54.

New Zealand

Introduction

New Zealand enacted its transfer pricing legislation on 12 December 1995, with effect from the income year ending 31 March 1997. The Inland Revenue Department (Inland Revenue) issued transfer pricing guidelines in final form in October 2000.

The Inland Revenue does not intend to update these guidelines in the future. Instead, the Inland Revenue now relies on the latest 2010 Organisation for Economic Co-operation and Development (OECD) Guidelines, which are consistent with New Zealand's transfer pricing legislation and double taxation treaties.

Inland Revenue's current focus

The Inland Revenue is continuously fine-tuning its targeting approach in terms of taxpayers and risk areas. We have seen clear evidence of this in our dealings with the Inland Revenue and commentaries published by the Inland Revenue in the last few years. The Inland Revenue has expressed its views on the transactions it will monitor, expectations for New Zealand-based companies when expanding offshore and risk areas that foreign multinationals should be aware of when restructuring their New Zealand operations.

Over recent years, the Inland Revenue has lifted its game and sophistication in terms of transfer pricing enforcement. In this regard, the Inland Revenue has instigated a number of specific transfer pricing review programmes. In particular, it maintains a special focus and conducts comprehensive annual reviews on the top foreign-owned multinationals (with revenue in excess of 300 million New Zealand dollars [NZD]). The Inland Revenue has also recently signalled that it is likely to reallocate some resources to obtain greater coverage of the middle market (taxpayers with revenue between NZD 30 million and NZD 300 million), which includes the majority of the New Zealand subsidiaries or branches of offshore multinational corporations.

In August 2012, the Inland Revenue announced that its compliance review programme for 2012-2013 will continue to cover the full range of both inbound and outbound associated-party transactions, with a special emphasis on:

- arrangements to import offshore losses through nonmarket pricing
- inbound service charges
- the transfer of intangible property out of New Zealand, particularly where it is intended that the property is subsequently licensed back to the original property owner
- all financing arrangements in excess of NZD 10 million principal
- groups carrying above-average debt that may have been exposed to losses and asset write-downs, and

- non-arm's-length subsidies and support payments.

In addition, the Inland Revenue continues to focus on companies that have incurred losses over a sustained period. The Inland Revenue has indicated that further audit work is likely to occur where the company fails to lift its performance following a transfer pricing review by the Inland Revenue. Transfer pricing adjustments could follow.

The Inland Revenue has identified several key issues in relation to intragroup financing, including the pricing of interest and guarantee fees, and capital restructuring that result in a major reduction in New Zealand tax paid (*refer to Thin capitalisation section, below*). In particular, the Inland Revenue will be closely monitoring all inbound loans over NZD 10million, all outbound loans and the appropriateness of a non-investment-grade credit rating (Standard & Poor's BB or lower). In these cases, the Inland Revenue expects to see robust benchmarking supporting interest rates and guarantee fees. The Inland Revenue also suggests that businesses consider seeking binding rulings for new funding arrangements to minimise any uncertainty.

In addition to the focus areas discussed above, the Inland Revenue encourages taxpayers to enter into advance pricing agreements (APAs) as they produce significant time and cost savings for both tax authorities and multinationals in comparison with adversarial audits (*refer to Advance pricing agreements section, below*).

Inland Revenue also will continue to monitor business restructures. The Inland Revenue is aware that multinationals continuously alter their supply chains in their quest to maximise efficiencies in their networks. The Inland Revenue is looking closely at supply chain restructures, particularly a change from a standard-risk operation to a low-risk operation.

For the first time, the Inland Revenue has articulated what it considers are the key governance questions all businesses should address to manage their transfer pricing risks adequately, such as:

- Whether the entity knows the nature and extent of their cross-border associated party transactions.
- If the transactions are material, whether there is documentation supporting the transfer pricing, which is kept up-to-date.
- Whether the finance function has been fully involved in the documentation process and signed off the factual analysis as well as the final outcomes.
- Whether the business has considered applying for an APA and if not, why not.

These questions indicate the Inland Revenue's likely approach when it comes to reviewing a business's transfer pricing.

Inland Revenue's review mechanism

The main tool that the Inland Revenue uses in assessing taxpayers' compliance with the transfer pricing rules is its transfer pricing questionnaire. There are three versions of the questionnaire: one for foreign-owned multinationals, one for New Zealand-owned multinationals and one for New Zealand branches. They vary slightly; however, they ask the same main questions.

The questionnaire requires taxpayers to provide details of, among other things, their financial performance; the worldwide group's financial performance; the type and amounts of cross-border, associated-party transactions; the method or methods used to test the transactions; and whether documentation exists to substantiate the transfer prices. The version pertaining to foreign-owned multinationals also includes questions designed to assess taxpayers' compliance with the thin capitalisation rules. The questionnaire is a risk assessment tool and does not constitute notice of the commencement of a transfer pricing audit.

The Inland Revenue first issued the questionnaires as part of its transfer pricing risk review project (i.e. 'bulk' rounds of questionnaires sent to multiple taxpayers) and during general tax audits. The department issued two rounds of questionnaires in 2000 and a further round in December 2003. Since then, questionnaires have remained central to Inland Revenue's compliance programme as a means of scoping risks efficiently and effectively.

Taxpayers with potential transfer pricing issues receive the questionnaire as standard practice during a tax audit. We also have seen an increasing number of taxpayers being asked by the Inland Revenue to complete questionnaires during routine tax investigations. In many cases, a request for transfer pricing documentation has accompanied the issuance of the questionnaire during a tax audit. Inland Revenue auditors have received training specific to transfer pricing, and recent experience suggests an increasing number of auditors are making transfer pricing queries.

Some taxpayers have also received the questionnaire as a 'one-off', not as part of a specific review project or a tax audit. We suspect that in these incidences, the Inland Revenue is seeking to obtain an understanding of the transfer pricing issues and risks associated with a particular industry.

The types of response the Inland Revenue gives a taxpayer following submission of the questionnaire include 'no further action required', 'please provide further information' and 'please explain'. In the second of these responses, the Inland Revenue generally requests the taxpayer to complete a further questionnaire for a subsequent financial year. The third response usually entails the Inland Revenue requiring the taxpayer to explain the nature of a particular (and perhaps unusual) transaction or the reasons for a loss being incurred.

In addition, the Inland Revenue has indicated to some taxpayers that have received the questionnaire that it is maintaining a 'watching brief' of their transfer pricing practices. The department monitors the financial performance of these taxpayers by accessing publicly available financial statements from the New Zealand Companies' Office website.

Statutory rules

Sections GB 2 and GC 6 to GC 14 of the Income Tax Act 2007[1] (tax act) contain the current transfer pricing legislation. The transfer pricing legislation closely follows the current OECD Guidelines and the US Section 482 rules. Other features of the legislation are as follows:

1 The relevant sections in the Income Tax Act 2004 are GD 13, FB 2 and GC 1. On 1 April 2008, the Income Tax Act 2007 superseded the Income Tax Act 2004. The purpose and intention of the provisions remain the same. The Income Tax Act 2007 applies to tax on income derived in the 2009 income year onwards.

- The basic principle is that of arm's length, as defined by the OECD Guidelines, using five permitted pricing methods: the comparable uncontrolled price (CUP), resale price, cost plus, profit split and comparable profits methods.
- The amount of arm's-length consideration must be determined by applying whichever method or combination of methods listed above will produce the most reliable measure that completely independent parties would have agreed on after real and fully adequate bargaining.
- The substitution of an arm's-length price applies only so as to increase New Zealand's tax base (GC 7 and GC 8)[2]. The burden of proof as to the arm's-length nature of consideration rests with the commissioner of Inland Revenue (the commissioner), unless the commissioner can show that the taxpayer has not cooperated or can demonstrate another amount to be a more reliable arm's-length measure (GC 13(4))[3].
- There are specific powers, in addition to those in the double taxation agreements (DTA), to allow compensating adjustments (GC 9 and GC 10[4]) and corresponding adjustments (GC 13(11))[5].
- Section GB 2[6] contains an anti-avoidance provision that includes arrangements entered into for the purposes of defeating the provisions of GC 6 to GC 14[7].

In addition to these outlined provisions, Section YD 5[8] stipulates the use of the arm's-length basis to apportion income between New Zealand and other countries in the case of branches and agencies.[9]

Guidance on applying New Zealand's transfer pricing rules

The following additional guidance on the application of the legislation is available from the Inland Revenue:

- A technical information bulletin, which deals with the introduction of the new legislation and provides an indication of how the Inland Revenue will interpret it; and
- Transfer pricing guidelines.

The Inland Revenue initially released draft guidelines in two parts: part one in October 1997 and part two in January 2000. No subsequent guidelines have been published since the 2007 rewrite of the Income Tax Act 2004.

The first part of the draft guidelines covered the arm's-length principle, transfer pricing methodologies, theoretical and practical considerations, principles of comparability, practical application of the arm's-length principle, documentation and the Inland Revenue's approach to administering New Zealand's transfer pricing rules. Part two of the draft guidelines covered the treatment of intragroup services, the treatment of intangible property and cost contribution arrangements.

2 Income Tax Act 2004 Sections GD 13(3) and (4).
3 Income Tax Act 2004 Section GD 13(9).
4 Income Tax Act 2004 Section GD 13(10).
5 Income Tax Act 2004 Section GD 13(11).
6 Income Tax Act 2004 Section GC 1.
7 Income Tax Act 2004 Section GD 13.
8 Income Tax Act 2004 Section FB 2.
9 In relation to the apportionment of income to branches, the Inland Revenue has made an explicit reservation on the new article 7 of the OECD model tax convention. The new Article 7 will only apply if and when it is adopted in New Zealand's double tax agreements. The Inland Revenue has stated that this is unlikely to happen in the near future.

New Zealand

The Inland Revenue issued final transfer pricing guidelines (Inland Revenue Guidelines) in October 2000. The Inland Revenue Guidelines consolidate the draft guidelines previously issued, with no substantive changes. The Inland Revenue Guidelines specifically do not apply to permanent establishments and branches that are covered by Section YD 5[10] of the tax act.

The Inland Revenue states that the Inland Revenue Guidelines are intended to supplement the OECD Guidelines rather than supersede them. In fact, the department fully endorses the comments set out in chapters one to eight of the OECD Guidelines. In its guidelines, the Inland Revenue indicates that the OECD Guidelines are relevant to DTA issues and issues not addressed by the Inland Revenue Guidelines.

The OECD Guidelines were revised in 2010. The Inland Revenue has noted that it will apply the revised OECD Guidelines but does not intend to update the Inland Revenue Guidelines to reflect the changes to the OECD Guidelines.

Taxpayers are also directed to guidelines issued by the Australian Taxation Office and the US 482 regulations, as long as these sources are consistent with the overall approach of the Inland Revenue. However, on issues concerning the administration of New Zealand's transfer pricing rules, the Inland Revenue Guidelines are stated as being paramount.

The comments in the Inland Revenue Guidelines dealing with the arm's-length principle and pricing methods are broadly consistent with the OECD Guidelines, except there is no explicit hierarchy for the transfer pricing methods. However, taxpayers must use the most reliable method.

In relation to the transfer pricing methods prescribed in New Zealand's tax act, a particularly interesting comment is made in the Inland Revenue Guidelines:

"… Inland Revenue does not consider that there is any practical difference between the TNMM [transactional net margin method] espoused by the OECD, the comparable profits method favoured in the US, and the profit comparison method adopted by Australia. It was also noted [previously in the Inland Revenue Guidelines] that the reference to 'comparable profits methods' in Section GD 13(7)(e) [of the tax act] is wide enough to encompass all three approaches" (the Inland Revenue Guidelines, paragraph 141)[11].

With respect to tested parties, the Inland Revenue Guidelines specifically allow taxpayers to benchmark the foreign party in particular circumstances where they believe that that is more appropriate to determine the most reliable measure of the arm's-length price. However, where a taxpayer does decide to use the foreign party as the tested party, it should be aware that the Inland Revenue is likely to also test the New Zealand party and, therefore, it is important there is some analysis in relation to the New Zealand operations. Specifically, the Inland Revenue is prepared to accept a foreign analysis provided that the analysis represents a fair application of the arm's-length principle and results in a return from the New Zealand operations that is, *prima facie*, commensurate with the operation's economic contribution and risks assumed.

10 Income Tax Act 2004 Section FB 2.

11 This reference provided by the Inland Revenue Guidelines refers to the Income Tax Act 2004. The relevant section in the 2007 rewrite is GC 13(2)(e).

The Inland Revenue recognises that applying the transfer pricing methods can often result in a range of arm's-length outcomes instead of a single arm's-length outcome. Where a range is established, the Inland Revenue considers that, rather than the entity applying statistical measures to the range, the more important issue is to assess whether the comparables used to construct the range are reliable.

New Zealand's transfer pricing rules do not contain an explicit statutory provision requiring taxpayers to prepare transfer pricing documentation. However, Sections GC 6 to GC 14[12] of the tax act require taxpayers to determine transfer prices in accordance with the arm's-length principle by applying one (or a combination) of the methods set out in Section GC 13(2)[13] of the tax act. For an entity to demonstrate compliance with this requirement, the Inland Revenue considers it necessary to prepare and maintain documentation to show how transfer prices have been determined.

The Inland Revenue considers there are two reasons for making this assertion for documentation. The first is the burden of proof rule in Section GC 13(4)[14] of the tax act. Under this section, the price determined by the taxpayer will be the arm's-length price, unless the commissioner can demonstrate a more reliable measure or the taxpayer does not cooperate with the commissioner's administration of the transfer pricing rules. If a taxpayer does not prepare documentation, there are two exposures. First, it is more likely the Inland Revenue will examine the taxpayer's transfer pricing in detail. Second, if the Inland Revenue substitutes a new transfer price as a result of the examination, the lack of documentation will make it difficult for the taxpayer to rebut that position.

The second consideration sustaining the Inland Revenue's view of documentation is the proposed application of the penalty provisions of the Tax Administration Act 1994 (Tax Administration Act) contained in the Inland Revenue Guidelines:

"In Inland Revenue's view, adequate documentation is the best evidence that can be presented to demonstrate that these rules have been complied with. If a taxpayer has not prepared any transfer pricing documentation, and Inland Revenue is able to demonstrate a more reliable measure of the arm's-length amount, Inland Revenue's view is likely to be that the taxpayer has, at a minimum, not exercised reasonable care (carrying a 20% penalty under Section 141C of the Tax Administration Act) or has been grossly careless (carrying a 40% penalty under Section 141C of the Tax Administration Act), in its determination of an arm's-length amount under Section GD 13" (the Inland Revenue Guidelines, paragraph 316)[15].

The Inland Revenue accepts that the creation and maintenance of documentation impose costs on taxpayers. In the Inland Revenue's opinion, if a taxpayer has reached the conclusion on the basis of a sensible cost-benefit analysis that it is not prudent to pursue a full transfer pricing analysis, this would be strongly suggestive that the taxpayer has taken reasonable care. Of course, the Inland Revenue would expect to see a document explaining how the conclusion was reached. In respect of the issue of whether a taxpayer has an acceptable interpretation, the Inland Revenue considers that the taxpayer must have explicitly considered that its transfer prices are at least

12 Income Tax Act 2004 Section GD 13.
13 Income Tax Act 2004 Section GD13(7).
14 Income Tax Act 2004 Section GD13(9).
15 This reference from the Inland Revenue Guidelines refers to the Income Tax Act 2004. The corresponding references for the Income Tax Act 2007 are GC 6 to GC 14.

broadly consistent with the arm's-length principle. In assessment of the risk of a potential transfer pricing adjustment, all of the following documentation is suggested at a minimum:

- An identification of the cross-border transactions for which the taxpayer has a transfer pricing exposure.
- A broad functional analysis of the taxpayer's operations to identify the critical functions being performed.
- An estimate of the business risk of not undertaking and documenting a more detailed transfer pricing analysis.
- An estimate of the costs of complying with the transfer pricing rules.

It is emphasised that this assessment will not preclude the Inland Revenue from substituting a more reliable measure of the arm's-length price. Where a cost-benefit analysis indicates the need for a full analysis, the Inland Revenue would expect to see all of the following documentation:

- Some form of functional analysis.
- An appraisal of potential comparables.
- An explanation of the process used to select and apply the method used to establish the transfer prices and why the taxpayer considers that it provides a result consistent with the arm's-length principle.
- Details of any special circumstances that have influenced the price set by the taxpayer.

It should be noted that these documentation requirements have no legislative authority and are not, therefore, binding on the taxpayer. Rather, they are an indication of the Inland Revenue's approach to an interpretation of New Zealand's transfer pricing rules.

The Inland Revenue Guidelines also consider cross-border transfers of intangible property, including any rights to use industrial property (such as patents, trademarks, trade names, designs or models), any literary or artistic property rights (copyrights, etc.) and any intellectual property, such as know-how or trade secrets.

The Inland Revenue acknowledges that the application of the arm's-length principle to transfers of intangible property can be problematic because appropriate comparable transactions can be difficult, if not impossible, to identify. Despite these difficulties, the Inland Revenue emphasises that applying the arm's-length principle is no different than for other types of property.

The Inland Revenue Guidelines also discuss the provision or receipt of intragroup services. Services can be either specific benefit or indirect. Specific benefit services are normally charged to the recipient entity directly. Indirect services should be charged using a cost allocation or apportionment approach.

The Inland Revenue Guidelines depart most significantly from the OECD Guidelines relating to both of the following:

- A detailed discussion of the different allocation methods that may be appropriate in the charging of indirect services.
- The provision of a safe harbour markup on cost of 7.5% in applying the cost plus method for non-core activity services and for services under the specified *de*

minimis threshold.[16] A non-core activity is defined as an activity that is not integral to the profit-earning or economically significant activities of the group. This provision will relieve taxpayers from having to benchmark these services. However, it does not relieve their obligations to demonstrate the benefits derived from the services or prepare adequate transfer pricing documentation.

Cost contribution arrangements are also discussed in the Inland Revenue Guidelines. The Inland Revenue Guidelines emphasise that to satisfy the arm's-length principle, a participant's contribution must be consistent with what an independent enterprise would have agreed to pay in comparable circumstances. Cost contribution arrangements remain an evolving concept from a transfer pricing perspective. Taxpayers should clearly consider the Inland Revenue Guidelines on such arrangements if they are participating in or considering participating in one.

Legal cases

No court cases have arisen in connection with New Zealand's current transfer pricing rules. It should be noted, however, that even under the previous legislation, there were effectively no transfer pricing court cases in the 20 years prior to its repeal. The two main reasons for this are:

- The previous legislation was considered to be defective.
- Because most transfer pricing disputes were settled by negotiation, there was no need to proceed to court.

Burden of proof

In New Zealand, the burden of proof normally lies with the taxpayer, not the commissioner. However, Section GC 13(4)[17] places the burden of proof on the commissioner where the taxpayer has determined its transfer prices in accordance with Sections GC 13(1) to 13(3)[18] of the tax act.

Where the commissioner substitutes an arm's-length price for the actual price, the commissioner must prove one of the following:

- This is a more reliable measure.
- The taxpayer has not cooperated with the commissioner.

According to the Inland Revenue Guidelines, non-cooperation constitutes either of the following:

- Where the taxpayer does not provide the requested relevant information to the commissioner.
- If a taxpayer does not prepare adequate documentation and provide it to the Inland Revenue if requested.

The burden of proof rule is essential in the context of transfer pricing in New Zealand. Clearly, if taxpayers maintain quality documentation of transfer pricing and produce

16 The Inland Revenue has recently updated the de minimis threshold from NZD 100,000 to NZD 600,000, effective 1 July 2010. This aligns the New Zealand threshold with that applied by the Australian Taxation Office, and therefore reduces compliance costs for multinational enterprises.
17 Income Tax Act 2004 Section GD 13(9).
18 Income Tax Act 2004 Sections GD 13(6) to 13(8).

it on request to the Inland Revenue, they will substantially reduce the risks of an intensive transfer pricing audit. And in any event, the burden of proof will fall on the commissioner to demonstrate that Inland Revenue has a more reliable measure of the arm's-length price.

Transfer of tax compliance work and records overseas

The Inland Revenue is becoming increasingly concerned about compliance issues with taxpayers whose accounting and tax functions are carried out offshore, especially in relation to the timeliness and quality of the taxpayers' tax records. Accordingly, the Inland Revenue continues to remind taxpayers that if it is necessary to keep and retain records outside New Zealand for commercial reasons, the business involved must apply to the Inland Revenue for approval to do so.

This is an important issue in a transfer pricing context, as in many cases New Zealand taxpayers rely on transfer pricing documentation prepared and maintained overseas to support New Zealand tax filing positions. We recommend that New Zealand taxpayers obtain this documentation for their own files and ensure that it specifically supports the New Zealand business concerned. Where New Zealand transfer pricing documentation is held by an offshore affiliate and not locally, an appropriate request for approval must be lodged with the Inland Revenue.

Tax audit procedures

The Inland Revenue will perform audits or investigations specifically for transfer pricing issues. Transfer pricing audits or investigations may also be combined with normal tax audits and investigations.

Selection of companies for audit

Whether a company or group is selected for investigation will depend on a variety of factors or situations, including:

- Previous transfer pricing disputes with the tax authorities, particularly if the authorities consider that these were unsatisfactorily resolved.
- The industry in which the company operates.
- Where an application for an advance pricing agreement has been withdrawn or unsatisfactorily resolved
- Following receipt of information passed to the tax authorities from overseas.
- Where there is evidence of transfer pricing disputes with other revenue authorities overseas.
- As a result of desk audits of returns and replies to correspondence seeking information.
- Inland Revenue risk assessment by reference to all of the following:
  - Level of profitability.
  - No evidence of negotiations with parent.
  - No economic or commercial basis for price.
  - Poor cooperation.
  - Limited transfer pricing documentation.

The Inland Revenue compliance programme focuses its resources on perceived risk to the New Zealand tax revenue base. A transfer pricing-specific review ultimately depends on the extent of tax risk perceived in the taxpayer's transfer pricing practices. The Inland Revenue Guidelines indicate that the Inland Revenue is likely to inspect

transactions involving an entity resident in a country in which New Zealand does not have a DTA more closely than transactions involving tax treaty countries.

Risk transactions or industries

The transactions which can be attacked are specified in Sections GC 6(2) and GC 6(3)19 of the Income Tax Act 2007. Particular types of payment or receipt that are likely to be targeted include payments of interest, management fees, royalties and other fees in relation excluded is share capital other than fixed-rate preference shares.

The Inland Revenue has indicated that as part of its compliance review programme for 2010-11, it will focus on ten industries that are considered high risk from a transfer pricing perspective, including the IT, pharmaceutical, energy, banking and insurance industries.

The provision of information and duty of the taxpayer to cooperate with the tax authorities

Information that tax authorities can request during investigations and the authorities' powers to enforce provision of the information are outlined in Sections 16, 17, 17A, 18, 19 and 21 of the Tax Administration Act. The most important are Sections 16 and 17, which give the Inland Revenue extensive powers, both to carry out investigations and to demand information.

The Inland Revenue Guidelines make it clear that the Inland Revenue expects New Zealand taxpayers on request to obtain information from overseas associated entities to justify the arm's-length nature of their transfer prices. Section 21 provides the Inland Revenue with further powers to require information, particularly in respect of information held offshore. Any information that is not produced in response to a Section 21 request will not be available to the taxpayer as part of his/her defence in any subsequent court action relating to such matters.

Effective 22 June 2005, taxpayers can claim a right of non-disclosure for certain tax advice in documents prepared by tax advisers. However, this right of non-disclosure can be claimed only in respect of 'tax advice documents'. The Inland Revenue has issued a standard practice statement (SPS 05/07) to provide guidance to taxpayers on this matter. The definition of 'tax advice documents' in the Inland Revenue's standard practice statement excludes transfer pricing reports.

Investigations in New Zealand are conducted by way of visits to the taxpayers' premises and interviews with relevant personnel. In some cases, these visits may be preceded by requests for the provision of documentation.

Usually in New Zealand, an investigation is decided through negotiation, but it may proceed to litigation if the issues raised cannot be resolved through negotiation. There is also a dispute resolution procedure that applies to transfer pricing disputes. This provides a form of dispute resolution that is primarily aimed at attempting to settle prior to an assessment. During this procedure, notice of intended assessment is given, followed by compulsory meetings. At the meetings, full disclosure of all relevant facts is required to be made, and it should be noted that any information not produced for these meetings is banned from any future court action.

19 Income Tax Act 2004 Section GD 13(2).

Revised assessments and the appeals procedure

Appeals start with the dispute resolution procedure. After the taxpayer proceeds completely through the dispute resolution procedure, any further appeal would be heard by the courts.

Additional tax and penalties

New Zealand's tax legislation specifies penalties that may be applied to adjustments arising from transfer pricing issues. Determination of the penalties focuses on culpability. The shortfall penalties are:

- Not taking reasonable care – 20% of tax shortfall.
- Unacceptable interpretation – 20% of tax shortfall.
- Gross carelessness – 40% of tax shortfall.
- Abusive tax avoidance – 100% of tax shortfall.
- Evasion – 150% of tax shortfall.

These penalties can be adjusted up or down to reflect the taxpayer's level of cooperation with the authorities during the investigation and the existence or otherwise to any disclosures to the tax authorities. Penalties are not tax-deductible. In addition to the shortfall penalties, an interest charge (deductible) is automatically applied from the date on which the tax should have been paid to the date on which it is finally paid. The rate is adjusted from time to time to reflect economic circumstances.

Resources available to the tax authorities

The Inland Revenue has advised that transfer pricing will not be dealt with by a separate, discrete transfer pricing unit. Rather, all tax inspectors and auditors will be capable of handling transfer pricing issues. The inspectors will be supported by the International Audit Team and will also receive relevant data and particulars of any APA applications being sought. The Inland Revenue has economists available as part of its staff resources, and it is clear the department will not hesitate to contract with outside experts, both economists and industry experts, to assist with its deliberations.

Inland Revenue has recently restructured the International Audit Team to separate compliance and strategic activities. This will allow Inland Revenue to focus on long-term compliance issues and key risk areas such as those discussed above.

Use and availability of comparable information

That a transfer price is at arm's length would, in theory, be demonstrated by means of one or more of the prescribed methods in Section GC 13(2)[20] of New Zealand's tax act. In practice, unless either a CUP or sufficient data to apply a resale price method or cost plus method is available, justification of the pricing used would almost certainly depend on a comparison of net profit margins. In most cases, unless the taxpayer has information available regarding its competitors and/or CUPs or internal comparable transactions, the taxpayer would depend on information available from commercial databases. This information, likely to be an analysis of published annual accounts, would almost certainly force any defence to be based on the comparison of net profit margins.

20 Income Tax Act 2004 Section GD 13(7).

In some cases, within particular industries, more detailed information is available, but this is the exception rather than the norm. Because of the small number of independent companies and large number of 'controlled entities', New Zealand taxpayers are often forced to look for comparable entities in foreign jurisdictions (e.g. Australia, the UK or the US). The Inland Revenue recognises that taxpayers may need to look overseas to find comparable data, which may need to be adjusted to ensure comparability.

Non-publicly available information

The Inland Revenue Guidelines raise the issue of the Inland Revenue's use of non-publicly available information. The Inland Revenue Guidelines state the Inland Revenue does not intend as a matter of course to use non-publicly available information in attempting to substitute an alternative measure of an arm's-length amount. The Inland Revenue concedes there are difficulties, including the likelihood that such information could not be provided to taxpayers whose transfer prices are under review because of the secrecy provisions of the Tax Administration Act.

However, the Inland Revenue does not rule out the possibility that non-publicly available information will be used in administering the transfer pricing rules because the New Zealand tax act requires that the most reliable measure of the arm's-length amount must be determined.

Use of hindsight

The Inland Revenue Guidelines make it clear that the use of hindsight is inconsistent with the arm's-length principle. However, the Inland Revenue Guidelines state that the use of hindsight may be valuable in appraising the reliability of comparables used. The Inland Revenue Guidelines provide an example of a newly developed intangible being difficult to value because of uncertainty as to its future value. Even if time does prove the intangible to be valuable, this is not grounds for automatically adjusting the transfer price.

Availability

The Inland Revenue could access information on other taxpayers, either during investigations into those taxpayers or through a direct request for information under Section 17 of the Tax Administration Act. The latter would enable the Inland Revenue to obtain precise information. Indeed, a recent comment from the head of the Inland Revenue's International Tax Policy Division indicated that such information might be used to select companies for audit, although it is uncertain whether, or under what authority, information obtained in this way could be used as the basis for transfer pricing adjustments.

As noted previously, the information available to taxpayers is likely to be limited to analyses of published accounts as found on commercial databases.

Limitation of double taxation and competent authority proceedings

The competent authority process in New Zealand operates in the way set out in a typical DTA, with nominated officers of the Inland Revenue acting as competent authorities for particular topics. The head of the International Tax Policy Unit is the competent authority for transfer pricing matters.

In addition to DTA provisions, specific provisions in the New Zealand tax act provide for both corresponding adjustments and compensating adjustments, but only in consequence of adjustments made in New Zealand, not in consequence of foreign adjustments.

Advance pricing agreements

APAs are available to taxpayers in New Zealand, and the Inland Revenue is keen to see a greater number of taxpayers seeking APAs. The Inland Revenue has established its APA programme under a broad framework using informal procedures and has stated it will not issue formal APA guidelines. The Inland Revenue considers that its flexible approach to APAs minimises the possibility of the process becoming too bureaucratic and enhances the efficiency of its APA programme. This flexible approach means that most unilateral APAs can be concluded within six months. New Zealand APAs are particularly efficient where APAs have previously been agreed by offshore affiliates with other revenue authorities (where the offshore affiliates are functionally similar to the New Zealand taxpayers).

The Inland Revenue concluded its first bilateral APA (with Australia) in 2001. Since then, the Inland Revenue has concluded several other bilateral APAs with Canada, Japan, Korea, Switzerland and the United States. The department is also party to a multilateral APA. The Inland Revenue has concluded over 81 APAs and is currently negotiating a number of others. Key areas covered by APAs that have been negotiated recently include distribution entities with large exposures, business restructures and complicated royalty structures.

The Inland Revenue expects to see a greater number of taxpayers seeking APAs, given the increase in its auditors' inquiries. The department is encouraging taxpayers to seek unilateral and bilateral APAs, particularly with Australia. The tax authority believes it is better for taxpayers to obtain APAs than run the risk of potentially costly and time-consuming transfer pricing audits. Its view is that given the subjective nature of transfer pricing, APAs are the best way for taxpayers to achieve certainty. As noted above, our experience with the Inland Revenue in relation to APAs has been positive. We believe this is attributable to the agency's informal approach to APAs and its pragmatic view on commercial realism.

Liaison with customs authorities

The Inland Revenue will normally obtain information from the customs authorities and, in fact, is expected to use customs specifically as a source of transfer pricing information. Indeed, customs officers are currently very active in checking the transfer price of goods, although this is ostensibly for customs duty purposes. However, customs has raised queries specifically for the purpose of actively sharing information with the Inland Revenue in relation to the price of goods being imported into New Zealand.

Although there is no legislation that directly requires transfer pricing adjustments to be reflected in returns made for customs or other indirect taxes, where transfer prices have been adjusted for income tax purposes, this may require customs to review the prices for customs duty.

The Inland Revenue has recently announced that it will work with the New Zealand Customs to better align their enforcement practices, taking into account developments overseas.

OECD issues
New Zealand is a member of the OECD. It has signed off on the OECD Guidelines and, as discussed previously, has stated express agreement with them.[21] Further, Inland Revenue personnel are involved in a number of OECD committees dealing with transfer pricing issues.

Joint investigations
New Zealand would undoubtedly join with another country to undertake a joint transfer pricing investigation of a multinational group. To this end, there is a formal, but private, agreement already in existence between the New Zealand and Australian tax authorities. In the past, the tax authorities have traditionally cooperated informally with other tax authorities, either in providing information for other transfer pricing investigations or, in some cases, participating in joint audits or enquiries.

A mutual administrative assistance is designed to enable multiple countries to work together to counteract international tax avoidance and evasion by sharing information and undertaking joint tax audits. New Zealand is considering signing up to the convention. If it does so, the convention would give Inland Revenue the ability to enter into joint tax audits with tax authorities in other countries that are signatories.

Thin capitalisation
New Zealand introduced a thin capitalisation regime to apply from the beginning of the 1996-97 income year. The key features are as follows:

- The regime is fundamentally designed to deny a deduction for interest if a non-resident allocates an excessive proportion of its worldwide debt to its New Zealand operations. An apportionment of deductible interest is required where an entity's debt ratio (calculated as total debt/total group assets) exceeds both:
  - 60%,[22]
  - 110% of the worldwide group's debt percentage.
- It is important to note that the use of debt-to-asset ratio differs from most thin capitalisation models, which monitor an entity's debt-to-equity ratio.
- The regime potentially applies to:
  - non-residents who derive New Zealand-sourced income,
  - New Zealand companies controlled by a single non-resident person (together with persons associated with that person), and
  - non-qualifying trusts that are 50% or more settled by non-resident persons.
- A concession exists for on-lent funds. One effect of this is to minimise the impact of the regime for financial intermediaries.

The thin capitalisation rules were extended in 2009 to include New Zealand companies that are controlled by New Zealand residents and have interests in controlled foreign companies (CFC), except where one of the following applies:

- The ratio of the New Zealand group assets to the worldwide group assets is at least 90%.

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21 The Inland Revenue has made an explicit reservation on the new article 7 of the OECD model tax convention. The new Article 7 (and any associated guidance issued by the OECD) will only apply if and when it is adopted in New Zealand's double tax agreements. The Inland Revenue has stated that this is unlikely to happen in the near future.

22 The 60% threshold only applies in relation to the inbound thin capitalisation rules (this threshold was reduced from 75% starting from the 2012 income year, i.e. 1 April 2011 for taxpayers with a 31 March balance date). In relation to the outbound thin capitalisation rules, the thin capitalisation threshold is 75%.

- The New Zealand group's interest deductions are less than NZD 250,000, and the New Zealand group does not have an interest in a CFC deriving rent from the CFC's country of residence.

Further concessions are available to taxpayers who do not fall below the above thresholds, subject to certain conditions.

Double taxation agreements (DTAs)

The new Turkey – New Zealand DTA came into force on 28 July 2011. In New Zealand, this DTA is effective for withholding taxes from 1 January 2012. For other provisions, the DTA is effective generally for income years beginning on 1 April 2012.

The Hong Kong – New Zealand DTA was concluded on 1 December 2010. This DTA came into force on 9 November 2011. The provisions of the DTA took effect from 1 April 2012.

New Zealand's DTAs with Chile and Mexico were updated to lower the withholding tax rates on certain transactions (applying retrospectively from 1 May 2010). The reciprocal withholding tax rate on royalties arising in Chile and New Zealand has decreased from 10% to 5%. The withholding tax rate for dividend payments arising in Mexico and New Zealand has decreased from 15% to either 5% or zero, depending on the size of the investor's shareholding in the company paying the dividend and certain other criteria.

The updated DTA between Canada and New Zealand was signed on 3 May 2012. The withholding tax rate on dividends will reduce from 15% to a maximum of 5% for an investor who holds at least 10% of the shares in the company that pays the dividend. The withholding rate on royalties has been reduced from 15% to 10% generally, with a further reduced rate of 5% for royalties relating to copyright, computer software and others. The updated DTA will come into force once both countries have given legal effect to it.

The Japan – New Zealand DTA has been updated and will include changes such as lower withholding tax rates on dividends, interest and royalties, and an arbitration provision to deal with taxpayer disputes. The DTA is now awaiting approval and signature by both governments. The DTA will come into force once both countries have completed their respective legal requirements.

Revised CFC rules

New Zealand's rules affecting the calculation of attributed CFC income were amended in 2009. The new rules apply from the 2009-10 income year for taxpayers with balance dates between 30 June and 30 September; for all other taxpayers, the rules apply from the 2010-11 income year.

The new CFC rules are less comprehensive than the old rules. For example, the new rules contain a worldwide exemption for CFCs with an active business. Under the new rules, inadequate pricing policies may no longer result in a zero sum game. Therefore, the Inland Revenue is more likely to scrutinise transfer prices in transactions involving CFCs. Inland Revenue recommends that taxpayers ensure they have sufficient documentation that transfer prices involving CFCs are in accordance with the arm's-length standard.