Inland Revenue
Te Tari Taake

Tuhinga utu whakawhiti

Transfer pricing documentation

New Zealand’s tax system operates on a self-assessment basis, where the taxpayer is expected to keep sufficient records to support their tax position. This includes transfer pricing documentation.

Obligation to maintain and provide documentation

If a company's documentation inadequately explains why its transfer prices are considered to be consistent with the arm's length principle, we are more likely to audit those transfer prices in detail. As the burden of proof for transfer pricing matters rests with the taxpayer, a lack of adequate documentation may make it difficult for the company to rebut an alternative arm's length transfer price proposed by us. In the event that documentation is inadequate and we propose a transfer pricing adjustment, penalties will most likely be incurred.

Taxpayers are required to provide documentation on request. This may occur as part of a risk review or audit.

Master file and local file content

New Zealand’s transfer pricing rules are to be applied consistently with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations - July 2022, including the guidance on documentation contained in Chapter V.

Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD)

Annexes I and II to Chapter V provide detailed guidance on the required content of the master file and local file. We recognise that there are considerable compliance cost benefits for taxpayers in aligning our practice with international standards. We expect documentation to be prepared in accordance with the guidelines and have not imposed additional requirements.

Local management responsibility

It remains the responsibility of local management to ensure a company's transfer prices are in accordance with the arm's length standard. In our experience, local management are best placed to review and confirm the factual accuracy of the local file. This step is essential where the file has been initially prepared by an overseas entity.

If we make transfer pricing adjustments, the quality of supporting documentation will be a key factor in determining the extent to which penalties might apply. A failure to prepare adequate transfer pricing documentation or acceptance of pricing that is clearly inappropriate could result in a 40% shortfall penalty for gross carelessness if apparent problems involving material associated party transactions are simply brushed over lightly or even ignored.

Good documentation packages

The quality of documentation prepared by multinationals can vary considerably. In our opinion, good documentation packages should include:

- a detailed discussion of the facts (analysis of functions, risks and assets - especially intangibles)
- industry analysis (to put the taxpayer's facts in the context of its industry), especially identifying the key profit drivers, performance of major competitors, and where the value added arises for the company
- careful consideration of associated party transactions (each category should be examined separately)
- a discussion as to the efforts made to find internal comparables (are there no sales or purchases whatsoever involving unrelated parties?)
- reasoning as to the selection of the best pricing method available

- full details as to the comparables search undertaken (database utilised, criteria employed, accept/reject list including reasons for rejection)
- an analysis of why the companies selected are indeed comparables
- an unadjusted income statement for each comparable with adjustments explained in detail
- conclusions, including sanity checks to demonstrate commercial realism
- copies of all inter-company agreements as well as the local and global corporate structures.

Common errors

Preparation of good transfer pricing documentation requires judgement as to the critical elements for inclusion relevant to the specific facts and circumstances of the case. Unfortunately, we have seen several cases where the documentation has not adequately reflected the facts and circumstances. Some of the common issues we have seen include:

Absence of basic building blocks

Understanding your business, including its legal structure and the terms of its contracts, is fundamental to any transfer pricing analysis. We have seen several cases where these building blocks have been absent. Examples include:

- confusion as to whether the entity in focus was a subsidiary or a branch
- failure to identify all parties to cross-border transactions
- contracts either not being read or simply misunderstood
- poor analysis of the nature of agency (in particular, the actions and contractual obligations of agent and principal).

Reliance on familiar descriptions

A rush to an analysis of potential comparables in reliance only on a familiar business description (such as 'wholesale distributor') without attending to the fundamentals, is inviting disaster. Anything which crops up later and does not match the starting position should ring warning bells for the taxpayer and the practitioner.

Centrally prepared documentation

Another issue is the use of transfer pricing documentation that has been centrally prepared by a parent company on a worldwide basis without regard to the specific facts and circumstances of the tested subsidiary or the local marketplace in which it is operating. Where material local facts and circumstances are omitted, or materially differ from the position documented in the centrally prepared documentation, the local documentation will be inadequate. In the event that documentation is inadequate and we propose a transfer pricing adjustment, penalties will most likely be incurred.

For example, there may be a policy to charge royalties at a uniform global rate. Thus, a New Zealand company which may have low market share is charged the same royalty rate as a foreign associate which is a market leader. No consideration is given to the utilisation of the intangible property in the New Zealand market, the size of the market or other economically relevant characteristics of the New Zealand transaction with the result that the uniform royalty rate may not represent an arm's length price.

There is no suggestion that this level of detail is required for every business that has cross-border associated party transactions. Clearly, the compliance costs for such an exercise would be excessive and inappropriate for a business with $100,000 of cross-border transactions. For a small business, it may be quite satisfactory to simply complete a transfer pricing questionnaire, evaluate the results and make notes to explain why the pricing is considered appropriate. This represents a small amount of time to identify any potential risk and provide an adequate explanation. It is infinitely better than having no documentation.

Risk

Documentation often states which entity bears risk without a clear rationale supporting the statement. During a review or audit, compliance costs associated with such an approach are likely to be higher as more follow-up questions may be required.

When an entity claims to assume risk, it is necessary to explain how that is achieved. For example:

- Is there a sale or return policy?
- In which currency is the transaction undertaken?
- Is there demonstrable support for defective goods?
- Is there a service or a financial guarantee?
- Is there an in-substance defeasance?
- Which personnel are making decisions regarding the risk?
- What is the nature of those decisions?
- Is there some other non-contractual way in which risk may be transferred?
- Does the entity assuming the risk have the financial capacity to carry that risk and the personnel to control that risk?

A common issue we encounter is a failure to account for foreign exchange risk when it is assumed by controlled distributors in New Zealand - do these operations have adequate financial capacity to absorb currency risks or manage an effective hedging strategy? The more volatile the currency, the greater the compensation received should be in the long run.

We have also encountered the argument that where a New Zealand subsidiary's transfer pricing policy guarantees the subsidiary a specific return, that the New Zealand subsidiary is by default a no or minimal risk entity, irrespective of any other facts and circumstances. We do not accept this argument. At the heart of transfer pricing is the requirement to test whether or not intercompany prices are arm's length. The application of an approach, such as the argument above, that relies solely on the very intercompany price that is being tested, is circular. For this reason, the functional analysis and the risk profile of an enterprise should be determined by an appropriate analysis of the facts and circumstances in each case.

Further guidance on the analysis of risk is contained in the OECD guidelines, Chapter I, D.1.2.1.

Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD)

Reconcile to financial statements

The tax manager needs to partner with the company's finance function to ensure associated party transactions are identified and accurate disclosures are made (including notes to the annual financial statements). Financial ratios calculated in the transfer pricing documentation should also reconcile to the financial statements and the reconciliation should be included in the documentation.

Do not rely on earlier documentation

Transfer pricing is an ongoing process, not a 1-time documentation exercise. Companies should not rely solely on transfer pricing documentation compiled some years ago. Regular re-evaluation of both the facts and transfer prices to determine that they are, and remain, arm's length is advisable. Issues to consider include:

- Has any restructuring taken place?
- Is the company now performing different functions or assuming new risks?
- Has there been a change in the group's business strategy impacting on transfer prices?
- Have any long-term supply contracts been concluded or amended recently?
- Is the bottom-line profit result still commercially realistic?
- Has there been a major change in the line of business that impacts significantly on prices or profitability?
- Are the comparables used previously still truly comparables?

Opportunity to streamline

Many of the documentation packages prepared by consultants could be streamlined by providing much less on our law, guidelines and overseas rulings and far more analysis of profit drivers and economic value added. For more routine business models,

extensive analysis of method selection (where only 1 method could ever be used in the circumstances) and lengthy comparable search exclusion matrices generally do not enhance the output and can distract from the key issues.