some guidance on this matter and splits IP into trade and commercial intangibles. It provides a general description of intangible property⁸⁵:

“...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).

One interesting afterthought when analysing the definition is that notwithstanding the IP being absent from the Statement of Financial Position, it still represents a good and significant portion of the company's value.

The types of IP that are included in commercial intangibles are patents, know-how, designs, and models⁸⁶. These IP's are generally used for the production of goods or the provision of services. Trade intangibles or marketing intangibles have been analysed under Part VIII of the research paper.

The OECD do acknowledge that IP is one of the difficult areas to “evaluate for tax purposes⁸⁷”, and consequently caution is required when an MNC is establishing the transfer price. There could be several possible reasons that has contributed to or exacerbate this problem.

Firstly, while it is important to establish if IP is involved in cross border transactions, it is sometimes difficult to even establish if a trade or marketing IP exists. Not all R&D expenditures necessarily lead to the creation of a trade intangible. The obvious example is the substantial amounts of money expended into finding a cure for AIDS, which to date have been unsuccessful. Connected to this, if an IP has

⁸⁵ OECD Guidelines, paragraph 6.2, page VI-1

⁸⁶ Ibid, page VI-1

been identified, to what extent one can reasonably measure it against the super profits as there would be several internal and external factors that would have contributed to the success of the IP.

Secondly, depending on the jurisdictions that the taxpayers are operating in, the different types of IP are defined differently and consequently the tax implications are different. An example of this is the tax treatment of a know how contract and a service contract. An inconsistent approach as such does not confer a degree of certainty to the MNC. To this end, the OECD has raised this issue in its Working Parties⁸⁸ to discuss such issues.

Thirdly, given that taxpayers interact in an environment of dynamic and constant evolution, arguably, the above definition does not cover the plethora of IPs that have been created. Secondary to this, if the definition does cover these sorts of new and emerging IPs, how does one categorise them with a degree of comfort and acceptance.

B. Ownership of IP

Legal ownership of an IP is an important distinction (when compared against economic ownership) as the tax treatments are quite different. Interestingly, the OECD does not provide any substantive guidance on how to establish legal ownership of an IP. Instead it sets out the approach to establish legal owner for “marketing activities undertaken by enterprises not owning trademarks or trade names⁸⁹”. Consistent with the failure to provide clear guidance on establishing legal ownership, the ATO⁹⁰, which do acknowledge the importance of identifying the legal and economic owner⁹¹, do not provide any guidance on this matter.

Typically, for transfer pricing purposes, ownership of IP can be broken down into two categories. Legal ownership of IP requires that the party have legal

⁸⁷ Ibid, page VI-1, para 6.1

⁸⁸ Ibid, page VI-8, para 6.19

⁸⁹ Ibid, page VI-13 para 6.36

⁹⁰ When analysing Division 13 of the ITAA which is the statutory provision for the transfer pricing rules

ownership or possession of the IP. Factors that indicate one party has legal ownership include:

- Ability to grant license and assignment of rights to use the IP
- Rights on exclusivity and prohibition
- Originality of work

Generally, the test for who owns the IP is by establishing the party that “bears the expenses and risks associated with its development”⁹². A simple and straightforward way is checking that the party that claims to be the legal owner does in fact have legal title to the IP. It is important to establish if one party has legal ownership as typically they will have exclusive rights to control the IP. Once this has been established, the legal owner becomes entitled to all “income attributable to the IP”⁹³. Moreover, legal ownership prohibits a subsidiary in a foreign jurisdiction to create its own IP, distinct and separate from the IP owned by the parent⁹⁴. The reasoning behind this is that unless an agreement exists that effectively disallowing all control/ownership by the parent, the local advertising and promotion expenses in relation to the IP are to be attributed, wholly or in part to the parent⁹⁵.

The economic ownership of IP has been analysed in Part VII of the research paper, an example of which was the Zantac drug in the *Glaxo* case.

C. Protection of IP

Given that IP is a very important part of a business, it is important to outline the protection mechanisms that exist to safeguard these assets. In saying this, there are forms of IP that exist as part and parcel of a business⁹⁶ and are inseparable. Further, there are other forms of IP that are covered by secrecy.⁹⁷ These situations complicate the quantification of an appropriate and acceptable royalty rate.

⁹¹ TR 98/11

⁹² IRD: taxation Information Bulletin, Vol 12, No 1(January), Appendix, page5 7

⁹³ Ibid, page 56 para 432

⁹⁴ Ibid, para 433-435

⁹⁵ Ibid, para 500-508

⁹⁶ An example is Goodwill which is attached to the business

⁹⁷ An example is Know how

If a MNC has a unique trade mark or patent, they may wish to seek legal protection under the Patents Act 1953. This essentially confers protection against situations of “passing off” i.e. prohibits other business from using the trade mark or patent, which is detrimental to the registered owner of the IP. The Patents Act 1953 also grants the owner of new patents an exclusive right to exploit the IP for a period of up to 20 years.

Registration for logos, names or marks are also permitted as long as they are used in a business, under the Trade Marks Act 2002. They are subject to renewal every 10 years. The legal rights conferred to the owner of the IP are consistent with the above, essentially granting the exclusive right to exploit.

The Copyright Act 1994 confers legal protection for the expression of ideas and applies to literary, musical, artistic works, software etc⁹⁸ as long as the work is “original”. The protection period is limited to the life of the “author” plus an additional 50 years.

D. Intangible Property – Approach by Inland Revenue

Inland Revenue acknowledges that the area of IP is “one of the most difficult areas to apply correctly in transfer pricing⁹⁹” There are two circumstances that give rise to such an acknowledgement:

Firstly, the transaction could be bundled and be inclusive of both tangible and intangible property. Hence, this makes it difficult to extrapolate the IP component in the transaction.

Secondly, the MNC could decide for commercially justifiable reasons to structure their business in a manner dissimilar to that of independent parties.

⁹⁸ Refer Section 14 of Copyright Act 1994 for full list

⁹⁹ IRD: Taxation Information Bulletin, Volume 12, No 1 (January 2000) Appendix, page 54

Given the uniqueness of the IP, the search for comparable data is complicated. In applying the comparable data for transfer pricing purposes involving IP, an important consideration is to establish the reliability of the comparables¹⁰⁰. The reason is that given the unique characteristics of an IP, minor differences could result in material differences¹⁰¹.

Clearly, a functional analysis becomes a vital exercise in establishing the arms length prices and should highlight the following¹⁰²:

- Ownership of the IP
- True nature of the IP that is being transferred
- Terms and conditions under which the associated party is using the IP
- Factors that have led to the creation of the IP

Additional to the functional analysis and before establishing the arms length pricing of the IP, it is important to “ascertain what the transaction involves¹⁰³”. This process identifies “what it is that will need to be priced¹⁰⁴” and assists in the search for useful comparables.

Inland Revenue has acknowledged that compared to OECD countries, New Zealand has a relatively “low level of intellectual property¹⁰⁵”. This minimises the risk of “high profit intangibles” being transferred out of New Zealand. One indicator in identifying locally created IP is through the analysis of the local remuneration packages, i.e. paying substantial amounts for specialist skills, which creates a non routine intangible. There is a clear concerted effort in identifying and understanding the “inbound licensing of intangibles¹⁰⁶”. In this regard, the IRD seek clarification to

¹⁰⁰ Ibid, page 55, para 426

¹⁰¹ Ibid, para 425

¹⁰² Ibid, page 5

¹⁰³ Ibid, para 428

¹⁰⁴ Ibid

¹⁰⁵ Nash, John:” Transfer Pricing”, New Zealand Institute of Chartered Accountants, 2005 Tax Conference, page 14

¹⁰⁶ Ibid, page 14

the following questions¹⁰⁷:

1. Have all intangible profit drivers been individually identified (including goodwill and any licensed IP)?
2. What is the value of all intangibles owned and used by the company and have they been valued by a professional firm?
3. Is the IP protected?
4. Who bore the cost of creating the IP?
5. How and to what extent does the IP contribute to the profit?
6. Has any IP been assigned and if so, what was the consideration?
7. How is the IP documented?
8. If a royalty is paid for the use of any IP, does the taxpayer produce appropriate profits for its functions, assets (including its own intangibles) and risks after payment of the royalty?

E. Goodwill

Goodwill is an important intangible property with intrinsic and peculiar traits, often posing major challenges for taxpayers and revenue administrators alike. For this reason, and the absence of legal definition of “goodwill”, it is useful to analyse the approach by the Courts.

The Courts have acknowledged that goodwill is an accounting, business and importantly a legal concept. Invariably, there have been instances where the definition of goodwill for accounting purposes has been applied to the legal environment. In New Zealand, International Accounting Standards (IAS -38) is authority for

¹⁰⁷ Ibid, page 14

accounting purposes. Useful jurisprudential authority can be found in the *Murry*¹⁰⁸ case, which involved an arguably simple interpretation on whether or not the disposal of business assets (namely tax license and certain shares) constituted goodwill for taxation purposes.

In handing down the judgement, *Hayne JJ*¹⁰⁹ confirmed the complexities in defining goodwill. In this instance, the Australian taxation legislation did not define goodwill. *Hayne JJ* cited with approval the judgement of *Lord Macnaghten*, as follows¹¹⁰:

“What is goodwill? It is a thing very easy to describe, very difficult to define”

The High Court in this case further acknowledged the different interpretations of goodwill from a legalistic and an accounting perspective. In handing down the judgement, the High Court confirmed that “many of the sources of goodwill are not themselves property¹¹¹” and effectively “widened” the net on the types of goodwill, which included:

”manufacturing and distribution techniques, efficient use of a business, superior management practices and good industrial relations with employees...”¹¹²

While this definition is concomitant to the definition of IP by the OECD¹¹³, the two important issues are:

- Identification of the different types of goodwill.
- Reliability in measurement

From an accounting perspective, goodwill is the difference between the fair value of the assets and the purchase price. To illustrate the problematic nature of goodwill, let’s theoretically postulate the facts in the *Glaxo* case and more importantly, the success drug Zantac. If *Glaxo* disposed off the IP to a third party who purchased the product on the back of substantial sales, and a small portion of those consumers after trying Zantac had disastrous and permanent long term medical

¹⁰⁸ Commissioner of Taxation (Cth) v Murry[1998] HCA 42;193CLR 605

¹⁰⁹ Ibid, para 12

¹¹⁰ Ibid, para17

¹¹¹ Ibid, para 25-29

¹¹² Ibid, para 25

¹¹³ Refer OECD Guidelines page VI-1, para 6.2

conditions. This would diminish the success of the brand, possibly leading to its failure and a major downturn in revenue. This simple example demonstrates the susceptible nature of goodwill.

Essentially, the key precedent that came out of the *Murry* case, *iter-alia* was that “goodwill does not exist apart from the business to which it is attached¹¹⁴” or “an existing business is the *sine qua non* of goodwill which cannot exist independently of the business which created and maintains it¹¹⁵”

Although we have an appreciation of what is goodwill, for transfer pricing purposes and cross border transactions, the key issues identified at the foot of the previous page still poses major challenges. This is notwithstanding that any valuations for goodwill and any subsequent compensation has to be consistent with the arms length principle.

F. Hidden Intangible Property

There are various forms of IP which are not visible when compared to IP's such as brands, trademarks etc. Examples of such hidden intangible properties are monopolies and oligopolies. MNCs trading in a monopolistic market essentially enjoy a valuable and privileged position. This position could soon disappear or be reduced if the high levels of profitability motivate other businesses to come up with comparable products and substitutes.

G. Bundled/ Embedded IP

Also referred to as “package deals¹¹⁶”, it complicates the valuation of an IP. It essentially flows from situations where a single charge has been levied by the parent and may include licensing of IP, sale of inventory and the provision of technical services. The revenue authorities will want to isolate the different components as they each have separate tax treatment under their domestic rules, subject to modifications

¹¹⁴ Commissioner of Taxation (Cth) v Murry[1998] HCA 42;193CLR 605

¹¹⁵ Ibid, para 48

¹¹⁶ Harr-Prescott Leslie and Edwards Keith: The New Zealand Transfer Pricing Environment for Intangible Property”, October 2006, NZICA Conference 2006.

imposed by the DTA. However, the practice of Inland Revenue is not to separate the IP from the physical products that are patented¹¹⁷. Inland Revenues approach to embedded IP is to “make the entity without the IP the tested party”¹¹⁸,

H. Valuation of IP

The statutory expectation to establish arms length pricing applies to both tangible and intangible properties. However, as outlined above, the application of the principle is difficult and not straightforward. The election to use the traditional transactional methods¹¹⁹, involves the identification of external comparable data, which for the reasons outlined above is complicated in its application. The following factors needs to be carefully analysed when comparing the intra-group transactions against the uncontrolled transactions¹²⁰:

- Expected benefits from IP
- Export restrictions on goods produced
- Capital investment
- Start up expenses
- Possibility of sub-licensing
- Licensee’s distribution network

The Profit Split (“PS”) method is an alternative to the traditional and transactional methods that could be adopted by a MNC that is facing difficulties in finding comparable data. The adoption of this method is particularly important when MNC are valuing “highly valuable IPs¹²¹”. Inland Revenue endorses the use of this method if difficulties arise in locating suitable comparable data¹²². Essentially, the PS method involves combining the gross profit or operating profit within a group and allocating them on a justifiable and economical basis, relative to the contribution of the parties to the transaction. One advantage of using the PS method is that this method is not reliant on finding comparable independent transactions. Consequently,

¹¹⁷ Ibid, page 10

¹¹⁸ Ibid, page 10

¹¹⁹ The methods are CUP, Resale Price, Cost Plus Method and TNMM

¹²⁰ OECD Guidelines: page VI-8, para 6.20

¹²¹ OECD Guidelines, VI-10, para 6.26

comparability factors connected with functions, risks, assets, products etc are largely irrelevant.

Despite being an alternative, this subjective method, especially in the quantification of the contribution of the parties could arguably minimise or eliminate its adoption. Additionally, is the adoption of this method consistent with the statutory expectation to select the most reliable method¹²³. Consequently, care and judgement is required in establishing factors that have a material impact on the contribution of the profits.

Generally, the level of profit is calculated by either using EBIT or EBITDA in some circumstances, supported by profit indicators including Berry Ratio, asset return percentage etc.

The Profit Split (“PS”) method is the preferred method by Inland Revenue¹²⁴. However, despite this acknowledgement, Inland Revenue follow two basic rules regarding its operation, which essentially forms the basis of the PS method¹²⁵:

Firstly, a licensee will not enter into a license that will reduce the profit it has historically made.

Secondly, the licensee requires and licensors accepts that the licensee must enjoy a benefit from the license agreement.

Another alternative method (similar in application to the Transactional Net Margin Method (“TNMM”) method outlined by the OECD) in the valuation of IP is the CPM, which theoretically compares the profits in cross border dealings in a MNC against those of independent parties, adjusted for functions, risks and assets. Similar to the adoption of the PS method, there are practical difficulties in the application of this method, i.e. the degree of subjectivity in quantifying the profit expectation of the licensee. Moreover, this method works on the underlying assumption that an

¹²² IRD: Taxation Information Bulletin, Vol 12, No 10, October 2000, page 60, para 465

¹²³ Section GD13(6) of Income Tax Act 2004

¹²⁴ Harr-Prescott Leslie and Edwards Keith: The New Zealand Transfer Pricing Environment for Intangible Property”, October 2006, NZICA Conference 2006.

¹²⁵ Ibid, page 16

“adequate level of information exists about the related party¹²⁶” as the results could be distorted if all the information is not incorporated in the analysis. The types of information that could have a bearing on the analysis and includes location savings, efficiency differences including economies of scale, capital structure etc.

Clearly, the valuation of IP is an important exercise for an MNC in establishing their transfer price. The key question is how to establish the arms length pricing of the use of the IP? The answer, arguably subjective could be found by both the taxpayers and the tax administrators checking their transfer prices against those of independent and un-associated entities, taking into account the uncertainties around the valuation of the IP. If there are insufficient comparables to support the transfer prices, there exists the possibility to adopt a valuation based methodology. The OECD provides some guidance on how to account for the uncertainties in the valuation of IP¹²⁷ from the perspective of the independent parties. One such method is the “anticipated benefits¹²⁸” which takes into consideration all the pertinent economic factors. Under this approach, the independent entities would factor in any future foreseeable and anticipated modifications to the IP. Alternatively, the independent parties might resort to short term agreements to hedge against the risks arising out of the valuation of the IP. Notwithstanding the method adopted, the crucial question is “how much extra value does the intangible create¹²⁹?”

I. Alternative Valuation Approaches

Given the uncertainties in valuing IP under the statutory methods¹³⁰, it is useful to consider the alternatives that are available. Notwithstanding the valuation method adopted, the view of Inland Revenue is that “...the licensee must derive a measurable benefit from the IP licensed before payment of any royalty¹³¹”. Additionally, the payment of royalties should be only from “super profits”, which are the profits over

¹²⁶ IRD: Taxation Information Bulletin, Vol 12, No 10 October 2000, para 470

¹²⁷ OECD Guidelines, page VI-II

¹²⁸ Ibid, page VI-II, para 6.29

¹²⁹ Ibid

¹³⁰ Refer GD13(7) of Income Tax Act 2004

¹³¹ Harr-Prescott Leslie and Edwards Keith: The New Zealand Transfer Pricing Environment for Intangible Property”, October 2006, NZICA Conference 2006.

and above the industry return¹³².

1.0. Cost Approaches

These approaches are based on the economic principles of substitution and price equilibrium¹³³, essentially working on the premise that potential buyers will pay no extra for the asset than the costs to develop or obtain legal rights. These approaches seek to establish the value of the IP by consolidating the total costs. From a theoretical perspective, this approach seems workable. However, difficulties arise in establishing the “costs”, which are largely dictated by the “supply and demand and the availability of substitutes¹³⁴”. A further drawback to this method is that it does not account for the economic benefits that flow from the markets.

2.0. Market Approaches

The underlying principles of substitution and equilibrium are also common to this method. Under this method, the IP is valued by comparing and utilising actual values from the IPs that have been sold, transferred or licensed etc. The problem with this approach is that it is very difficult to locate market based comparables as IPs are unique by definition and seldom disposed of in the open market. Even if comparable transactions were located, the other issue is that it is generally difficult to extract key information regarding their components and elements. If the above issues are addressed and reliable comparable data has been obtained, this method is reliable as it uses the market data to value the IP.

3.0. Income Approaches

Underpinning this approach is the “economic principle of expectation¹³⁵”, i.e. an investor will pay the present value of future economic inflows for the IP. Framed another way, the future income is discounted using a present value to establish the current values. Adoption of this approach is subject to two constraints. Firstly, the MNC has to carefully isolate only the income from the IP, excluding income from the

¹³² Ibid, page 18

¹³³ Ibid, page 17

¹³⁴ Ibid, page 17

¹³⁵ Ibid, page 17

business. Secondly, since the process works by discounting future income to current values, one has to have a very detailed and thorough understanding of the impacts of competition and the general economic environment. If the impacts of these two are not considered, it could contribute to distorted outcomes, thus making the whole exercise counter-productive.

When choosing a method to determine the value of the IP, it is recommended that the following factors be considered¹³⁶:

- Identification of substitutes
- Availability of information to determine key influences on prices paid in observed transactions
- Ability to identify cash flows and earnings that can be attributed to the IP
- The ability to determine the required rate of return need to discount earnings and cash flows attributable to the IP

¹³⁶ Ibid, page 17

XI. ARMS LENGTH PRINCIPLE

“No one knows what arm’s length means. This is especially true because there are simply no comparable transactions for many of these companies. The arm’s length standard exists in a world of smoke and mirrors. The arm’s length standard pretends that related companies behave as if they are unrelated, and assumes that in each market place there are willing buyers and sellers. This assumption clearly does not work where the market is controlled...no one knows or can agree on what exactly is arm’s length standard¹³⁷”

Interestingly, this quote was made by Ms Francis Zuniga who was a former IRS International Examiner. Given the inherent difficulties in the transfer pricing rules, most jurisdictions have minimum expectations, which involves exercising their minds and coming up a fair and acceptable transfer price , supported by some actual uncontrolled comparable with an un-associated and independent MNC.

Notwithstanding these expectations, it is still possible to manipulate income in two ways. Firstly, given the inherent lack of comparable transactions, the tax administrators are often identifying a spectrum of acceptable transfer prices. Secondly, given the uniqueness and intricate nature of different businesses, this will make the search for comparable more difficult.

A. Introduction

What has been established in the preceding pages is the contentions nature of what constitutes arm’s length principle (“ALP”). The importance of arm’s length cannot be under-emphasised as it could have huge financial consequences. The lack of reliable external comparables has strained this issue. There is a great deal of reluctance on revenue authorities to rely on internal comparables. A useful point before understanding what ALP and its application is to define ALP.

From a pragmatic point of view, the ALP is workable and an internationally recognised method. However, the discussions in the subsequent sections will

¹³⁷ McCormack, J: “Getting What You Pay For: Transfer Pricing and Division 13”, NSW Intensive Seminar, Taxation Institute of Australia, (October 1992) 29, quoting Ms Frances Zuniga

demonstrate that it is not a perfect model.

B. Definition of ALP

Paragraph 1 of Article 9 of the OECD Model Tax convention is authoritative statement of ALP. It states:

“[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 accrued, may be **included** in the **net profits** of that enterprise and taxed accordingly.”

C. Principle of Comparability

Implicit in the definition of ALP is the principle of comparability. Essentially, an analysis is undertaken between comparing the conditions between two associated persons against two independent parties. In other words and simple terms, would an un-associated party have paid the same amount as the associated party for the supply of goods and services, discounted for risks and assets used.? If the prices charged are not arm's length when benchmarked against the comparable data, this forms the basis for a transfer pricing adjustment

The OECD has issued a discussion document on comparability. Its prefatory page clearly sets out the mandate¹³⁸:

“Comparability issues encountered when applying the transfer pricing methods authorised by the 1995 TP Guidelines”

Comparability is an issue that is becoming an impediment in cross border transactions and its importance will increase given the spread of globalisation. From a theoretical perspective, it is conceded that this principle is understandable and workable given that ALP is well settled as the most direct way to establish prices¹³⁹.

However, its application gets complicated when an attempt is made to search for comparables as part of this comparability analysis. While these two steps are

¹³⁸ OECD: “Comparability: Public Invitation to Comment on a Series of Draft Issues Notes”, 10 May

¹³⁹ Ibid, page 5.

mutually exclusive, they are quite clear and should not be confused or separated. In this regard, the OECD have acknowledged the “disconnect between these two processes¹⁴⁰”. Put another way, what has to be comparable to be comparable?

Before searching out the comparable data, it is useful for the taxpayer to perform their own analysis and establish the degree and nature of their controlled transactions with the parent, referred to as the “broad base analysis¹⁴¹”. Typically, it will involve broad perspective on factors such as the nature of industry, competition, assessment of regulatory factors etc.

One issue with the comparability analysis is the cost incurred in obtaining the relevant data. In establishing the transfer pricing risk, the application of ALP does not make any distinction is made between its application to large taxpayers and small to medium taxpayers. However, the OECD recommends a “prudent business management¹⁴²” approach to theoretically establish ALP. Under these circumstances, an assessment requires asking the following question¹⁴³:

“...whether the conditions of the controlled transactions under review are consistent with what a reasonable independent party “*would have done*” if confronted with the same opportunities or set of circumstances”

Undeniably, the reason for the costs incurred in locating comparable data is its scarcity¹⁴⁴. There are several reasons that have contributed to this problem. Firstly, and unlike New Zealand, most countries do not have a legal requirement to lodge financial statements with the equivalent of the Companies Office. Against this constrained nature, taxpayers operating in unique and highly specialised areas are less likely to submit their financial statements for the sake of disclosing factors that give them the competitive edge.

Thirdly, and probably the most important point is the New Zealand is the size of the local market. New Zealand could be described as¹⁴⁵:

¹⁴⁰ Ibid, page 6

¹⁴¹ Ibid, page 6

¹⁴² Ibid, page 6

¹⁴³ Ibid, page 6

¹⁴⁴ Ibid, page 23

¹⁴⁵ Various information obtained from Statistics NZ at www.stats.govt.nz/NR/rdonlyres/30F1F283-F784-4306-8C7C-

- A population of 4.1 million people;
- A limited corporate population;
- An annual estimated GDP of NZD\$97.39 billion (2005);
- GDP per capita estimated at NZD\$25,200 (comparative figures are Australia NZD\$31,900 and United States NZD\$41,800);
- Free and open market with limited trade barriers;
- European (predominately British), Māori, Pacific Island and Asian cultural influences;
- An agriculturally based economy, with 8% of GDP attributable to the primary sector (more than double the OECD norm);
- Geographical isolation;
- Expansive land mass relative to population (i.e., NZ has one of the world's lowest population density).

Despite these positive characteristics which are good for marketing and tourism purposes, they are also self inhibiting for the purposes of transfer pricing. Consequently, taxpayers have to look at foreign sourced comparables to support their transfer pricing. The issue with foreign sourced comparables is verification, i.e. the information might not be able to be verified by the IRD.

D. Sources of Information

Working with the inherent difficulties in getting comparable data, generally tax administrators have three sources of information on external comparables¹⁴⁶.

1.0. Informal and confidential information

Taxpayers may have confidential information about certain businesses or industry types that has been obtained through interactions with each other. Using these information raises complicates the administrative requirement around record keeping. Further, the onus of proof is difficult to discharge due to confidentiality issues.

On the same vein, tax administrators have access to detailed confidential information about taxpayers obtained either through the taxation returns or

[88D00F602163/0/NZinProfile2006.indd.pdfandWikipedia](#)aten.wikipedia.org/wiki/New_Zealand#Economy
¹⁴⁶ Ibid, page 23

compliance audits. This information could be classified as “secret comparables”¹⁴⁷ and poses similar challenges as outlined in the previous paragraph. In saying this, the CRA used secret comparables in the *Ford*¹⁴⁸ case, which essentially involved the utilisation of third party confidential data for the purposes of satisfying and “squeezing out”¹⁴⁹ the minority shareholders in Ford Canada.

Although the case provided a good discussion on ALP, the Ontario Superior Court rejected the use of the secret comparable by *Ford*. This rejection is notwithstanding the CRA issuing an official document¹⁵⁰ which stated that “in the event that comparable information is not available publicly, the CRA uses confidential information obtained from third parties”¹⁵¹. Undoubtedly, there are instances when the search for comparables are complicated and difficult¹⁵². This does not create the presumption and more importantly, give approval to utilise confidential information, obtained for other means.

2.0. Databases

This can be broken down into commercial databases and proprietary databases. Commercial databases are developed by external parties that extrapolate relevant information filed by companies and present them in an electronic format. An example in New Zealand of this is Dunn and Bradstreet Limited. Despite the huge costs involved in receiving the data, the adoption of such databases is fraught with constraints.

The biggest constraint is that the information collated and provided by such agencies is designed for reasons other than transfer pricing. Although appropriate care and diligence should address any remedial concerns, it really calls into question the reliability of the external data.

¹⁴⁷ Ibid, page 24

¹⁴⁸ *Ford Motor Co. of Canada Ltd v. Ontario Municipal Employees Retirement Board* (2004), 41 B.L.R.

(3d) 74, [2004] O.J No 191 (Ont.S.C.J Commercial)

¹⁴⁹ McKenzie, B: “Transfer Pricing Annual Update Part 2”, page 16

¹⁵⁰ Transfer Pricing Memorandum (TPM-04)

¹⁵¹ Ibid, page 16

Given the above, any information stored in such databases, while being detailed enough does not provide sufficient detail to support the adoption of a particular transfer pricing method. Further, databases in different countries have differing levels of detail and reporting which does not provide any degree of comfort. Apart from this, the level of reporting in some countries is limited to comparing companies, as opposed to the transactions as these sorts of information are generally not disclosed.

Given these limitations, it is hardly surprising to note the position of the OECD¹⁵³. Given the tendency to encourage quantity over quality, commercial databases should only be used when they “add value”¹⁵⁴.

The second type of database is a proprietary database, which is designed for the same commercial reason as the other database. The concerns raised with the proprietary database are same as a commercial database. However, one key concern, unique to proprietary database is that the information stored on such databases are client orientated, i.e. limited disclosures on the market that the taxpayer is operating in.

In the event of a transfer pricing review, the issue of confidentiality becomes a material consideration as the information provided to such database belongs to the taxpayer.

3.0. Public Information

This is the last source for external comparable data and typically involves looking at annual reports of listed companies.

Notwithstanding the choice between the three options in the search for comparable data, what is common to all of these methods is the quality and the reliability of the information.

¹⁵² For example, if the IP is unique and possess special characteristics

¹⁵³ Ibid, page 28 - On this matter, the OECD acknowledge its importance and advise to supplement with another database

¹⁵⁴ Ibid, page 28

E. Justification for Internal Comparable

While the writer is not advocating the abandonment of the limited external comparables, there are instances where parties within a group would be reluctant to transact with an independent party. There is a general preference of external comparable data over internal comparable¹⁵⁵. The reason for this is that internal comparables are “likely to have a more direct and closer relationship to the transaction under review¹⁵⁶”. Further, the adoption of internal comparable comes with a degree of caution. There exists the potential to be relaxed around the maintenance of records making the whole process a “less objective selection process¹⁵⁷”. Further, there are accessibility issues around “reliable internal comparables¹⁵⁸”. In acknowledging the concerns around internal comparable, similar issue exist in the selection of external comparable data, i.e. which data would objectively assist in assessing ALP?

However, the caveat to this point is that internal comparables could be used if they are subject to rigorous analysis and if “reliable adjustments for differences between the transaction under review and the proposed internal comparable can be made¹⁵⁹”. If reliable adjustments for differences cannot be made, then internal comparables cannot be used.

It is also possible to use a combination of both internal and external comparable in the assessment of transfer pricing risks. Arguably, when comparing the gross profits of taxpayer A with a related party and un-associated party, the whole process is likely to be more reliable and easier

Notwithstanding the preference of the OECD for external comparables, there are real benefits in the use of internal comparables. Firstly, comparing two purchase transactions carried out by the same buyer or two sales carried out by the same supplier, the quality of the comparability analysis is likely to be enhanced¹⁶⁰.

¹⁵⁵ Ibid, page 19

¹⁵⁶ Ibid, page 19

¹⁵⁷ Ibid, page 21

¹⁵⁸ Ibid, page 19

¹⁵⁹ Ibid, page 19

¹⁶⁰ Ibid, page 19

Secondly, the real costs associated in accessing information on internal comparables are reduced and this facilitates the prompt completion of transfer pricing reviews. When compared against the drawbacks with external comparables, the adoption of internal comparables is certainly an attractive proposition.

F. Approach by Inland Revenue

In New Zealand, the transfer pricing rules are based on the application of the ALP. This approach could be classed as a principle based approach (or alternatively principle based legislation), i.e. the operation and the statutory expectation of the regime are based on agreed principles, quite distinct to specified definitions¹⁶¹. This broad brush approach fundamentally revolves around the “operation of market forces¹⁶²”, involving real bargaining in setting of prices. Emanating out of this, the prices charged between associated parties [for inter-company transactions], referred to as “controlled transactions¹⁶³” involving the supply of goods or services are measured against “uncontrolled transactions¹⁶⁴” in the market.

The ALP has been enacted into the Income Tax Act 2004:

GD 13(6) [Method of applying arm's length consideration] For the purposes of this section, the arm's length amount of consideration must be determined by applying whichever 1 (or combination) of the methods listed in subsection (7) produces the most reliable measure of the amount completely independent parties would have agreed upon after real and fully adequate bargaining.

Theoretically, this principle seems workable and Section GD13 (6) sets clear expectations on taxpayers that are undertaking cross border transactions.

The IRD has endorsed the approach by the OECD on ALP. The reasons for this are as follows¹⁶⁵:

- The arm's length approach is considered the most reliable way to determine

¹⁶¹ See for example Section OB1 of the Income Tax Act 2004 which contains statutory definitions

¹⁶² IRD, TIB, Vol 12, No 10 (October 2000), page 10

¹⁶³ Ibid, page 10, para 58

¹⁶⁴ Ibid

¹⁶⁵ Ibid, page 11, paragraph 61

the amount of income properly attributable to a multinational's New Zealand operations

- Because the arm's length approach represents the international norm, the potential for double taxation is minimised

Unlike the IRS¹⁶⁶ and the ATO¹⁶⁷, the IRD have implicitly applied that the OECDs guidelines on transfer pricing will be binding in the event of cross border disputes.

Given the complexities involved in interpreting the taxation acts, coupled with its arbitrary nature, the failure to define ALP opens up lots of debate about what ALP actually is.

Interestingly, even the Government acknowledged the increased susceptibility to disagreements in applying the ALP.¹⁶⁸ A natural consequence of this is that it would lead to uncertainties and unanticipated tensions when the taxpayers are interacting with IRD. Further, this uncertainty will have a negative impact on the features of a good tax system. In fact the discussion document clearly summed up the application of the ALP as follows¹⁶⁹:

“...mere estimates of what prices what the price would have been if the transaction had been conducted between arm's length parties”

Notwithstanding these difficulties, two solutions were provided to make the legislation workable. The first approach involved taxpayers utilising a statistical database to see if their transfer pricing is within the upper and lower quartile, a practice prevalent in the United States.

The second approach involved taxpayers exercising judgement and making estimates about arm's length prices.

¹⁶⁶ See for example for *GlaxoSmithKline* analysis where the IRS did not use the DTA for arbitration purposes in settling the dispute.

¹⁶⁷ See for example the decision in the *San Remo* case where the Courts implied the sub-ordinate nature of the DTA compared against the domestic transfer pricing rules.

¹⁶⁸ Refer Government Discussion Document issued in 1995, Part B reform proposals, paragraph 7.2.13

¹⁶⁹ Ibid, paragraph 7.2.13

G. Comparability – New Zealand Approach

This is the most important principle that is at the cornerstone of the New Zealand transfer pricing regime. It forms a useful backdrop in the application of ALP. The New Zealand regime in many respects is unique. This uniqueness also has a downside, especially in the quest for searching comparable companies in establishing arm's length prices. The issue of comparability gets further complicated for several reasons, including the following:

Firstly, the product could be a branded product. The search for comparable data is limited and requires extensive adjustments.

Secondly, there could be confidentiality matters that restrict certain taxpayers or groups of taxpayers from disclosing protected information.

Lastly, there could be no relevant comparable data at all, making the whole benchmarking exercise rather difficult.

The application of the ALP imposes an administrative burden on taxpayers that undertake cross border transactions. When comparing controlled transactions against uncontrolled, adjustments need to be made for all “economically relevant characteristics¹⁷⁰” that affect this comparability. Interpreted another way, the whole benchmarking process is redundant if all factors that materially affect the data are not accounted and appropriately adjusted. The factors that impact on the comparability of the data include¹⁷¹:

- Characteristics of property or services/ Product Differentiation.

This is usually the starting point in the comparability process¹⁷².

Some of the characteristics that may have an impact on the comparability of data, especially in the allocation of tangible property include physical features (reliability, volume of supply, quality etc).

¹⁷⁰ OCED Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrators, page I-7

¹⁷¹ Ibid, page I-9, para 1.19

¹⁷² IRD: Taxation Information Bulletin, Volume 12, No 10 (October 2000)

- Functional Analysis

This aspect in the comparability process is more important than the last point¹⁷³. Generally when two independent parties interact, there is usually compensation for the functions performed by each of the parties, relative to the risks borne and assets used. In this analysis, the functions performed by the entity in the group are compared with independent parties. The intention behind a functional analysis is to identify “economically significant activities¹⁷⁴” that are provided by the entity, for which some form of compensation is expected. The process of conducting functional analysis is quite separate and should not be mixed with the setting of transfer prices, i.e. functional analysis is not a substitute in the search for comparables. It simply provides guidance on type of comparables that can be used in the setting of transfer prices.

- Contractual Terms

Another important aspect that needs to be considered is typically the agreement/contract will set out the responsibilities, benefits and risks that are to be borne by the parties.

- Economic Circumstances

Given that the arm's length prices will vary across markets and countries even for the same product, adjustments need to be made to account for matters such as substitute goods, size of the market, competition etc

- Government Policies

In some countries, the Government might intervene to set transfer prices. The intervention could be in the form of controlling outward flowing royalties, management fees, price controls etc. When faced with such situations, these “interventions are to be treated as conditions of the market in the particular country¹⁷⁵”, and should be considered in the ordinary sense. However, this

¹⁷³ Ibid, page 5

¹⁷⁴ Ibid, page 4

¹⁷⁵ Ibid, page 16

important issue is “whether independent parties would engage in transactions where there are Government interactions?”

H. Approach by OECD

Notwithstanding the positive spin offs in adopting ALP¹⁷⁶, the OCED acknowledge its constrained nature. Relying on market forces to set prices for goods and services, the OCED acknowledge the autonomy that exists within members in a MNC when undertaking commercial and financial transactions, leading to cost synergies and efficient allocation of resources. It would be fallacious on the part of the tax administrators to “assume that the associated enterprises have sought to manipulate their profits¹⁷⁷”. Certainly from an accounting perspective, it is an expectation of the management team to set prices that reflect arm’s length, consistent with the stewardship and the statutory fiduciary obligations under the respective Companies Act. Further, the implications of compliance with GAAP and the FRS/IFRS cannot be ignored as they impose onerous compliance obligations

I. Approach by ATO

Given that the Australia is one of our trading partners, it is useful to analyse the approach adopted by the ATO. Further, the ATO have had several transfer pricing tax cases which forms a useful backdrop when analysing the statutory framework against the judge made laws. Incidentally, the approach on ALP is in principle identical to the OECD guidelines on TP.

Statutory authority is found in Section 136AD of the Income Tax Assessment Act 1936, located in Division 13, Part III. Since this section is silent on the TP methods, the taxation rulings issued by the ATO needs to be considered.

The taxation ruling TR 97/20 provides guidance in establishing the arm’s length price, which replaced TR95/D22. The introductory comments clearly sum up the inherent difficulties with TP. It states¹⁷⁸:

“Transfer pricing is not precise science and applying the concepts requires some flexibility...”

¹⁷⁶ OCED Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrators, page I-3

¹⁷⁷ Ibid, page I-1, para 1.2

¹⁷⁸ ATO, Taxation Ruling TR 97/20, page 5, Chapter 1, point 1.1

The transfer pricing regime does not suggest a preference over the prescribed methods. It is acceptable for taxpayers to use a novel method¹⁷⁹, which does not invalidate the arm's length pricing, as long as it is consistent with the statutory intent of the transfer pricing provisions. Notwithstanding the method adopted, it is implicit that the transfer prices are a reasonable approximation of what would have been charged if the transaction was undertaken by independent parties.

In the search for comparable data to establish ALP which is not limited to Australia, the ATO pose a hypothetical question which is¹⁸⁰:

“What would have happened if the ownership link had been severed and the enterprise was motivated by its own interest?”

The rationale behind posing a hypothetical question is to get the taxpayers thinking about whether an un-associated person would transact in the similar manner. Framed another way, it is the independent party test which is important for comparability purposes. Theoretically, this would drive them away from pursuing their own motivations or economic interests. To achieve this, they could approach it from three related perspectives¹⁸¹:

Firstly, from an “external” view, which essentially brings out the associated cross border transactions and compares it against third parties.

Secondly, from an “process view”, which as the name suggests is an administrative issue and compares the conditions/environment that two associated entities operate in against un-associated parties.

Lastly, from a “performance view” which compares the profits that have accrued in the cross border dealings and whether this profit would be consistent if the parties were independent.

One practical concern from the analysis of the taxation ruling is that while it sets out the minimum expectations of the ATO in establishing ALP through the adoption of one of the methods, it does not clearly state the principles that are

¹⁷⁹ Case N69 (1962) 13 TBRD 270at 279

¹⁸⁰ ATO, Taxation Ruling TR 97/20, page 10

¹⁸¹ Ibid, page 10

applicable to these methods.

J. Assumption: Single Entity for Transfer Pricing

To make the operation of ALP effective, the TP rules work on the hypothetical and fictitious principle that the entities in the group are treated as unrelated, despite all other things being unchanged. Consequently, the ALP is “viewed by some as inherently flawed because of this approach.....¹⁸²”

This foundation for this principle certainly has several positive spin-offs. Firstly, it relies on the competitive economic and market conditions to allocate the resources and manage risks. This certainly has to represent an efficient measure. Arising out of this, secondly this environment places the MNC and independent parties on the same wavelength for taxation purposes, eliminating distortions that arise from differential or preferential tax treatment.

Notwithstanding this, there are practical constraints that do arise from the application of this contentious concept. Multinationals often and deliberately run integrated operations, where the allocation of responsibilities is spread amongst the members in the group. Through this integration MNC's are often able to achieve an efficient reduction in group total costs thus achieving economies of scale in areas such as allocation of risks, functions, logistics, development and management of intangible property, technological gains, research and development allocation etc. Replicating this integration and finding a comparable and un-associated entity to establish arm's length is difficult and not easy. Therefore, applying the ALP and breaking the entities in a group, treating them as separate entities will lead to ambiguities, relative to the profitability of the members and the closeness of the integration.

Secondly, there are certain activities that are conducted between two associated parties that an independent party may refuse to participate in. Take for

¹⁸² OCED Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrators, page I-4, Para 1.9

example, a strategic decision by management to establish a subsidiary, continuously sustaining losses and having a mere presence. A further example of a strategic decision driven with tax implications is transferring a valuable intangible property which was closely held to a subsidiary located in a tax haven. These arrangements and relationships between members in a MNC will fundamentally differ with comparable transactions in independent parties. In attempting to adjust for the significant differences, there could be the possibility that some of these differences are not capable of being adjusted. If some of these adjustments were capable of being made, a degree of caution and scepticism has to exist, making them disputable between the parties concerned.

Since the application of the ALP is premised on comparing transactions in a controlled environment to un-associated and independent parties, the above could make the whole search for comparable potentially fruitless. Therefore, to make the concept of ALP workable, it not only has to satisfy the statutory regulations but also clearly addresses the tax and business needs of the MNC.

K. Judicial Approach to ALP – Australian Tax Cases

It is useful to analyse the approach of the Courts in ascertaining the application of ALP. A useful starting point is examining Australian transfer pricing tax cases. For this research, only a selected number of cases have been analysed, commencing initially from the *Sam Remo*¹⁸³ case. Interestingly, *San Remo* sought judicial review on the administrative aspect of the audit undertaken by the ATO, seeking to quash the mandamus as the determinations made were a result of improper exercise of statutory powers. Similar approach was adopted by *E R Squibb*¹⁸⁴, the only reported transfer pricing case in New Zealand under Judicature Amendment Act 1923. Interestingly, this approach was taken in the *Daihatsu*¹⁸⁵ case, which did not cover in any great detail the whole area of transfer pricing.

¹⁸³ *Remo Macaroni Co v Commissioner of Taxation* [1999] FCA 1468 (27 October 1999)

¹⁸⁴ *Commissioner of Inland Revenue v ER Squibb & Sons (NZ) Ltd* (1992) 14 NZTC 9,146 Court of Appeal, CA 212/91.

¹⁸⁵ [2001] FCA (24 May 2001)

In arriving at a conclusion, effectively quashing the judicial review, the Court provided an interesting analysis in the area of transfer pricing. It confirmed the subjective nature of transfer pricing and application of ALP. The Courts even went to the extent of setting out possible permutations that MNC may utilise, including interposed entities incorporated in “low or no taxed country”¹⁸⁶ and obtaining “a deduction in full for the purchase of the stock under the general business deduction provisions”¹⁸⁷.

The relevant facts could be summarised as follows:

- *San Remo* was an Australian tax resident at all purposes, whose core business was the manufacture and distribution of pasta products;
- The Directors of *San Remo* made an executive decision around December 1984 to import pasta from Italy;
- This was facilitated by the Directors travelling to Europe, commencing discussions with Mr Seglias, who was associated with international accountancy firm Howarth and Howarth regarding *inter-alia* incorporating a Swiss company and conducting several visits to the Italian manufacturers. Interestingly, this accountancy firm also acted for San Remo on various matters in Australia;
- Mr Seglias incorporated *Bigalle SA* in February 1985, a Swiss corporation and held 98% of the bearer shares. At all material times, *San Remo* maintained the view that they did not advance the idea about incorporating the Swiss company;
- San Remo executed an agreement with *Bigalle* in March 1985 to supply all the pasta products for the “Zafarelli” range for the domestic market for a minimum of 12 months;
- Products were ordered as follows:
 - San Remo instructing “Geinmex”, an Italian agent to order the products from the manufacturer;
 - Geinmex arranged for the order and the subsequent shipment of these goods

¹⁸⁶ Ibid, page 5141, para 6

¹⁸⁷ Ibid, page 5141, para 7

- The Italian manufacturer invoiced *Bigalle* for these products. *San Remo* would pay *Bigalle*, who in turn paid the local manufacturer.
- *Bigalles* mark up on providing this service was 56%

The ATO concluded that the interposed entity, *Bigalle* did not add any value to the business. It merely re-invoiced *San Remo* for the products that were imported out of Italy. Further, *San Remo* was able to function independent of *Bigalle* as it added no commercial or economic substance to the whole process of importing the products. It was “merely a straw/paper company with no substance¹⁸⁸”

Further, the ATO concluded that the parties were not dealing in “arm’s length” for the cross border transactions and sought to rely on Division 13 to adjust the transactions. Typically, Division 13 contains the domestic transfer pricing regime, applicable to associated and un-associated parties.

1.0. Analysis of Key Leanings

In handing the decision, several issues require careful analysis. Firstly, based on the evidence advanced, it was very clear that on paper, there was no association whatsoever between *Bigalle* and *San Remo*. This distinction is fundamental as the whole tenet of transfer pricing is designed to adjust cross border transactions between associated persons. The definition of associated persons in Australia¹⁸⁹ is similar to the definition in New Zealand¹⁹⁰. Essentially, both countries treat one entity to be associated with the other, if one owns at least 50% of the other.

The OCED defines “associated persons” as:

“Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise.

This decision has certainly tested the lack of association between the DTA and the domestic transfer pricing legislation. Further, the decision of the Federal Court has clearly indicated that the domestic legislation takes precedent over negotiated bi

¹⁸⁸ Idem, page 5147, para 43

¹⁸⁹ Part 6-5 Dictionary Definition, Division 995 and Section 820-605(1) of ITAA 1997

lateral agreements, in the form of DTA's. Unquestionably, the International Tax Agreements Act¹⁹¹ of which Australia is a member clearly states that the domestic legislation is sub-ordinate to the DTA. The inverse approach, endorsed by the Federal Court raises a further question about whether or not the taxpayer operating in the foreign country is able to seek relief from double taxation that will arise from the adjustments. This was one of the main reasons for having DTA¹⁹².

It is certainly questionable whether the outcome would have been the same if the ATO had used the DTA with Switzerland to support its arguments. The approach by the judiciary is analogous in parts to the approach by the US IRS in the *Glaxo* case, where it did not seek to use the DTA to initiate arbitration proceedings. This opens up the possibility of a wide range of conclusions and questions the application of the DTA's.

Notwithstanding the approach, the decision by the Federal Court is certainly reconcilable. There were several factual features that existed in the contract between *San Remo* and *Bigalle* that assisted the Court in arriving at a decision¹⁹³. Elements of the contract that the Court found unsatisfactory included the inability of the taxpayer to produce documents showing that real bargaining had taken place and setting out the terms and obligations of the parties¹⁹⁴. The Federal Court concluded that given the inability to provide explanations and produce documents, "one is inescapably drawn to the conclusion that *Bigalle* is merely a straw or paper company without substance...."¹⁹⁵,

The second issue that requires analysis is the approach by the ATO in providing comparable data as part of its evidence. The ATO used the CUP method in substantiating its arguments regarding the application of ALP. To support the arm's length prices, the ATO provided independent comparable data from three sources. Despite being straightforward in its application, there seems to be a preference by the

¹⁹⁰ Section OD8 of Income Tax Act 2004

¹⁹¹ Section 4(2)

¹⁹² Refer Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrators

¹⁹³ Idem, page 5147, para 46

¹⁹⁴ Ibid, page 5146

¹⁹⁵ Ibid, page 5147, para 45

Courts in the election to use this method. The judgement made no mention about the alternative methods that were available to be the ATO in the establishment of ALP. In effect, the Courts have endorsed the adoption of the CUP as the preferred method, a view that is consistent with the IRD¹⁹⁶. However, San Remo did not provide to the ATO any comparable data to support the basis of its transfer pricing.

What is most interesting is the approach by the Courts in the endorsement of this method. Although the ATO were incorrect in their calculations to demonstrate the arm's length prices¹⁹⁷, the Courts upheld the assessments on the basis that "a bona fide attempt was made to determine the arm's length prices....."¹⁹⁸ What this indicates is that the application of ALP does not provide any greater re-assurance than the decision to adopt it. So long as the arm's length pricing is between the acceptable levels, or the upper and lower quartile, then its acceptability is almost unquestionable. The key issue is balancing the need to uphold the statutory intent of the transfer pricing legislation and accepting what is reasonable given the "availability and reliability of information"¹⁹⁹. Unquestionably, issues with the application of ALP cannot be answered by "rigid and mechanical application of standardised or predetermined rules"²⁰⁰.

An important issue, not addressed in the judgement is the definition of arm's length. The Court accepted that the transactions between *San Remo* and *Bigalle* were not arm's length. It set out the characteristics that contributed to this conclusion. However, the elusive concept of ALP was not defined. In the absence of an express guidance on defining arm's length, it is useful to look outside the area of transfer pricing and establish what constitutes dealing with arm's length.

In the *Trustee for the Estate of the late AW Furse No 5 Will Trust v FC of T*²⁰¹, Hill J cited with approval a passage from *Barnsdall v FC of T*²⁰²:

¹⁹⁶ Refer Section GD13(7) of ITA 2004, which creates a de-facto hierarchy in setting out the TP methods

¹⁹⁷ Idem page 5152

¹⁹⁸ Idem, page 5152, para 72

¹⁹⁹ ATO TR 97/20, page 5, point 1.2

²⁰⁰ ATO, TR 97/20, page 5, point 1.1

²⁰¹ 91 ATC 4007

²⁰² Refer page 4015

“What is required in determining whether the parties dealt with each other in respect of a particular dealing at arm’s length is an assessment whether in respect of that dealing they dealt with each other as arm’s length parties would normally do, so the outcome of their dealing is a matter for real bargaining”

Quite clearly, if this definition was applied in the establishment of arm’s length prices and transfer pricing, it is not the supply of goods and services that is determinative of ALP, but the contract(s) between the parties. The emphasis is on the legal form over the substance approach, a view endorsed by the New Zealand judiciary²⁰³.

A recent case that has provided more clarity to the elusive concept of ALP is the *Syngenta*²⁰⁴ group of companies who challenged the ATO on providing documentary evidence in the establishment of arm’s length prices what was provided was insufficient.

In disallowing the taxpayers’ request, *Gyles J* discussed the objective test²⁰⁵, i.e. whether or not the property or the supply between independent parties represent arm’s length should be answered objectively, assisted by the evidence. Notwithstanding the above, *Gyles J* equally created the expectation on taxpayers, which was that they are in a better position or “much better equipped²⁰⁶” to deal with the issue of whether the transactions are arm’s length and should be in a better position to dispose of the Commissioners contentions. In disposing of the Commissioners appeal, the taxpayer only has to show that on the balance of probabilities, the Commissioner was incorrect in arriving at a figure which in its eyes is representative of arm’s length.²⁰⁷

In relation to the application of the DTA or the “treaty ruling²⁰⁸”, *Gyles J* observed that they represented a “practical consequence of the s 136AD and s 136AD Determinations²⁰⁹”. Given the decision of the *San Remo* case, this puts a different

²⁰³ See, *Europa Oil (N.Z.) Limited v Commr. of I.R. (No. 2)*; *Commr. of I.R. v Europa Oil (N.Z.) Limited. (No. 2)*, 1976) 2 NZTC 61,066 Privy Council. 13 January 1976.

²⁰⁴ [2005] FCA 1649 (9 November 2005)

²⁰⁵ Page 15

²⁰⁶ *Ibid*, page 15

²⁰⁷ *Ibid*

²⁰⁸ *Ibid*, para 20

²⁰⁹ *Ibid*, para 20

perspective as the Federal Court did not analyse the implications of the DT, leading to a logically conclusion about its sub-ordinate nature.

What is clear from the review of the above transfer pricing cases is that they have involved “procedural skirmishes²¹⁰”, i.e. judicial review until the decision in the *Roche*²¹¹ case, which was handed down by the Australian Appeal Tribunal (“AAT”) on 2 April 2008. The preliminary decision of Roche could be regarded as substantive in the area of transfer pricing notwithstanding the matter being decided in what we could be described as low court²¹². While this judgement will be regarded as a victory to *Roche* in respect of reversing the assessments imposed by the ATO, there are some important findings that are worthy of analysis.

Firstly, the AAT has acknowledged the complicated nature of transfer pricing, which essentially forms the backbone of disputes between the taxpayers and the revenue authorities. In this matter, *Downes J* acknowledged that “this has been a very complicated matter....²¹³”.

Secondly, it went some say in upholding the precedent out of the *Bausch and Lomb* case regarding low profitability as an indicator of unacceptable transfer pricing. In disposing of the argument advanced by the ATO regarding the low profitability of *Roche* Australia, compared to the worldwide group, the judge acknowledged that the legal owner of the patent was *Roche Switzerland* who was entitled to a profit on the use of the IP, and not *Roche Australia*. Additionally, if the subsidiary in sustaining losses in its operations, it is not direct consequence of their transfer pricing and that the transactions are not arm’s length. This effectively disposes any such “presumptions” from tax authorities.

Thirdly, while the statutory intention behind the transfer pricing provisions is to achieve arm’s length pricing for cross border transactions, which can be achieved by the adoption of some “novel method²¹⁴” other than the prescribed methods,

²¹⁰ http://www.gf.com.au/477_632.htm: Transfer Pricing Emerges From the Shadows, 10 April 2008, 1

²¹¹ *Roche Products Pty Limited v Commissioner of Taxation* [2008] AATA 261 (2 April 2008)

²¹² Contrast judgements out of the Federal Courts, Supreme Courts which are high appellate courts.

²¹³ *Ibid*, paragraph 194

²¹⁴ Refer ATO, Taxation Ruling TR 97/20

Downes J expressed that “...retreats to other methods, while avoiding one problem, are prone to result in the substitution of other problems, possibly more serious”²¹⁵.

Fourthly, the AAT had to decide whether the DTA conferred powers to the ATO to impose tax since it relied on both the domestic transfer pricing provisions and the DTA. The conclusion reached by the AAT, despite being a preliminary judgement was that the DTA does not confer powers to impose tax. As it turned out, it was immaterial in this case as the quantum was the same in both situations. Fifthly, when analysing the transfer prices charged by the parent to the subsidiary for the pertinent years in question, the transfer pricing for each year has to be computed separately and not consolidated with the other years. In this regard, *Downes J* said “It accordingly seems to me to be necessary to look at each year separately...”²¹⁶,

Lastly, and probably the most important point was the approach by the AAT in the whole area of comparable data. Unsurprisingly, the AAT endorsed the OECD²¹⁷ preference of traditional methods²¹⁸ of establishing the transfer prices over the profit based methods²¹⁹. The AAT have acknowledged that given the nature of industry taxpayers operate in, it really makes the task of getting comparable data difficult. A further complication is that specialist industries (for example pharmaceutical) because taxpayers are less likely to sell their unique products to third party.

When searching for comparable data, the Courts expect that “all arm’s length transactions are included”²²⁰ unless they are atypical. The caveat to this conclusion is that only comparables in similar to tested industries are to be included. If a particular industry has insufficient data to support the transfer prices, the tax administrators should be demonstrate the arm’s length prices be looking outside the industry. The ATO appeared to have adopted such an approach²²¹. In disposing this approach, *Downes J* said “I do not think that this explanation [referring to the evidence of Dr

²¹⁵ Roche Products Pty Limited v Commissioner of Taxation [2008] AATA 261 (2 April 2008), page 5, para 20

²¹⁶ Ibid

²¹⁷ Refer OECD Guidelines

²¹⁸ In particular the CUP method

²¹⁹ As opposed to the adoption of TNNM

²²⁰ Ibid

²²¹ http://www.gf.com.au/477_632.htm: Transfer Pricing Emerges From the Shadows, 10 April 2008,

Wright who used advertising agents as comparable for the marketing aspect of the sales and marketing function of Roche Australia's pharma division²²² justifies the using of profitability of international advertising agencies, as comparable to internal marketing deliberations of a pharmaceutical company²²³

In establishing the appropriate transfer prices, the taxpayers' are to utilise general accounting valuation principles to determine the market prices for comparable products. This goes a long way to correct the position that "there is something particularly special and arcane about transfer pricing in the tax area"²²⁴,

L. Judicial Approach to ALP – USA Tax Cases

Given the approach by the Australian Courts towards transfer pricing, it is important to analyse the approach by the US Tax Courts. For this research project, selected tax cases have been isolated, starting from *Bausch and Lomb*²²⁵. The relevant facts are as follows:

- BL had subsidiaries all over the world, manufacturing, marketing and selling soft contact lenses
- BL Ireland incorporated (1980) to take advantage of preferential tax benefits
- Agreement between BL and BL Ireland for granting use of technology to manufacture lenses
- Royalty of 5% paid in return
- Lenses sold by BL Ireland to BL for \$7.50
- IRS challenged the royalty agreement and transfer prices
- BL in its defence produced comparable evidence showing the price of lenses was on par or below \$7.50
- Further evidence of other uncontrolled transactions with similar lenses selling for more than \$7.50
- IRS argument based on functional difference, i.e. in-built component of R&D in the pricing

last accessed 22 April 2008

²²² Ibid, page 3

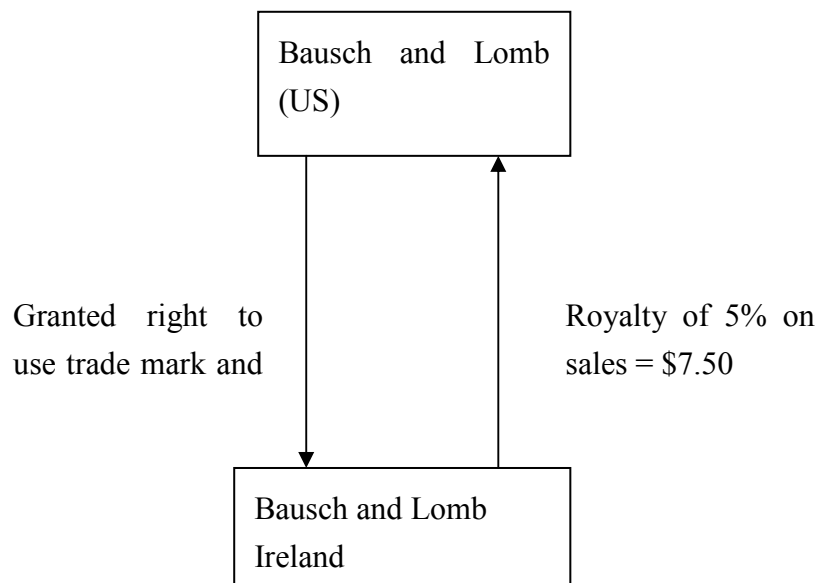
²²³ Roche Products Pty Limited v Commissioner of Taxation [2008] AATA 261 (2 April 2008)

²²⁴ http://www.gf.com.au/477_632.htm: Transfer Pricing Emerges From the Shadows, 10 April 2008

²²⁵ Bausch and Lomb Inc. v Commissioner of Internal Revenue, Tax Ct.Dkt.No. 4754-89, Cited as T.C.Memo 1994-1995

- IRS then advanced argument on volume difference, which will affect the pricing due to rebate system
- Last argument of IRS was that BL possessed unique technology that enable it to produce lenses at around \$1.50

Simple diagrammatic illustrations of the facts are as follows:



In disposing off all of the substantive arguments advanced by IRS, the Tax Courts enunciated several key findings. Firstly, if a MNC locates in one country to take advantage of the privileged tax shelters, the tax authorities should not use this to justify a transfer pricing adjustment. This principle was consistent with the decision in the *US Steel Corp.*²²⁶ tax case. Extrapolating this analysis further, there is case law²²⁷, cited in New Zealand that the tax administrators are not responsible for telling the taxpayers how to run their business, which will include the location of the subsidiary.. As long as the MNC complies with their statutory obligation in providing reliable comparable third party data, this is sufficient for transfer pricing purposes. Further,

²²⁶ *United States Steel Corporation v. Commissioner of Internal Revenue*, docket Nos 79-4092, 79-4112

²²⁷ *Ronpibhon Tin*

the motivation to locate in a jurisdiction that provides tax savings is arguably consistent with the *Duke of Westminster*²²⁸ principle.

Secondly, when performing functional analysis for the process of establishing comparable data, the mere fact that a functional difference exists should not trigger off a transfer pricing adjustment. If the functional difference does not correlate to the pricing, a strong case exists, *prima facie* for a transfer pricing adjustment.

Along the same vein, if there are volume differences that exist when comparing data, this should not be an indicator for a transfer pricing adjustment. This is notwithstanding that associated parties could negotiate a favourable purchasing policy. The market value of the products that are being compared is critical.

The IRS challenged the transfer price that arose through the “location savings”²²⁹ of an associated party, as seen in the *Sundstrand*²³⁰ case. Essentially, “location savings refers to the savings or other economic benefits generated by locating certain manufacturing functions in an offshore jurisdiction”²³¹. *Sundstrand* was the in the business of manufacturing and distributing CSD’s (constant speed devices), which was an integral part in the aircrafts generator. It granted an exclusive license to Sundstrand Pacific Limited (“Sunpac”) to manufacture the CSD’s. A royalty agreement was executed for the right to use the IP.

The Tax Court rejected the argument advanced by IRS and in doing affirmed the problem of transfer pricing, i.e. the difficulties associated in finding comparables when the products are unique and has special characteristics²³². Further, *Sundstrand* operated in a monopolistic environment hence the search for comparables were limited. To support the arm’s length pricing, Sundstrand hypothetically reconstructed the “location savings” that would accrue if the manufacturing were done in Denver,

²²⁸ Commissioner of Inland Revenue v. Duke of Westminster, [1936] A.C. 1

²²⁹ Patton, Michael F and Ors: “Location Savings after Sundstrand v. Commissioner: Out of the BALRM and Into the Game Room? Tax International Journal, July 12, 1991, page 283

²³⁰ Sundstrand Corporation and Subsidiaries v. Commissioner of Internal Revenue, Tax Ct. Dkt.No.26230-83, Cite as 96T.C.226

²³¹ Ibid, page 283

²³² Ibid,

Colorado. In the case of Sundstrand, there were around 300 different componentaries that were used in the manufacture of CSD's.

The IRS relied on *Sabena* Group to illustrate its transfer pricing argument and demonstrate comparable third party data. However, there were fundamental and important differences between *Sabena* and *Sunpac*.

Firstly, *Sunpac* bore the normal carrying costs of inventory in relation to the parts. Secondly, *Sabena* had a provision in its contract to return the un-used parts, which was not the case for *Sunpac*. Thirdly, *Sabena* intended to use the parts as spare parts, while *Sunpac* intended to sell them to airline operators to be consumed in the production of other products. Based on the above differences, the Tax Court rejected the use of *Sabena* as comparable data²³³. This decision is understandable as under the application of ALP, un-associated parties would have negotiated discounts for the risks that they are not bearing. Paraphrasing this, if the parties are carrying additional risks isolated in the functional analysis, then the appropriate adjustments need to be made.

M. Judicial Approach to ALP – Canadian Tax Cases

A case with arguably straightforward facts²³⁴ was the *Hofert*²³⁵ case, which involved the transfer price charged on the transfer of Christmas trees from *Hofert* Canada (subsidiary) to *Hofert* US (parent). The selling prices of the trees to un-related parties were different and higher than the selling price to *Hofert* US. This in essence formed the basis for the dispute with the Canadian Revenue Agency.

In outlining the essential difference between the market value of the trees sold to the parent against those sold to independent parties, *Fordham J* said:

"...entirely different from those that prevailed where the American purchaser was concerned"

²³³ Ibid

²³⁴ When compared with the facts with other cases discussed - for example Sundstrand

²³⁵ J. Hofert Limited v. Minister of National Revenue, 62 DTC (T.A.B.), p 50-53

The basis for the difference was that the parent was making a contribution towards the cost of the Christmas trees, regardless of its condition and more importantly, the independent parties had no obligation to purchase any unsatisfactory trees. Added to this, the US parent prepaid the cost of the trees in advance through its contribution in the harvesting process. Conversely, the independent parties made no such contribution until the Christmas trees was in a condition, satisfactory to their needs.

N. Statutory Burden of Proof

The Australian tax cases analysed have all had a common feature, i.e. they have sought assistance from the judiciary to compel the Commissioner in providing the supporting evidence to support the proposed determinations. The legal remedy is referred to as judicial review, a process which reviews the state of mind and the exercise of powers by the Commissioner in arriving at an assessment. In effect, judicial review seeks to nullify the assessments based on improper exercise of powers.

The reason for resorting to such legal avenue is connected with the statutory burden of proof in the transfer pricing regime. In Australia, the burden of proof is on the taxpayers to prove that the determinations issued by the ATO are incorrect. This issue was challenged in the *WR Carpenter*²³⁶ case. In this respect, it is worthwhile noting the observation of *Edmonds JJ*²³⁷:

“A major issue in this case is whether the Commissioners’ use of this power [referring to issuing of determinations] is subject to judicial review”

In declining the request by *WR Carpenter* to get the Commissioner to produce additional particulars, The Full Federal Court provides meaningful analysis to support the conclusion. For transfer pricing purposes, the starting point is that the existence of a “condition”. In this instance, the Commissioner is dissatisfied that the “parties to the agreement were not dealing at arm’s length with each other²³⁸”. Subject to the existence of this “objective condition²³⁹”, the transfer pricing regime allows the

²³⁶ *WR Carpenter Holdings Pty Ltd & Anor v FC of T* 2007, ATC 4679

²³⁷ *Ibid*, page 4683 para 12

²³⁸ *Ibid*, page 4683, para 21

²³⁹ *Ibid*, page 4683, para 21

Commissioner to exercise the statutory power. In exercising this statutory power, “it is not open to the appellant [in this case WR Carpenter] to challenge the Commissioners’ state of mind and reasoning processes leading to the making of determinations²⁴⁰”. The exercising of this statutory power is consistent with the intention of the legislation, as laid down by the Parliament. The legislation [in this case s.136AD (1) or (2) and (4)] are triggered when the Commissioner is not satisfied that the parties are dealing in arm’s length.

The judgement goes some way in endorsing the approach by the OCED²⁴¹ and the IRD²⁴² that market forces should form an independent measure of how prices are to be set. In this aspect, Edmonds *JJ* observed that²⁴³:

“The market may be able to tell the Commissioner without much difficulty, after appropriate consultation with economists and other experts, what the property in question would have fetched between arm’s length traders”

Further, these independent prices should provide a useful backdrop from which the analysis of establishing comparable pricing should propagate. Once the Commissioner has exercised his mind in establishing the arm’s length prices for inter-company transactions, subject to the taxpayers’ disproving the prices, the Australian transfer pricing provisions “provides for an incontestable tax²⁴⁴”. To this end, it is not “a matter of the Court substituting its opinion [in this case, WR Carpenter] of the arm’s length consideration for that determined by the Commissioner²⁴⁵”.

In contrast, New Zealand transfer pricing regime imposes the statutory burden of proof on the Commissioner²⁴⁶. In the quest for establishing arm’s length prices, the actions undertaken by the Commissioner are two fold²⁴⁷:

Firstly, the Commissioner has to exercise his mind and arrive at what he considers is arm’s length.

²⁴⁰ Ibid, page 4683

²⁴¹ Refer OCED Guidelines for Multinational Enterprise and Tax Administrators, para 1.3, page I-3

²⁴² Refer IRD Transfer Pricing Guidelines, TIB Vol 12, No 10 (October 2000) page 9, para 40

²⁴³ Ibid, page 4687, para 31

²⁴⁴ Ibid, page 4688, para 38

²⁴⁵ Ibid, page 4688, para 39

²⁴⁶ Refer Section GD13(9) of Income Tax Act 2004

Secondly, demonstrate that in arriving at the arm's length prices, the method adopted by the taxpayers does not provide the best reliable measure.

Given the onerous expectation on the Commissioner, it is logical to assume that unless the Commissioner has a very strong case, where the inter-company prices are beyond its acceptable levels of tolerance, then an assessment is highly unlikely.

There are two instances where the Income Tax Act "deems" a statutory shift in the burden of proof onto taxpayers²⁴⁸. Firstly, the obvious instance where the Commissioner is able to arrive at arm's length using another method. Secondly, where "the taxpayer has not co-operated with the Commissioner in the Commissioner's administration of this section in relation to that taxpayer and the non-co-operation has materially affected the Commissioner²⁴⁹" in the statutory administration of the provisions.

The key words that deserve further analysis are the "lack of co-operation" and "material". Section GD13 is silent on the definition and does not provide any explicit or implicit guidance what constitutes "lack of co-operation" and "materially". Obviously, the "lack of co-operation" is the antecedent step to "materially". In the view of the writer and mindful of the subjectivity nature, it is analogous to instances where there has been a breakdown in communication between the two parties which has led to the non-advancement of the issues. This conclusion has been arrived at on the pre-condition that the Commissioner has exercised the statutory requisition powers to interview the person(s) concerned²⁵⁰ and/or made formal requests for the supporting documentation²⁵¹.

The Policy Advise Division of IRD recently published a discussion document²⁵², which *inter-alia* proposes to shift the burden of proof to taxpayers in transfer pricing. The reason for such a shift is to make it consistent with other "burden

²⁴⁷ Section GD13(6) of ITA 2004

²⁴⁸ Section GD13(9) of the ITA 2004

²⁴⁹ Ibid, sub-section (b)

²⁵⁰ Refer Section 19 of the TAA1994

²⁵¹ Refer Section 17 of the TAA 1994

²⁵² New Zealand's International Tax Review: A direction for change, December 2006

of proof matters...”²⁵³. Further, this move will align the New Zealand transfer pricing regime with countries such as Australia and United Kingdom²⁵⁴. However, there seems to be an implicit reason that is motivating this change, i.e. the lack of transfer pricing cases in New Zealand due to the onerous statutory burden of proof.

Amongst the parties making submission, NZICA totally rejected the proposed shift in the burden of proof on the grounds that “it will allow IRD significant leverage in transfer pricing disputes²⁵⁵. The Institutes position appears to be driven out of the subjective nature of transfer pricing²⁵⁶, essentially stating its manipulative nature.

²⁵³ Ibid , page 50, para 6.49

²⁵⁴ Ibid, page 50 6.48.

²⁵⁵ NZICA: Submission on the Government discussion document, 13 March 2007, page 26

²⁵⁶ Ibid, page 26

XII. CONCLUSION

This research has demonstrated the subjective nature of transfer pricing. Theoretically, this concept is understandable, at least from the perspective of underlying policy objectives. From a practical point of view, this concept is difficult to administer and the increase in the number of transfer pricing cases is clear testament to this. In acknowledging this, one point that is abundantly clear is the statutory minimum expectation from tax administrators.

All jurisdictions have the expectation of arm's length pricing expressed in some other way. To make this concept work, "artificially", the entities involved in cross border transactions are treated as independent. Clearly, this imposes practical constraints on MNC's.

The OECD has been a pivotal figurehead in the area of transfer pricing and importantly, in the facilitation and resolution of cross border disputes. However, the *Glaxo* case certainly tested the effectiveness of this expectation. It can be argued that these arbitration regulations were imprecise and did little to advance the issues between USA and UK. The fallout from the Glaxo has motivated the OECD to revisit these procedures. The jury is still out as to the effectiveness of the "modified procedures". No doubt they will be certainly tested in years to come.

In the pursuit of the maximisation of profits, MNC's are restructuring, relocating, and downsizing to achieve this objective. Given that this issue is relatively new, it can be said that all the transfer pricing risks involved with corporate restructuring have not been fully identified. Arguably, one consequence of this is the failure to publish discussion documents, setting out its expectations.

Intangible properties are by their very nature unique. Its uniqueness "adds value" and gives the competitive edge. Working with a clear definition of what is an intangible property and the legal protection conferred upon ownership, one area of concern is the valuation of intangible properties. Before valuation of intangible

properties can commence, MNC's have to identify all the types of intangible property, including hidden and goodwill. Goodwill by its very nature is inseparable and part of the business. Although there are several methods and alternatives to value intangible properties for transfer pricing purposes, MNC's have to be mindful that the value is consistent with the arm's length principle. Valuation of intangible property is a difficult area as MNC's are reluctant to provide specific details for the simple reason of losing the competitive edge or run the risk of getting cheap and similar substitutes.

Arm's length principle is another concept which is very important to transfer pricing. Essentially testing transactions against independent parties, it acts as a safety valve for compensation that is deemed excessive.

The principle of comparability insulates the concept of arm's length pricing and makes it workable. Despite these theoretical abstracts, the difficulty lies in locating comparable data to support the transfer pricing. However, a MNC is permitted to rely on overseas data to support its transfer pricing, after making specific adjustments to eliminate the differences.

The New Zealand transfer pricing framework, unlike most other OECD member countries lacks "firepower" because of the statutory burden of proof requirements. Unless there is a shift to normalise this with the other countries, it can be argued that the Courts will be unlikely to litigate on transfer pricing matters. This practically constraints the Commissioner of Inland Revenue from challenging transfer prices of MNC's. As an afterthought, perhaps there is a deeper social issue because of the size and demographics of the New Zealand market. If New Zealand commenced an aggressive approach to transfer pricing, the social and economical impacts of MNC's departing the country will be felt by one and all.

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XIV. APPENDIX 1 – GD13

Income Tax Act 2004 - GD 13 Cross-border arrangements between associated persons

GD 13(1) [Cross-border arrangement with associate to be at arm's length] Subject always to its express provisions, the purpose of this section is to require a taxpayer, who enters into a cross-border arrangement with an associated person for the acquisition or supply of goods, services, or anything else at a consideration which reduces the taxpayer's net income, to substitute an arm's length consideration when calculating the taxpayer's net income.

GD 13(2) [When this section applies] This section only applies to require the substitution of an arm's length amount of consideration in the case of an arrangement—

(a) that involves the supply and acquisition of goods, services, money, other intangible property, or anything else; and

(b) where the supplier and acquirer are associated persons; and

(c) where the supplier and acquirer are—

(i) 2 persons each not resident in New Zealand (unless each enters into the arrangement for the purposes of a business carried on by the person in New Zealand through a fixed establishment in New Zealand); or

(ii) a person resident in New Zealand and a person not resident in New Zealand unless—

(A) the non-resident is entering into the arrangement for the purposes of a business carried on by the non-resident in New Zealand through a fixed establishment in New Zealand; and

(B) the New Zealand resident has not entered into the arrangement for the purposes of a business carried on by the New Zealand resident outside New Zealand; or

(iii) 2 persons each resident in New Zealand if either or both enter into the arrangement for the purposes of a business carried on by the person outside New Zealand.

GD 13(3) [Payment deemed to be at arm's length] If the amount of consideration payable by a taxpayer under such an arrangement exceeds the arm's length amount, then for all purposes of the application of this Act in relation to the income tax liability for any tax year of the taxpayer, an amount equal to the arm's length amount is deemed to be the amount payable by the taxpayer in substitution for the actual amount.

GD 13(4) [Receipt deemed to be at arm's length] If the amount of consideration receivable

by a taxpayer under such an arrangement is less than the arm's length amount, an amount equal to the arm's length amount is deemed to be the amount receivable by the taxpayer in substitution for the actual amount for all purposes of the application of this Act in relation to—

- (a) the income tax liability for any tax year of the taxpayer; or
- (b) the obligation of the taxpayer under subpart [NH](#) to make a withholding or deduction from the amount; or
- (c) the obligation of any person other than the taxpayer to make a withholding or deduction under Part [N](#) from the amount.

GD 13(5) [Non-application of s GD 13(4)] Subsection [\(4\)](#) does not apply if the taxpayer is neither resident in New Zealand nor entering into the arrangement for the purposes of a business carried on in New Zealand through a fixed establishment in New Zealand, and—

- (a) the amount is a deduction of the other party (or, in the case of an interest-free loan, would be a deduction but for the application of subpart [FG](#) if an arm's length amount of interest were substituted) and is interest, royalties, or an insurance premium; or
- (b) the amount is a dividend receivable on a fixed rate share.

GD 13(6) [Method of applying arm's length consideration] For the purposes of this section, the arm's length amount of consideration must be determined by applying whichever 1 (or combination) of the methods listed in subsection (7) produces the most reliable measure of the amount completely independent parties would have agreed upon after real and fully adequate bargaining.

GD 13(7) [Calculation of arm's length consideration] The arm's length amount of consideration must be calculated under any 1 (or a combination) of—

- (a) the comparable uncontrolled price method; or
- (b) the resale price method; or
- (c) the cost plus method; or
- (d) the profit split method; or
- (e) comparable profits methods.

GD 13(8) [Criteria for calculation and application of method] The choice of method or methods for calculation and the resultant application of the method (or methods) must be made having regard to—

- (a) the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer; and

- (b) the completeness and accuracy of the data relied on; and
- (c) the reliability of all assumptions; and
- (d) the sensitivity of any results to possible deficiencies in the data and assumptions.

GD 13(9) [Commissioner may determine arm's length amount] The arm's length amount of consideration is determined by the taxpayer under subsections (6) to (8), and the amount so determined is the arm's length amount for the purposes of subsections (3), (4), and (10), unless—

- (a) the Commissioner can demonstrate another amount to be a more reliable measure of the arm's length amount; or
- (b) the taxpayer has not co-operated with the Commissioner in the Commissioner's administration of this section in relation to that taxpayer and the non-co-operation has materially affected the Commissioner in that administration,—

in either of which events the Commissioner determines the amount under subsections (6) to (8) for the purposes of subsections (3), (4), and (10).

GD 13(10) [Arm's length amount deemed payable/receivable] If—

- (a) the amount of consideration payable by a taxpayer for an acquisition is less than an arm's length amount or the amount of consideration receivable by the taxpayer for a supply exceeds an arm's length amount (that acquisition or supply being referred to in this subsection as the **compensating adjustment arrangement**); and
- (b) in the same tax year or in the immediately preceding or succeeding tax year, either—
 - (i) an amount of consideration payable by the taxpayer is adjusted down under subsection (3); or
 - (ii) an amount of consideration receivable by the taxpayer is adjusted up under subsection (4); and
- (c) the adjustment down (or up) is in respect of an arrangement for acquisition (or supply) with the same other party and—
 - (i) involving goods, services, money, other intangible property, or anything else of the same type as that supplied and acquired in the compensating adjustment arrangement; or
 - (ii) where the amount of consideration actually payable (or receivable) is set having regard to the amount of consideration actually payable (or receivable) under the compensating adjustment arrangement,—

then for all purposes of the application of this Act in relation to the income tax liability for any tax year of the taxpayer (or, if the amount is receivable by the taxpayer, to the obligation

of the taxpayer or any other person to make a withholding or deduction from the amount under Part N), an amount equal to the arm's length amount is deemed to be the amount payable (or receivable) by the taxpayer under the compensation adjustment arrangement in substitution for the actual amount.

GD 13(11) [Commissioner may apply substituted amount] If—

- (a) an arm's length amount of consideration is substituted under subsection [\(3\)](#) or [\(4\)](#) in respect of an arrangement entered into by a taxpayer; and
- (b) the other party to the arrangement (or, if the other party is a controlled foreign company, any person with an income interest in the controlled foreign company) applies to the Commissioner in writing within 6 months after an assessment is made in respect of the taxpayer which reflects the substitution; and
- (c) the Commissioner considers it is fair and reasonable to do so, having regard to any adjustment made under a double tax agreement or any other matter, and has notified the other party,—

then the substitution so applies for all purposes of the application of this Act in relation to the other party—

- (d) excluding the determination of whether and the extent to which the other party has derived or been paid a dividend; and
- (e) including, in any case where the other party is a controlled foreign company, the calculation of branch equivalent income or branch equivalent loss in respect of the other party and the resultant calculation of the attributed CFC income or attributed CFC loss or attributed CFC net loss of any person.

GD 13(12) [Application of section to Part N] Except to the extent that subsection [\(11\)](#) applies, an adjustment under any of subsections [\(3\)](#), [\(4\)](#), and [\(10\)](#) has no effect on any obligation of the taxpayer to make a withholding or deduction in respect of the amount under Part [N](#), other than under subpart [NH](#).

GD 13(13) [Definitions] In this section,—

acquisition —

- (a) subject to paragraph (b), includes obtaining the availability of any thing; and
- (b) does not include the mere receipt, or retention, by a company of consideration for issue of a share (unless the share is a fixed rate share)

amount includes a nil amount

insurance premium means a premium treated as being derived from New Zealand under section [FC 13](#)

supply —

- (a) subject to paragraph (b), includes making any thing available; and
- (b) does not include the mere payment, and subsequent continuing making available, by a person to a company of consideration for issue of a share (unless the share is a fixed rate share).