



TRANSFER PRICING GUIDELINES

Amendments to the draft Transfer Pricing Guidelines

The revised Guidelines incorporate changes arising as a result of extensive external consultations. While the majority of amendments are for clarification purposes, notable points include:

- Highlighting that reference to the SNF Case in Australia is purely for information purposes and refers to the use of internal comparables.
- Further specific clarification on the use of arm's length ranges.
- Qualification to the use of Australia and New Zealand as comparable markets.
- Qualification to the use of royalty "rules of thumb".
- Reference to OECD on the use of Mutual Agreement Procedures (MAP's).

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Introduction

A guide to the application of Section 34 of the Fiji Income Tax Act.(Refer to Income Tax (Transfer Pricing) Regulations 2012 as gazetted Vol 13 No.8, 10 January 2012).

These guidelines are intended to provide an overview of the framework within which the transfer pricing rules operate, and a practical assistance guide.

Establishing appropriate transfer prices for tax purposes often involves the application of judgment, which will depend on taxpayers' individual circumstances. Transfer pricing is therefore not an exact science and the guidelines have been drafted as a practical guide, rather than as prescriptive rules. It is in fact not possible or practicable to draft prescriptive guidelines that attempt to deal with every transfer pricing issue that may arise.

FRCA adopts the positions outlined in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, and proposes to follow these guidelines in administering Fiji's transfer pricing rules. Consequently, these guidelines supplement the OECD guidelines, rather than supersede them. The OECD guidelines should be referred to if more detail is required in relation to issues referred to herein (e.g. concept of tested party, and refer to June 2012 discussion draft on revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions. Issues not included in these guidelines at this stage include cost contribution arrangements and business restructuring. In this regard, we will review the current guidelines as the need arises.

We expressly acknowledge the cooperation of New Zealand Inland Revenue Department (John Nash) in agreeing to the use of material obtained from their published guidelines and website.

The principle reason why FRCA has drafted its own guidelines is to provide a practical Fiji focus on issues. This also assists in explaining transfer pricing in a way that is more accessible to taxpayers and advisors dealing with transfer pricing issues than the OECD guidelines. By way of example, the OECD guidelines do not state documentation requirements whereas the Fiji transfer pricing regulations contain statutory provisions.

Specifically the guidelines consider:

- Rationale for transfer pricing rules and the arm's length principle
- Key features of Fiji's transfer pricing regulations
- Practical transfer pricing compliance
- Transfer pricing methods and selection
- Comparability principles and Functional analysis
- Intra group charges such as management fees
- Documentation requirements
- Financing
- Intangibles including royalties
- Transfer pricing Key Flag Indicators

- Advance Pricing Agreements
- Branches

In these guidelines, we are taking the opportunity to outline tax policy surrounding Branches. This is a major policy review required following the OECD 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS. The changes have significant transfer pricing implications for those businesses which typically use branch structures e.g. banks and insurance companies.

Rationale for Transfer Pricing Rules and the Arm's Length Principle

Importance of Transfer Prices to the Determination of Host Country Tax Base

Transfer pricing has become one of the most important international tax issues around the globe and it is therefore timely that Fiji should be addressing this problem. Transfer pricing rules apply to all sectors of the economy involving international transactions between associated parties.

The transfer prices adopted by a Multinational Enterprise (hereafter referred to as a MNE) have a direct bearing on the profit it derives in each country in which it has operations. If inadequate or excessive consideration are paid for the transfer of goods and services (including intangible property/loans) between the MNE members, the income calculated for each of those members will not be consistent with their relative economic contributions. As a result the host country will not be getting its fair share of the total tax take. Transfer pricing regulations also reduces the possibility of double taxation.

As a general example, consider an MNE member in Fiji which sells goods overseas to an associated company, at a price that is less than the market selling price. The profit earned in Fiji is therefore reduced. Similarly, if Fiji company purchases goods or services from an offshore associated MNE member at inflated price, the profit it earns in Fiji is similarly reduced.

Transfer pricing is therefore concerned with an MNE's ability to manipulate prices either by paying too little or too much for goods and services resulting in "shifting profits" from one country to another.

For example, consider a Fiji manufacturer owned by a foreign parent company which pays less than market prices for the manufactured goods bought from the Fiji subsidiary company.

The result is that profit is increased overseas and reduced in Fiji.

Again, consider a Fiji manufacturing company (ultimately owned by overseas residents) which sells the same product to both an overseas related party distributor and an independent distributor serving similar markets e.g. USA and Canada.

This is a case where there is an internal comparable are in practice a useful tool in determining a CUP or an acceptable CUP.

The selling price per unit to the related party distributor is US\$5 and the selling price to the independent distributor is US\$8

Say the manufacturing costs are US\$2 per unit; therefore the profit per unit to the Fiji manufacturer is US\$3 on related party sales and US\$6 on independent party sales respectively. The issue is why the difference? Is this transfer pricing resulting in shifting profits overseas?

The transfer pricing rules allow tax authorities discretion to adjust transfer prices for income tax purposes where there is either excess consideration paid, or inadequate consideration received by a taxpayer, in respect of an associated party cross border transaction. In such circumstances, an arm's length amount may be substituted by the Commissioner. This is the crux of the transfer pricing rules.

Arm's Length Principle.

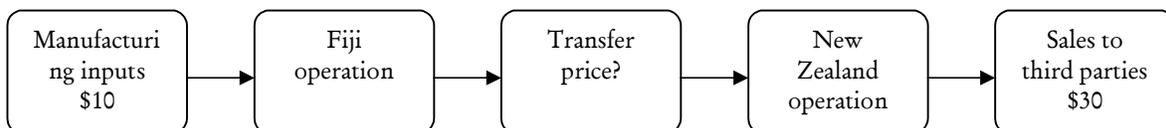
The arm's length principle is fundamental to transfer pricing and requires that transactions between associated parties are conducted at arm's length. This means that the transaction should have the substantive financial characteristics of a transaction between independent parties where each aims to get optimum benefit from the transaction.

The arm's length principle is based on the notion that the operation of market forces results in a true return to the economic contribution of participants in a transaction. It seeks to remove the effect, if any, of common ownership (i.e. the effect of control.) In this way, the true return for economic contribution by each member of the MNE is determined.

In simple terms, the arm's length principle attempts to replicate what independent enterprises would have freely determined in relation to commercial and financial outcomes. The theory being that profits accrue to parties commensurate with relative economic contributions.

The theory is fine, but the reality of international business is that specific regulations are required to ensure that the theory is reflected in so far as possible, in MNE's transfer pricing policies.

Consider an MNE that manufactures goods in Fiji and has a distribution operation in New Zealand. The cost of producing one unit of a product in Fiji is \$10.00. The finished product retails in New Zealand for \$30.00. The combined profit for each unit sold therefore \$20.00. (For simplicity, this ignores SG&A expenses).



The allocation of the \$20.00 per unit profit is determined by the transfer price at which the product is transferred from the Fiji manufacturing operation to the New Zealand distribution operation.

If the transfer price was equal to the cost to the Fiji operation (\$10.00), the whole profit from each unit sold would accrue to the New Zealand operation:

	Fiji Operation	New Zealand Operation
Transfer price	\$10.00	
Sales	\$10.00	\$30.00
Costs	(\$10.00)	(\$ 10.00)
Profit	\$0.00	\$20.00

At the other extreme, the transfer price might be set equal to the ultimate selling price of the New Zealand operation (\$30.00). The entire profit from each unit sold would then accrue to the Fiji operation:

	Fiji Operation	New Zealand Operation
Transfer price	\$10.00	
Sales	\$30.00	\$30.00
Costs	(\$10.00)	(\$30.00)
Profit	\$20.00	\$ 0.00

Often seen as complex, transfer pricing involves a mixture of accounting, tax consulting, and economic analysis that allows an MNE to set and defend its position in countries in which it carries on business.

Risk Assessment

The determination of whether the result of a transaction or series of transactions is consistent with the arm's length principle is made by using the most appropriate transfer pricing method or a combination of methods having regard to –

- (a) The respective strengths and weaknesses of the transfer pricing methods in the circumstances of the case;
- (b) The appropriateness of a transfer pricing method having regard to the nature of the controlled transaction determined, in particular, through an analysis of the functions undertaken by each person that is a party to the controlled transaction;
- (c) The availability of reliable information needed to apply the transfer pricing methods; and
- (d) The degree of comparability between controlled and uncontrolled transactions, including the reliability of adjustments, if any, that may be required to eliminate differences.

Key features of Fiji's Transfer pricing regulations

- Fiji's transfer pricing regulations are OECD based and reflect the arm's length principle as stated in paragraph 1 of Article 9 of the OECD Model Tax Convention.
- The Regulations are consistent with transfer pricing rules adopted by Fiji's major trading partners including Australia, New Zealand, UK, USA, China, India, Japan, Singapore, Malaysia, Korea, and PNG.
- The scope is very wide in terms of whom the regulations apply to and relevant transactions e.g. refer to the definition of associated person which includes various relationships.
- Regulations apply arms length consideration to transfers involving;
- **Goods** including;
 - Equipment
 - Raw materials
 - Finished goods
 - Work in Progress and
- **Services** including;
 - Management Services
 - Loans
 - Guarantees
 - Computer, Technical Services
 - Commissions
 - Use of trademarks,
 - brand names
 - Information and technology transfers
 - Licenses and other transactions involving various Intellectual Property
- The focus of Fiji's transfer pricing regulations is to ensure that the appropriate amount of income derived by a MNE carrying on business in Fiji is properly attributed to its Fiji operations. Similarly, Fiji companies doing business with foreign associated entities should carry out transactions at arm's length thereby ensuring income is properly reported in Fiji.
- Fiji has adopted the arm's length principle because it is considered the most reliable way to determine the amount of income properly attributable to an MNE's Fiji operations and, represents the international standard.
- The 5 generally accepted transfer pricing methods recognized by the OECD are adopted using the most reliable method or a combination of methods.

- The 5 transfer pricing methods are-
 - (a) Comparable uncontrolled price method;
 - (b) Resale price method;
 - (c) Cost plus method;
 - (d) Transactional net margin method;
 - (e) Transactional profit split method.

- There are provisions for the use of other methods; however we do not envisage wide use of these.

- There are documentation requirements to record in writing sufficient information to verify that controlled transactions are consistent with the arm's length principle.

- Consistent with the move to self-assessment, the onus of proof remains with the taxpayer.

- Fiji's transfer pricing regulations apply equally to Branches (and other permanent establishments as defined in Article 5 of the OECD Convention Model Tax Convention).

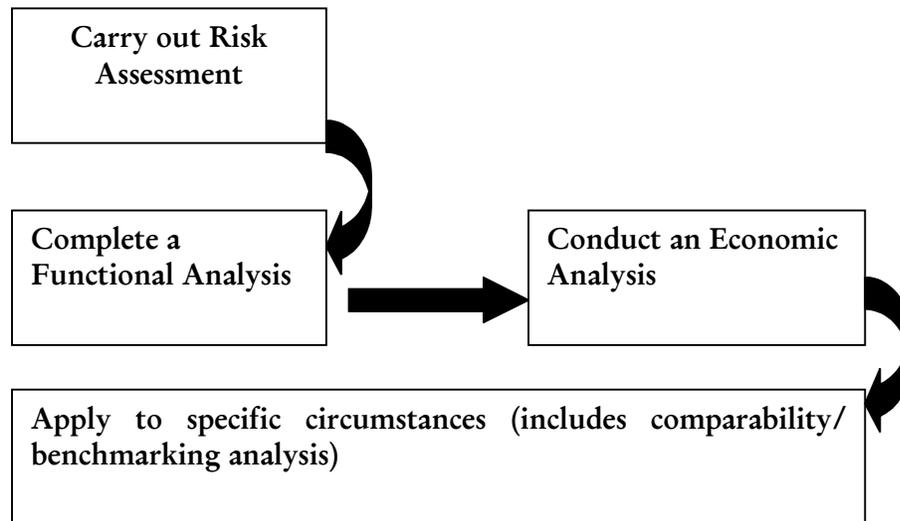
- There are provisions for corresponding adjustments to avoid double taxation in the case of adjustments by Competent Authorities of countries with which Fiji has concluded a Double Tax Agreement (DTA).

- The regulations apply from 1 January 2012.

Practical Transfer Pricing Compliance

It is essential to get the fundamentals clear from the start. You need to understand the business, its legal structure, contractual terms, that is, a basic analysis of who does what and in what legal capacity. FRCA's practical approach to transfer pricing is as follows;

Summary Practical Approach



Risk Assessment Analysis

- Examine the extent of cross border dealings with associated parties (i.e. dollar values)
- In this regard, the related party disclosures in the notes to the financial statements are particularly useful in identifying cross border transactions.
- Examine the nature of cross border dealings (i.e. transfers of goods and services)
- Examine the financial performance of the tested party assumed in this instance to be the Fiji entity.

Functional Analysis

- Understanding the cross border dealings, the business, the industry etc.
- Purchases and Sales.
- Services.
- Assets, employed.
- Risks (e.g. market, competitors, product and funding/foreign exchange risks).
- Accounting and Administration activities.
- Economic conditions

Financial Performance

- Key Performance Indicators

Examine profit/assets/sales ratios including by reference to the Berry and other ratios.

In a practical sense, the financial performance of the taxpayer is cornerstone to transfer pricing considerations. Robust financial performance is indicative of compliance with the rules.

Economic Analysis

This involves the prescribed selection of most reliable transfer pricing method or methods:

- the Comparable Uncontrolled Price (“CUP”) method;
- the Resale Price (“RP”) method;
- the Cost Price (“CP”) method;
- the Profit Split (“PS”) method or
- the Transaction Net Margin Method (“TNMM”)

Determination of an Arms Length Amount

- The regulations do not impose a hierarchy for the use of the stated methods. In practice, there is however an effective hierarchy based on the availability of reliable data and the taxpayer’s specific circumstances.
- Also in practice, there is a preference to use the traditional methods over transactional methods.
- Because the methods require the exercise of judgment, a transfer pricing analysis is expected to result in a range of arms length outcomes and a conclusion on “an” arms length price, rather than “the” definitive arms length price.
- In practice, it is important to understand that the quality of an identified arm’s length range is only as good as the imputed data. The range of statistical tools (e.g. the inter-quartile range) may be used to enhance the results. However, the range of results should be as narrow as possible to reflect accurate functionally comparable entities.

In other words, a narrow range with a small number of good comparables is much better than a larger range containing mediocre comparables and/or superficially similar companies.

- Therefore in practice, the use of a median average price is often indicative of an arm’s length price. However, any point within the range is considered arm’s price provided comparability criteria are met.

Four Step Process

A four step process developed by the Australian Tax Office and endorsed by FRCA is useful in practice for determining arm's length transfer prices. We acknowledge the invaluable practical assistance the ATO's 4 step process provides us.

Step 1: Understand the cross-border dealings between the associated enterprises in the context of the taxpayer's business.

Identify cross-border dealings with associated enterprises and collect or maintain relevant documentation to explain the nature of those dealings in the context of the taxpayer's business. Undertake a preliminary functional analysis of the functions undertaken, risks assumed and the assets employed to assist in understanding the business and selection and applying methodology.

Step 2: Select the methodology or methodologies.

Broadly identify any comparable uncontrolled dealings. Assess the reliability of the data on comparable deals or comparable enterprises. Determine the most appropriate methodology or methodologies based on the facts and circumstances of the particular case. Ensure that sufficient documentation and data is available to support the application.

Step 3: Apply the methodology or methodologies.

Use the detailed data to extend and improve the functional analysis of the taxpayer and of any comparables. Refine, examine and organise the data to enable comparability to be assessed. Data points or a range of results may emerge.

Step 4: Determine arm's length outcome.

Record practical considerations such as any judgements made and how data points or ranges were interpreted.

We expand on the foregoing.

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

It is important that both the taxpayer and FRCA understand the nature and extent of the cross border transactions between the taxpayer and associated parties in the context of the taxpayer's business. It is important for a taxpayer to be able to explain at a high level review:

- How the international related-party dealings of the enterprise are undertaken;
- The purpose or object of the dealings;
- What the taxpayer obtains from its participation in the dealings, such as products, services or strategic relationships;

- The significance of the dealings to the taxpayer's overall business activities and those of the MNE.

At this stage of the process, the taxpayer should consider a functional analysis and comparability in applying the arm's length principle. The taxpayer should develop a preliminary functional analysis to consider the broad functions performed by the relevant associates of the MNE. This will assist in determining an appropriate pricing method or methods in step 2 of the process.

The functional analysis should be broad and not comprehensive at this stage as the detail included in a fuller functional analysis is affected by a taxpayer's choice of pricing method or methods. At this stage, the aim of the functional analysis should be to determine which method or methods is likely to be appropriate in the circumstances, and the information that will be required to apply that method.

Comparables

A taxpayer should now assess potential comparables which may be identified internally within the MNE (if a member of the MNE transacts with an independent external party), or by reference to transactions between independent external parties.

Step 2: Select the pricing method or methods

The regulations require that the application of a method or methods for determining an arm's length price must be made having regarded to:

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

The application of these criteria will depend on the quality of the information available to the taxpayer. Thus at this stage of the process, the taxpayer will need to make an assessment of the quality of the data it has available. This assessment should be made for the purpose of determining which pricing method (or methods) is likely to provide the best reliability.

Step 3: Application of the pricing method or methods

When a pricing method (or methods) has been decided the preliminary functional analysis prepared in step 1 can be extended to reflect that choice of method.

Step 4: Determine arm's length outcome.

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

The process to date can deliver to a taxpayer an objective, documented and considered review of the available material and possible choices for arriving at an arm's length

outcome.

However, the nature of the arm's length principle is such that there are a number of practical problems in its application. Transfer pricing will always require an element of judgement, and taxpayers and FRCA need to bear this in mind in undertaking transfer pricing analysis.

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

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

Transfer Pricing methods and Selection

The arm's length principle is fundamental to transfer pricing and requires that transactions between associated parties are to be conducted at arm's length. This means that the transaction should have the substantive financial characteristics of a transaction between independent parties where each aims to get optimum benefit from the transaction.

Transfer Pricing Methods

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

The regulations require the use of one or a combination of the prescribed methods stated earlier as CUP, RP, CP, TNMN or PS.

The OECD refers to the CUP, RP and CP methods as traditional transactional methods. The TNMM and PS are referred to as transactional profit methods.

Selection of Most Reliable Methods

- **CUP Method**

The CUP method compares the price charged for goods/services in a controlled transaction to the price charged for goods/services in a comparable uncontrolled transaction. In practice, we are seldom going to locate a true CUP. Therefore, an acceptable CUP is usually required.

This method requires a high degree of similarity in both the service being transferred and the economic conditions of the transactions being compared. Where differences exist in either the product or the economic conditions of the transactions being compared between the controlled and uncontrolled transactions, and those differences would be expected to materially affect the price paid, and then an adjustment should be made.

In the absence of internal comparables, the CUP method is therefore most helpful for establishing an arm's length price for a) sales of commodities traded on a market, subject to the controlled transaction and comparable uncontrolled transaction(s) taking place in comparable circumstances, including at the same level of the commercial chain (e.g. sale to a secondary manufacturer, to a distributor, to a retailer, etc.), and b) some common financial transactions, such as the lending of money. Market prices (such as commodity prices or rates of interest) may be publicly available for these types of transactions.

The CUP Method is also used in practice in royalty determinations.

- **RP Method**

The RP method is generally considered to be potentially applicable where a company performs a pure distribution function and/or where no significant value is added to the transaction prior to resale. This method calculates an arm's length consideration by reference to the price at which the product(s)/services purchased/sold to an associated enterprise is transferred to an independent enterprise.

The RP method is not suitable for transactions involving intangible property.

This method is probably most useful where it is applied to sales and marketing operations such as those typically carried out by a distributor. In some circumstances, the resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (an internal comparable). In other circumstances the resale price margin may be determined by reference to the resale price margin earned by independent enterprises in comparable uncontrolled transactions (external comparables).

- **CP Method**

The CP method begins with the costs incurred by the supplier of goods/services in a controlled transaction for services provided to an associated purchaser.

In addition, the general objectivity with which costs can be identified and measured make it practical and reliable method to apply in varying circumstances. Hence, the CP method may be applicable to say management fees.

This method probably is most useful where a) goods are sold by a manufacturer that does not contribute valuable unique intangible assets or assume unusual risks in the controlled transaction, such as may be the case under a contract or toll manufacturing arrangement; or b) where the controlled transaction is the provision of services for which the provider does not contribute any valuable unique intangible assets or assume unusual risks.

- **TNMM**

The OECD Guidelines define the TNMM as follows:

“The transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction for transactions that are appropriate to aggregate under the principles of Chapter 1. Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarly means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied.”

The TNMM looks to net margins on appropriately grouped associated party transactions

of the tested entity as compared to the net margins on comparable uncontrolled groups of transactions are conducted at arm's length.

The TNMM is often considered an appropriate transfer pricing methodology to assess the arm's length nature of the tested transactions (looking at required returns for risk and investment by the various parties). This is where there is sufficiently reliable publicly available financial information that can be used to apply this method, and other methods (other than CUP's) cannot be reliably applied.

The IRD in New Zealand have stated at page 13, paragraph 89 of the Guidelines that they do not consider that there is any practical difference between the TNMM, the comparable profits method favoured by the United States, and the profit comparison method adopted by Australia. It is also noted that the reference to "comparable profits methods" in New Zealand is wide enough to encompass all three approaches.

We agree with the IRD's views. In general, it is observed that cost-based net profit margin indicators are used for manufacturing and service activities; sales-based indicators are used for sales activities; and asset-based indicators are used for asset-intensive activities. Asset based TNMM should be used only where reliable comparables for cost plus or cost plus TNMM methods are unavailable..

The selected financial indicator should be one that:

- I Reflects the value of the functions performed by the tested party (*i.e.* the party to the controlled transaction for which a financial indicator is tested), taking account of its assets and risks;
- II Is reasonably independent from transfer pricing formulation, *i.e.* it should be based on objective data (such as sales to unrelated parties), not on data relating to the remuneration of controlled transactions (such as sales to associated enterprises); and
- III Is capable of being measured in a reasonably reliable and consistent manner at the level of the controlled transaction and of the comparable uncontrolled transaction(s).

Functional comparability is generally of greater importance than product comparability in applying the TNMM.

- **PS Method**

The PS method seeks to eliminate the effect of special or unique conditions in associated party transactions by determining the division of total profits that independent enterprises would have expected to receive from engaging in the transaction or transactions.

The PS method encompasses two potential methods, being the contribution analysis method and the residual analysis method, although the OECD also recognises that other profit split methods may also be acceptable.

Applied to a dealing or group of dealings between a company and its overseas affiliates, the profit split method would take the combined profit from the dealing(s) and split that

profit between the parties based on the economic value each has contributed. The relative contributions of the parties are valued by reference to the economic returns that independent parties would seek for performing comparable functions, contributing comparable assets, and assuming comparable risks.

The process for determining a basic return for this purpose would be the same in the present circumstances as that used to apply TNMM, i.e. obtaining publicly available data on market rates of return achieved by independent companies with a comparable functional profile

A description of the acceptable transfer pricing methods and the differences between them is best given through the use of a simple example. Consider two members of a multinational that have the following profit and loss statements:

Manufacturer Co:

Sales to Distributor Co	\$10,000 (transfer price)
Less manufacturing costs	<u>(\$ 5,000)</u>
Gross profit	\$ 5,000
Operating expenses	<u>(\$ 3,000)</u>
Net profit	<u>\$ 2,000</u>

Distributor Co:

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

The comparable uncontrolled price (CUP) method focuses directly on the price of the property or services transferred between parties to a transaction. The price charged between independent parties forms the basis for determining the arm's length price under the CUP method.

Thus in the example, the issue to be determined is whether the transfer price adopted between Manufacturer Co and Distributor Co (\$10,000) is consistent with the price adopted by independent firms for a comparable product in comparable circumstances.

The resale price method focuses on the gross margin obtained by the distributor. This margin represents the amount from which a reseller would seek to cover its selling and other operating expenses and make an appropriate profit in relation to its functions performed, assets used, and risks assumed. The margin obtained by independent distributors performing similar functions, bearing similar risks and contributing similar assets is used as the basis for determining the appropriate margin for the member of the multinational.

In the example, the gross margin obtained by Distributor Co is 50% ($10,000/20,000$). The issue to

be determined is whether this margin is consistent with the gross margin earned by independent distributors performing comparable functions, bearing similar risks and employing similar assets to those of the multinational.

The cost plus method focuses on the gross mark-up obtained by the manufacturer. The arm's length price is determined by adding a mark-up to the costs incurred by the member of the multinational to determine an appropriate profit in relation to its functions performed, assets used and risks assumed. This mark-up is determined by reference to the mark-ups earned by comparable independent manufacturers performing comparable functions.

In the example, the gross mark-up obtained by Manufacturer Co is 100% ($(10,000-5,000)/5,000$). The issue to be determined is whether this mark-up is consistent with the gross mark-up earned by independent manufacturers performing comparable functions, bearing similar risks and employing similar assets to those of the multinational.

The profit split method starts by identifying the combined profit to be split between the related parties in a controlled transaction. In general, combined operating profit is used, although gross profits may be appropriate in some circumstances (paragraph 3.17, OECD guidelines). That profit is then split between the parties based upon an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

In the example, the combined operating profit of Manufacturer Co and Distributor Co is \$8,000 (\$20,000 sales, less \$5,000 manufacturing costs, less \$7,000 operating expenses). One way that profit could be split might be on the basis of the relative contribution of each member to that profit.

The comparable profits methods are a range of methods that examine the net profit margin realised by a taxpayer from a controlled transaction relative to an appropriate base. Possible bases include the return on assets, operating income to sales, and other suitable financial ratios.

In the example, the distributor may apply the ratio of net profit to sales, giving a net margin of 30% ($6,000 / 20,000$). The issue to be then determined is whether this net margin is consistent with the net margin earned by independent distributors performing comparable functions to those of the multinational.

The net profit approach recognised in the OECD guidelines is the TNMM.

An important decision providing practical lessons for taxpayers on the application of transfer pricing methods is the Australian case of SNF (Australia) Pty Ltd P.T.O V Commissioner of Taxation [2010] FCA 635. In this case, the first transfer pricing case the Full Federal Court held that the taxpayer was able to use the CUP method and rejected the view of the Commissioner taxation that the TNMM was applicable. This case is an example of the preferred use of traditional methods over transactional methods.

We highlight this case, which is regarded as a landmark decision in Australia, purely for information purposes. We understand that Australia maybe amending its transfer pricing rules in light of this decision. The case looks at the use of internal comparables which is

useful.

The following points were referred to by the trial Judge.

- The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where those transactions are undertaken at arm's length, or if not taken at arm's length, where suitable adjustment can be made to determine the arm's length consideration that would have taken place if the acquisition was at arm's length.
- Any particular methodology chosen is not to be applied rigidly. The process to be undertaken in considering arm's length consideration is one involving evaluation and judgement, and cannot be based upon any strict and inflexible rules. It may well be that in any given case, a number of different methodologies could be employed to arrive at a determination, even if only as check and balance to ensure the correctness of the analysis initially undertaken.
- As to methodology, the Judge referred to the relevant Explanatory Memorandum, which stated as follows:

“There are a number of methods by which an arm's length consideration might be calculated. The more commonly accepted of these are what are called the “comparable uncontrollable price method”, the “cost plus” method and the “resale” method. Which of these or other methods might appropriately be adopted in a particular case, and the way in which it is applied, will depend upon all the circumstances. For example, in relation to a transaction between related parties for the supply of a particular item of property that is traded exclusively within the group, no comparable uncontrollable price may be found. It would therefore be necessary to seek to establish at arm's length consideration for the particular property by some other method.”

- A hierarchy of methods that can be used to determine transfer price is set out in the 1995 guidelines. There are three “traditional transaction methods”: Comparable Uncontrollable Price (‘CUP’), cost-plus, and resale price. The 1995 guidelines provide for two additional methods, one of which is the Transactional Net Margin Method (‘TNMM’), which can be used if none of the other three traditional methods is appropriate.
- The guidelines confirm that the ideal approach to determining arm's length prices is to use comparable transactions. In most instances, this is the most appropriate method and in theory the easiest.
- The 1995 guidelines stress the importance of looking for comparable transactions so long as they are comparable. They also stress the need to strive to make adjustments to create comparability if at all possible, and that more than one method may be considered.

- There is no need to apply with exactness the CUP method as described in the 1995 guidelines in satisfying the burden imposed upon it under Div 13 of the ITAA.

TRANSFER PRICING METHODS SNAPSHOT

	REQUIRED COMPARABILITY	APPROACH	APPLICATION
CUP	Very High	Prices benchmarked	Can be very difficult but preferred method. Goods, services, loans, royalties
CPM	High	Gross Margin benchmarked	Manufacturer Service Providers
RM	High	Gross Margin benchmarked	Distributors
TNMN	Medium	Net Margin benchmarked	Widely used; Manufacturing/ Service providers/ Distributors
PSM	Medium	Net Margin benchmarked	Manufacturing/ Distributors/ intangibles

Comparability Principles and Functional Analysis

Comparability is fundamental to the application of the arm's length principle. Transactions involving an independent firm are used as a benchmark against which to appraise the transfer prices adopted by a taxpayer.

- For comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable, or reasonably accurate adjustments must be able to be made to eliminate the effect of any differences.
- Functional differentiation between a multinational and a benchmark independent firm is often the most significant factor in analysing comparability. With the exception of the CUP method, which focuses directly on product differentiation, application of the acceptable transfer pricing methods hinges on the comparability of functions performed, assets employed and risks assumed.
- A functional analysis will, in most cases, be an essential tool for finding and organising facts about a business in terms of its functions, risks and intangibles. It identifies how the economically significant activities undertaken by a multinational are divided between each member involved in a transaction under review, and for which respective members should expect to be rewarded. Applying the arm's length principle involves an appraisal of whether the transfer price adopted by a multinational is consistent with the price adopted by independent parties in a benchmark transaction conducted at arm's length. This appraisal process involves three steps:
- A transaction (or transactions) involving an independent firm has to be identified as a basis for comparison.
- Any differences between the transaction of the independent firm and that of the multinational must be identified. To be useful as a basis for determining the arm's length price, the transaction (or transactions) of an independent firm has to be sufficiently similar to the one undertaken by the multinational that either:
 - none of the differences between the situations being compared can materially affect the relevant price or margin being compared, or
 - Reasonably accurate adjustments can be made to eliminate the effect of any such differences. The effect any differences would be expected to have on relative prices must be quantified. The price adopted by the independent parties is then adjusted to reflect these differences in determining an arm's length price for the transaction of the multinational.

Product differentiation

The starting point for discussing comparability is with product differentiation. As noted in the previous chapter, the actual characteristics of the product or service being transferred are most critical when the CUP method is to be applied. This is because it focuses directly on the market price for a product, whereas the other methods focus more on the functions performed by each party to the transaction.

The OECD guidelines, at paragraph 1.19, cite a number of features that may be relevant in comparing two products:

Characteristics that it may be important to consider include the following:

- (i) in the case of transfers of tangible property,
 - (a) the physical features of the property,
 - (b) its quality and reliability, and
 - (c) the availability and volume of supply;
- (ii) in the case of the provision of services,
 - (a) the nature and
 - (b) extent of the services;
- (iii) and in the case of intangible property,
 - (a) the form of transaction (eg, licensing or sale),
 - (b) the type of property (eg, patent, trademark, or know-how),
 - (c) the duration and degree of protection,
 - (d) the anticipated benefits from the use of the property.

It is extremely important when considering comparables that the companies are in fact comparable and/or the data is comparable. For example, mere reference to manufacturing or wholesaling would not be acceptable but information on an actual product being manufactured or sold wholesale would be.

In view of the lack of information available in Fiji, we provide information to assist in locating comparable overseas data but highlight the following practical experience provided from overseas on the use of such databases.

- There is often an incorrect analysis of the commercial reality and substance of the associated party transactions.
- The commercial rationale for the selection of the most reliable transfer pricing method is either not correctly considered and /or is incorrect.
- The comparable companies identified are not acceptable comparables. Hence the range of outcomes is of little value.
- The transfer pricing method adopted is not the most appropriate in the circumstances.
- New Zealand IRD have highlighted cases where transfer pricing documentation prepared by consultants too often use comparable and other data that is not appropriate and contain “lengthy comparable search exclusion matrices (where four companies are selected and 404 are rejected) which do not enhance the output and can distract from the key issues.
- For some years now the IRS USA has recognised that a significant number of

professionals in the private sector and the Service often undertake little analysis in selecting company comparables. They rely instead only on SIC code classification in the public corporations context.

- A useful study is provided by Dr. Barbara McLennan in , "Finding and Applying Arm's Length Comparables under the Comparable Profits Method" in the Transfer Pricing Handbook, Third Edition, (John Wiley & Sons, Inc.) In her analysis, Dr. McLennan highlights that both taxpayers and IRS auditors most often apply the Comparable Profits Method for transfer pricing purposes by selecting the relevant Standard Industry Classification (SIC) code and then using the data for companies that classify themselves in that SIC code as the comparison.
- This shortcut approach ignores whether the SIC classification is correct for the company or its comparables, functional analysis, risks, contract terms, economic conditions, and the like, as well as the nature of the firm being evaluated. As such, the shortcut approach deviates most strongly from the transfer pricing regulations, resulting in invalid approaches and results. The essential ingredient in applying the comparable profits method is finding and applying arm's-length comparables.

In chapter I-III of the 2010 OECD Transfer Pricing Guidelines, detailed guidance is provided on comparability issues and transactional profit methods. A key message contained in Chapter III is that comparability is about seeking to arrive at arm's-length pricing. It discourages:

- the use of extensive database selections to provide quantity over quality;
- the formulaic use of, for instance, capital intensity adjustments;
- the use of comparability adjustments when the underlying data is simply not comparable.

The "same or similar market" principle is important in Fiji. New Zealand and Australia are generally recognized as our closest reference countries. The Fiji economy is closely connected to the New Zealand/Australian economies. This means in practice that we look to New Zealand / Australia to obtain comparable data. Obviously, economic and other market differences have to be taken into account. In practice, NZ/ Australia provide useful benchmarks.

In addition however, in order to find practical solutions and/or enhance or confirm our findings, we often have to look beyond New Zealand/Australia to markets in Europe (in particular the United Kingdom) and North America where reliable data may exist. Provided the industry and functions in question are similar, less emphasis is placed on the country from which a comparable is taken, but recognition must still be given to greater economies of scale and competition as well as higher cost of capital and higher distribution costs resulting from low population density.

The best comparables are those that exhibit key economic characteristics closest to the targeted company or transaction. These policy guidelines require the consistent use of one or more reliable comparables. "Industry data dumps" are not acceptable, even if additional statistical analysis is provided using various measures such as interquartile ranges, medians

and averages. Statistical tools may to some extent enhance the reliability of data carefully selected, but cannot enhance inappropriately selected comparables.

Functional differentiation

In practice, functional differentiation will tend to be more important than product differentiation. This is because it is often difficult to locate CUPs on which a transfer pricing analysis can be based. In that case, one of the other pricing methods will have to be used instead. Those other methods focus more directly on the functions being performed, assets employed and risks assumed, than on the product or service being transferred. It is the comparability of functions performed by the multinational and by the comparable independent party, therefore, that become central to the transfer pricing analysis.

An important tool in appraising functional differences between a multinational and an independent party is the use of functional analysis. Functional analysis is a method of finding and organising facts about a business in terms of its functions, assets (including intangible property), and risks. It aims to identify how these are divided between the parties involved in the transaction under review.

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

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

Examples of relevant functions

At its broadest level, a functional analysis would result in the identification of such general categories as:

- research and development
- product design and engineering
- manufacturing, production and process engineering
- product fabrication, extraction, and assembly
- purchasing and materials management
- marketing and distribution, such as inventory management, warranty administration and advertising
- transport and warehousing
- managerial, legal, accounting and finance, credit and collection, training, and personnel

management services.

The following is an example of a functional analysis checklist for a manufacturing development company.

CHECKLIST 1
FUNCTIONAL ANALYSIS OF MANUFACTURING

1. Develops products	
2. Develops product process and know-how	
3. Develops product specification	
4. Designs plant, machinery, and equipment	
5. Purchases capital equipment	
6. Supervises construction/Fit out	
7. Determines supplies needed	
8. Develops source purchases	
9. Purchases materials	
10. Warehouses materials	
11. Develops workflow technique	
12. Controls workflow materials	
13. Arranges for freight and insurance on purchases	
14. Plans productions schedules and output	
15. Co-ordinates production and selling	
16. Develops cost standards	
17. Develops quality control standards	
18. Performs quality control functions	

19. Manufactures components	
20. Manufactures finished goods	
21. Does manufacture engineering	
22. Determines factory personnel needs	
23. Hires and trains factory personnel	
24. Supervises the different manufacturing operations	
25. Performs maintenance of factory buildings, grounds and equipment	
26. Packages and labels products	
27. Plans investment in plant and equipment and handles financial needs of manufacturing functions	

CHECKLIST 2
FUNCTIONAL ANALYSIS OF GENERAL, ADMINISTRATIVE AND SELLING
FUNCTIONS

1. Develops financial needs and budgets for the group	
2. Plans investments and makes investment decisions	
3. Develops overall marketing strategy	
4. Plans, co-ordinates and supervises market research	
5. Performs market research	
6. Determines advertising and marketing policy	
7. Supervises advertising and marketing	
8. Determines the needs for general, administrative and selling personnel	
9. Hires Personnel	
10. Develops training materials	
11. Supervises training of personnel	
12. Trains general, administrative and selling personnel	
13. Determines compensation of personnel	
14. Determines pricing and pricing policy	
15. Establishes credit terms	
16. Develops advertising formats and translations	
17. Determines media in which advertising is to be placed and places advertising	

18. Plans and develops TV commercials	
19. Plans sales promotions and develops promotional materials (e.g. design point of display advertising, engineers manufacturing design and manufactures displays)	
20. Plans trade conventions and shows	
21. Supervises sales force and does customer contact	
22. Designs and develops packaging material	
23. Manufactures packaging material	
24. Designs material for and develops catalogues	
25. Co-ordinates production schedules with sales	
26. Purchases finished goods	
27. Supervises purchasing and warehousing of finished goods	
28. Warehouses finished goods	
29. Performs inventory control	
30. Ships finished goods	
31. Provides insurance coverage	
32. Warrants product	
33. Handles patent and trademark protection	
34. Assumes inventory risk	
35. Assumes credit risk	

36. Develops accounting systems and software	
37. Maintains accounting records	
38. Performs tax planning and administration	
39. Handles customer's complaints	
40. Handles billing and collection	
41. Handles government matters	
42. Prepares statistical data and financial reports	

CHECKLIST 3
FUNCTIONAL ANALYSIS OF MARKETING FUNCTIONS

1. Supervises marketing activities	
2. Develops new promotional themes for advertising and product promotion and to whom such services are provided	
3. Develops training material and trains personnel	
4. Develops marketing plans for new products and guidelines for marketing	
5. Co-ordinates the execution of planned marketing strategy of foreign subsidiaries	
6. Approves product authorisation	
7. Designs and develops packaging material to implement marketing strategy and effort	
8. Plans and develops TV commercials	
9. Plans and develops advertising formats, and determines media to be used, such as magazines, newspapers, etc	
10. Co-ordinates production schedules with sales	
11. Plans and develops other promotional material, such as brochures, catalogues, display advertising etc.	
12. Plans trade conventions and shows	
13. Determines personnel needs	
14. Establishes compensation and other personnel incentives	
15. Determines pricing and pricing policy and co-ordinates policy with foreign subsidiary	

16. Establishes credit terms	
17. Responsible for customer contact	
18. Supervises sales force	
19. Performs market research and develops new markets	
20. Identifies need for product modification	
21. Warehouses finished product	
22. Ships product and provides insurance coverage	
23. Warrants product	

Databases for use in identifying comparative information

The range of accessible information is increasing by technological change. Large amounts of information/ data can be obtained on CD-ROM and DVD, e.g. the AMADEUS database of information on European companies and the OSIRIS international database. In practice, the internet allows direct access to huge amounts of information for example published public company annual reports which include relevant financial information that may be useful in establishing arm's length pricing. Often information is placed in the public domain, either by individual companies or by commercial information providers. The latter make a charge for accessing their databases.

Databases and other useful sources of information are typically built from 'traditional' sources, including the following;

US

Annual Report and SEC Filings and Forms (EDGAR)
Dun and Bradstreet's Hoover's (North America)
Standard and Poor's Compustat North America and Global Vantage
Thomson's Financial/Disclosure SEC and Worldscope

Pan-European

Dun and Bradstreet's Who Owns Whom (Europe) Europe Top 15,000
Fortune Top 500 (Non-US) Industrials Forbes Top 500 Foreign Companies Extel
Kompass Europe
Moody's International Manuals Directory

UK

Companies House
Stock Exchange Official Year Book
Dun and Bradstreet's Who Owns Whom (UK)
FT Supplement Top Companies
UK's Top 10,000 Companies
'Business' 1,000
McMillan's Unquoted Companies
Jordan's Top 4,000 Privately Owned Companies
Kompass
Extel
ICC
OneSource
Juniper
Experian Bureau van Dijk – Fame
Annual Business Enquiry carried out by the UK Department of Statistics.

Australia

ATO Statistics
Australian Securities Exchange
Australian Securities and Investment Commission

New Zealand

Annual reports filed by companies with foreign ownership

Intra Group Charges such as Management Fees

The OECD guidelines identify two key issues in the treatment of intra-group services:

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

Arm's Length Nature of Fees

In general, management fees are deductible for tax purposes, provided they are at arms length being;

- Justifiable for services rendered.
- Reasonable and not excessive.
- Allocated on a fair method;
- Representative of management support provided.

The two methods most relevant to management service charges are as follows;

- i. The comparable uncontrolled price (CUP) method which focuses on the charges made and whether they are consistent with the charges that would apply between independent parties. If they are, then the charges are regarded as arms length.
- ii. The cost plus method involves an analysis of costs and the application of a mark up or margin. If the cost plus method is used the mark up on costs is that of performing similar services.

Documentation

In order to support the charges, adequate documentation should be maintained and be available for review as follows;

- i. A management services agreement. This should document the services to be provided and calculation of management services charges.
- ii. Invoicing of payments.
- iii. Annual calculation (supported by the charging company's Financial Statements) and statements detailing the total charge for the year and any final adjustments.
- iv. A functional analysis summary of the various types of services intended to be provided and details of tasks relating to the management services provided etc.
- v. Documentary evidence of the services actually provided e.g. memo, faxes, e-mails and other correspondence.
- vi. Evidence of the application of the method to support the charge arising from the CUP/cost plus methods e.g. estimates of the hours involved in providing services, estimates of the hourly rates that might apply for comparable services sourced independently (both from an overseas supplier and a Fiji supplier), then extending the hours by an appropriate rate to arrive at a "comparable price".
- vii. An annual minute by the directors, ratifying acceptance of the fees and confirming the reasonableness of the charge having regard to the services provided.

The charges for services would relate principally to services provided by the relevant individuals working on the respective businesses. The total costs of that individual are identified (salary and other remuneration) and a time estimate is made of the time spent on each company's business and, costs allocated accordingly. Using CP a mark-up on internal salary costs is made the salaries we envisage would comprise executive and office salaries where there is an identifiable direct input. For example, a finance officer's time spent on Fiji business would be charged at a margin of perhaps 15% whereas a store person would be as an overhead recovery of cost plus say 7.5%.

The determination of an appropriate mark-up should be documented as circumstances will vary.

7.5% is we understand an acceptable mark-up on non core business overheads. This is the rate used in both Australia and New Zealand. Other rates could apply if reliable data (i.e. CUP's) were produced. In this regard, FRCA is adopting 7.5% as the safe harbour rate for non core services. Non core services are those that are not central to the business e.g. overheads.

Such clearly identifiable persons with direct input details should be recorded on schedules

of management services charges.

Alternatively, an appropriate charge out rate (CUP) could be used. This is calculated as:

12 months x No. of days (total average time per month) x no. of hours per day x appropriate dollars per hour = charges in respect of time spent on the company's business.

It would be preferable if the time spent on various operations was supported by relevant diary extracts, however we accept that in practice that such time recording may not be made and the percentages may represent the best available estimates.

Financing

Cross-border funding forms a substantial part of associated party dealings by Fiji MNE's.

Key issues are interest charges and guarantee fees. The same transfer pricing principles apply in that market rates of interest should be charged. Whether it be inbound or outbound financing.

Most interest rate analyses begin with an appropriate reference rate or base indicator. For variable rate loans, this is typically the bank bill rate; for fixed rate loans, usually swap rates are applicable.

Financing is largely concerned with margins. An important factor in determining interest rate margins is credit risk or the probability of default. Other factors such as liquidity, ranking (senior or subordinated) and early repayment have only limited impact compared with credit risk. Therefore the margin added to the base indicator in order to arrive at an interest rate is reflecting credit risk.

The following factors need to be considered

- relative size and profitability of the Fiji operation compared with the global group
- whether the Fiji operation is strategic to the global group
- whether the Fiji operation is part of a wider integrated supply chain,
- whether valuable name and/or brand flows through the group.

We seek to strike a balance between protecting the tax base and minimizing compliance costs. In consequence, for smaller value loans (i.e. less than FJ\$2 million principal), we currently consider 300 basis points (3%) over the relevant base indicator is broadly indicative of an arm's length rate, in the absence of a readily available market rate for a debt instrument with similar terms and risk characteristics. In Fiji, the base indicator rate is determined by reference to the Government Treasury Bill Rate (obtained from the Reserve Bank of Fiji).

For loans up to FJ\$10 million principal, independent banker quotes are generally acceptable, but once again considerable care is required. In particular, such quotes are generally accepted as indicative only and do not involve a full due diligence process nor is the bank making any funding commitment. For all loans in excess of NZ\$10 million principal, we would advise more analysis and benchmarking to support interest rates applied.

Guarantees require an explicit written undertaking and a letter of guarantee or irrevocable letter of credit, before a guarantee fee is accepted. Justification for the amount of fee is also required for example, by reference to interest rate savings.

Intangibles including royalties

While the same arm's length principles apply, the issue of intangibles often creates difficulties in transfer pricing as opinions vary on the range of possible arm's length outcomes.

In reviewing royalty payments it is important to have due regard to both qualitative and quantitative aspects. Qualitative factors include identifying the actual IP (e.g. trademarks) and quantitative factors look at pricing the IP (i.e. the royalty rate).

A proper analysis requires confirmation that there is actual value in the intangibles. Identify the nature of the intangibles in terms of marketing and trade intangibles and other assets e.g. associated technology transfers, and assess value in monetary terms.

On the basis that the existence of intangibles is confirmed, an arm's length price strategy is developed, for example in the case of trademarks/patents it may be possible to locate CUPs (or in practice a reasonable comparable).

A quantitative analysis of performance is required, having regard to actual performance and comparisons of key performance indicators, industry norms or averages. The overall analysis is designed to determine an appropriate royalty range and conclude on a fair royalty rate.

For inbound licensing, the intangibles need to be clearly identified and companies must be able to demonstrate that they add significant and substantial value if large royalty payments are to be substantiated.

Questions: 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? Obviously, this is a general observation and individual cases may vary. Have all intangible profit drivers been individually identified (including goodwill and any licensed IP)?

1. What is the value of all intangibles owned and used by the company and have they been valued by a professional firm?
2. Is the IP protected?
3. Who bore the cost of creating the IP?
4. How and to what extent does the IP contribute to the profit?
5. Has any IP been assigned and if so what was the consideration?
6. How is the IP documented?

The following checklist might be useful to companies involved in licensing arrangements with offshore associates:

1. Is there an up-to-date licensing agreement in place?

2. Does the agreement clearly identify the intangible property being supplied and accurately reflect the commercial arrangement for the New Zealand market, or is it merely a standard document used in many markets?
3. Does the intangible property add significant and substantial value to the New Zealand business operations taking into account existing valuable goodwill, monopoly position, local know how or other domestic intangibles?
4. If a royalty is paid for the use of the intangible property, has a standard global/regional rate been used or has the rate been customised to the circumstances of the Fiji business?
5. Some activities of the licensee may not require use of the intangible property - have these been excluded from royalty computations?
6. Has the 25% rule been used as a cross-check?
7. If royalties are high relative to earnings derived from the intangible property, has consideration been given to renegotiating the terms of the license? If not, why not?
8. Has withholding tax been deducted?
9. Has any additional assistance been provided from offshore in connection with the supply of scientific, technical or commercial knowledge or information? (Such assistance may also be subject to withholding tax).

The 25% Rule

The whole issue of setting royalty rates is a somewhat complex subject as evidenced in the publication "100 factors in technology licensing", Arnol White and Durbee 1989 Licensing Law Handbook, Clark Boardman. However, certain methodologies have been developed to assist in this regard. We would emphasise that care needs to be taken in using these indicators or rules as the individual circumstances will determine outcomes in terms of royalty rates and related issues.

The "25% Rule" is often used as a guide or starting point to setting royalties. The technique (as opposed to "rule") suggests that a licensor should receive 25% of the extra profits derived from the licence. Studies suggest that a 25%/75% split works well for both parties where the rights licensed are important but not pioneer in nature and which are likely to attract and retain customers.

Licensing practitioners regularly consider the 25% rule at least as an indication of the order of magnitude of where their negotiations should focus. In other words, the 25% rule cannot be used for any substantial purpose (see *Uniloc v Microsoft Corp* Fed.Cir. 2011). We are advised however, that professional advice received by Inland Revenue is to the effect that the 25% rule is common practice in New Zealand at least as a cross check in royalty rate determinations.

Care needs to be exercised in using these rules of thumb (20%/5%) and while useful in certain situations are not typically in other, e.g. pharmaceuticals, computer software and biotechnology.

For further discussion of the "25% Rule", refer to Structuring Royalty Payments to Mutual Advantage. Crispin Marsh, Managing Director, SCP Technology and Growth Pty Ltd.

The 5% rule

The specific circumstances of a party or case will always take precedence over any hypothetical negotiation. In practice, we have found that the CUP method is more reliable in “reasonable royalties” determinations.

In terms of determining royalties, it has been observed that many royalty negotiations result in an agreed royalty of 5-6% of net sales/revenues. With the “median royalty rate across all industries in the order of 4.5 percent.(This ranged from a low of 2.8% in the Food industries to a high of 8% in Media and Entertainment.) Source: Mark Berkman, *Valuing Intellectual Property Assets for Licensing Transactions*, 22 THE LICENSING JOURNAL 16 (April 2002).

However, the rule should not be taken as a prescriptive means of determining a particular royalty rate rather as a tool to assist in setting a royalty.

Residual Profit Split

Tax authorities often use a residual profit split methodology for computing appropriate royalty levels (See for example the IRS findings in the GlaxoSmithkline case). Essentially this methodology is applied to the licensee (as the tested party) and attributes to that party a routine profit for the type of operation which it undertake. The remaining profit is then treated as the royalty to be paid to the licensor. Often the starting point to splitting residual profit is a 50/50 approach. This is not to suggest that a 50/50 split is anymore appropriate than any other split, the overriding result should reflect arm’s length pricing.

Documentation

Statutory Requirements

A company's main purpose in preparing documentation is to be in a position to demonstrate that it has complied with the arm's length pricing principle.

In interpreting the documentation requirements we note that the OECD 2010 refers to reasonable efforts to ensure transfer pricing is at arm's length. We endorse the OECD's governing principle of "prudent business management."

In the guidelines on management fees we provide an example of expected documentation.

In overseas jurisdictions where there are no statutory provisions regarding documentation, it is recognised that it is commonly perceived that the costs of preparing transfer pricing documentation often acts as a barrier to compliance. As such taxpayers will adopt a "wait and see approach" rather than addressing transfer pricing issues.

In this context, it is to be noted that in Fiji there is a statutory requirement for the taxpayer to "record, in writing, sufficient information and analysis to verify that its controlled transactions are consistent with the arm's length principle."

It is also noted that the documentation must be contemporaneous and must be in place prior to the due date for filing the relevant tax return.

From a practical perspective, this means the taxpayer must prepare and maintain such documentation as is reasonable in the circumstances. Therefore we emphasise that it is up to local management to determine documentation requirements in view of the nature of the relevant transactions.

The OECD outlines the following principles;

- Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle.
- Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations.
- Documentation requirements should not impose on taxpayers' costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.
- Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive

documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of exchange of information articles in certain cases so that less need be asked of the taxpayer in the context of an examination.

Transfer Pricing Risks

Before expending what can be significant sums of money for the preparation of documentation it is important to consider the transfer pricing risk in relation to the overall operations of the company. Thus if a company has cross-border associated party transactions that are not material it may be that the transfer pricing risk is itself not material.

If a risk is present then documentation should be prepared to show that the transfer pricing has been reviewed and considered arm's length.

The level of detail required will vary. The compliance costs would be excessive if every company with cross border associated party dealings were required to produce the same documentation packages.

If no or inadequate documentation exists and an adjustment is made, the costs will increase in terms of penalties.

As a practical observation, it is noted that often preparation of transfer pricing documentation has clear business benefits as well as meeting tax obligations. For instance, preparation of a functional analysis and determining business profit drivers are great tools in identifying the areas of strength and weakness in the business, and thus enable a focus on enhanced profitability.

Documentation packages

While it is not possible to prescribe adequate documentation to cover all cases, the following may assist in ensuring the quality of documentation packages.

- Statement of the facts (analysis of functions, risks and assets including intangibles)
- Industry analysis , especially identifying the key profit drivers, performance of major competitors, and where the value added arises for the company
- Consideration of each category of associated party transactions
- Discussion on internal comparables that is transactions with independent parties which allow comparison.
- Reasoning for selection of most reliable pricing methods available
- Full details as to the comparables search undertaken (databases 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
- Cross-checking using at least a second profit level indicator (for example, if an EBIT : sales yardstick has been applied, then a Berry ratio cross-check should be carried out for a distributor or a return on assets calculated for a manufacturer) - if one methodology produces a result that is significantly different to another it is not sufficient to simply assert that one method is preferable without exploring why those results are different
- Conclusions, including sanity checks to demonstrate commercial realism, and
- Copies of all inter-company agreements as well as the local and global corporate structures

Transfer Pricing Key flag Indicators

In determining cases for review/audit from a transfer pricing perspective, the following are particularly relevant in the preliminary evaluation process. Note the fact that a company which has associated party cross border transactions and/or any of the features below does not of itself; mean there are transfer pricing issues and automatic case selection.

- Company incurring ongoing losses.
- Lower than expected profitability.
- Dealings with associates in tax haven jurisdictions Below is a list of these and special purpose jurisdictions, which while not covering all jurisdictions they are nonetheless fairly comprehensive.
- Dealings with associates in special purpose tax haven jurisdictions. These jurisdictions with relatively high headline tax rates but offer significance tax savings for specified activities. Those who offer special reduced tax rates for a particular activity e.g. manufacturing in Ireland.
- Poor compliance processes and records. For example the taxpayer has little or no documentation to support its dealings with associates or does not know what charges are for.
- Intra group charges e.g. management/technical fees
- Large royalty payments and excessive debt levels (i.e. interest payments)
- Transfer of Intangibles
- Business restructurings

Tax Havens and special purpose tax jurisdictions

- Andorra
- Anguilla
- Antigua
- Aruba
- Bahamas
- Bahrain
- Barbados
- Belize
- Bermuda
- British Virgin
- Cayman Islands Cook Islands
- Costa Rica
- Cyprus

- Djibouti
- Dominica
- Ireland (Low and special purpose)
- Gibraltar
- Grenada
- Guam
- Guernsey
- Hong Kong
- Isle of Man
- Israel
- Jersey
- Labuan, Malaysia
- Liechtenstein
- Luxembourg
- Macau
- Malta
- Marianas
- Marshall Islands
- Mauritius
- Micronesia
- Nauru
- Netherlands Antilles
- Nevis
- Niue
- Panama
- Philippines
- Puerto Rico
- Seychelles
- Singapore
- St Kitts
- St Lucia
- St Vincent - Grenadines
- Switzerland
- Tahiti
- Tangier
- Thailand

- Turks and Caicos
- United States - Delaware
- Uruguay
- Vanuatu
- Samoa

Advance Pricing Agreements (APA's)/ Mutual Agreement Procedure (MAP's)

APA's are written binding agreements between a tax authority (FRCA) and a taxpayer that a transaction(s) comply with the transfer pricing regulations. APA's involve a written application and are normally preceded and followed by substantial dialogue and conference between the tax authority and taxpayer. They are designed to provide certainty as to the tax effect of dealings between the associated parties. APA's are of course beneficial and useful in dealing with difficult facts and circumstances such as intangibles.

However, APA's must be viewed in terms of the practical circumstances in Fiji.

APA's are time consuming and absorb substantial resources. At this stage, we cannot commit to an APA process.

What is proposed is an alternative means of assisting taxpayers meet their obligations. This can be achieved through comprehensive taxpayer education and guidance. These guidelines for example, are publicly issued to assist taxpayers in understanding the transfer pricing rules and application. Further public practice statements (advisory and explanatory) will deal with specific transfer pricing issues, as required.

A very important part of taxpayer education is the clear understanding of individual transfer pricing risk rating;

Taxpayers should assess their risk rating by looking initially at 2 important factors;

- The quality of the business's processes and documentation; and
- The commercial realism of their outcomes.

As an illustration, a business that consistently returns losses and has low quality processes and documentation is at the highest risk of a transfer pricing audit.

We will review APA's at some future time in the context of introducing a binding rulings process.

MAP's are procedures in DTA's to avoid double taxation. We will follow the detailed procedures as described in the 2007 Manual on Effective Mutual Agreement Procedures. Specifically refer to paragraph 2.2.1 in connection with a general format in making a MAP request.

Branches

Background

The concept of Permanent Establishments (e.g. branches) has a long history in Double Tax Agreements (DTA's) and the tax issues surrounding branches has been under review by the OECD for at least the last 15 years.

Typically, Article 7 of a DTA such as that in the Fiji/Australia DTA, provides that in determining the profits of a branch there shall be “attributed to a permanent establishment the profits which it might be expected to make if it were **a distinct and separate enterprise** engaged in the same or similar activities under the same or similar conditions and **dealing wholly independently with the enterprise of which it is a permanent establishment** or with other enterprises with which it deals” (**emphasis added**).

The separate entity and arm's length principles, on which Article 7 (2) is based, has already been incorporated in many DTA's.

However, practical experience has shown that there was considerable variation in the interpretation of these general principles and a lack of common interpretation created problems of double taxation and non-taxation. Despite several OECD reports since the 1977 model DTA was issued, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries interpretation of Article 7 continued to vary significantly.

2010 OECD Review

Consideration of the above issues culminated with the issue of the major review contained in the **OECD 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS**.

The changes have significant transfer pricing implications.

In the review, the OECD decided that a new version of Article 7 should be included in the next update to the Model Tax Convention to allow the full incorporation of the confirmed principles.

The new Article 7 was included in the 2010 update to the OECD Model Tax Convention.

In terms of approaching discussion of the issues it is important to remember that a fundamental policy has been decided in that FRCA will follow OECD Guidelines in relation to transfer pricing and other matters. It is therefore logical that the recommendation of the 2010 OECD Report be adopted.

This will not require any legislative amendment rather will be implemented by Policy and Practice.

The review noted 2 possible approaches being the “relevant business activity” and “functionally separate entity “.In simple terms this can be described as a “head office allocation” method and the analogy with a “subsidiary” method.

The latter method recommended by the OECD Treats a Branch as a hypothetical distinct and separate enterprise, and to attribute profits to it in accordance with the arm's length principle, applying the OECD Transfer Pricing Guidelines by analogy. By definition therefore the OECD rejects the Head office allocation method.

Two-Step Analysis of Authorized OECD Approach

Step One

- Determine the activities and conditions of the hypothetical “distinct and separate enterprise”, engaged in “same or similar activities” under “same or similar conditions”, and “dealing wholly independently” with the enterprise of which it is a part (i.e., describe the branch/PE).

How to do Step One:

By applying the principles of the OECD's Transfer Pricing Guidelines by analogy to perform a factual and functional analysis:

- to identify functions performed, assets used, and risks assumed by the PE,
- to attribute adequate free capital to the PE in light of its risks, and
- to identify any “dealings” between PE and rest of enterprise

Recognition of “dealings” between PE and rest of enterprise:

- Dealing is a “real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.)”
- Taxpayer's internal documentation potentially useful in establishing and characterising dealings

Step Two

Determine the profits of the hypothetical separate enterprise by applying the OECD's 1995 Transfer Pricing Guidelines (as updated) by analogy to “dealings” between PE and other parts of the enterprise.

Key Practical points

- The 2 step approach will in practice require taxpayers to address the issue of determining profits in a branch context. This is a compliance reality otherwise the taxpayer risks penalties etc.
- “Dealings” between the branch and head office will be recognised where they are readily identifiable and at arm's length.
- “Dealings” are real and identifiable events that are not notional items where there is no real dealing.
- The net result is tax deductions for legitimate dealings and withholding tax on source

payments e.g. management and other fees, interest and royalties.

- It is important to note that the resulting profits after recognising all dealings should reflect a commercial outcome consistent with the arm's length principle (as noted previously when outlining documentation requirements).
- Increased level of certainty for branch structures and transactions.
- There will be issues where an overseas country does not endorse the OECD recommendations e.g. New Zealand does not agree with the findings.
- There are in practise issues such as levels of "free" capital which need to be resolved on a case by case basis. Free capitals is funding that does both a policy and not give rise to tax deductible interest payments.
- Documentation will need to identify dealings.
- Unlike separate associated companies, an enterprise cannot legally enter into binding agreements with itself. However, in order to achieve a hypothetical separate entity, then hypothetical agreements giving effect to various intra-company arrangements should be contemporaneously documented. It is therefore explicitly recognised that there are situations where documentation is not usually prepared by taxpayers, yet the preferred OECD approach is that such documentation should be prepared on a contemporaneous basis.