[Revenue Law Journal](http://epublications.bond.edu.au/rlj)

[Volume 1](http://epublications.bond.edu.au/rlj/vol1) | [Issue 1](http://epublications.bond.edu.au/rlj/vol1/iss1) | [Article 3](http://epublications.bond.edu.au/rlj/vol1/iss1/3)

February 1990

Specific legislative responses to international transfer pricing - a trans-Tasman comparison

Martin Smith
Ernst & Young, New Zealand

Specific legislative responses to international transfer pricing - a trans-Tasman comparison

Abstract

The importance of international trading and multi-national corporate groups means that tax regimes will commonly contain provisions allowing for the adjustment of transfer prices on cross-border transactions. An examination of the taxation Acts of Australia and New Zealand reveals vast differences in scope and clarity, with the New Zealand legislation (presently) containing only a single, rather dated, provision. The author contrasts the two legislative approaches, and also examines the relevant article of the Double Tax Treaty which exists between the countries. One of the most difficult issues in this area is the determination of an arm's length price, and recent developments in the USA are discussed. The author stresses the need for transfer pricing laws to provide guidance to taxpayers and the Revenue as to the method(s) to be adopted in such cases.

Keywords

transfer pricing, taxation legislation, Australia, New Zealand, Double Tax Treaty

SPECIFIC LEGISLATIVE RESPONSES TO INTERNATIONAL TRANSFER PRICING—A TRANS-TASMAN COMPARISON

Martin Smith
LLB (Hons), LLM, Dip Fin Mangt
Director of Taxation Research
Ernst & Young, New Zealand

The importance of international trading and multi-national corporate groups means that tax regimes will commonly contain provisions allowing for the adjustment of transfer prices on cross-border transactions. An examination of the taxation Acts of Australia and New Zealand reveals vast differences in scope and clarity, with the New Zealand legislation (presently) containing only a single, rather dated, provision. The author contrasts the two legislative approaches, and also examines the relevant article of the Double Tax Treaty which exists between the countries. One of the most difficult issues in this area is the determination of an arm's length price, and recent developments in the USA are discussed. The author stresses the need for transfer pricing laws to provide guidance to taxpayers and the Revenue as to the method(s) to be adopted in such cases.

Introduction

The term 'transfer pricing' refers to the determination of the price to be charged—generally between associated persons or entities—for the supply of property or services (including loan funds). Between arm's length parties, market forces can safely be left to fix the sale or transaction consideration, but revenue authorities become anxious where similar transactions are conducted between parties who are connected in some way apart from the transaction in question. Those parties may fix their transfer price without any regard for market values—in fact, of course, the price may be determined by reference to costs, percentages, corporate policy, profitability (or the lack of it) or even the desire to make financial statements more attractive (subject to the accounting requirements for consolidations).

It is also possible for transfer pricing to have regard to the *tax* impacts for the parties to the transaction or a group as a whole. This will particularly be the case where the expenditure by the acquiring party is tax deductible, or where the receipt would be tax-exempt or concessionally treated in the hands of the other party. It can be seen as advantageous where the transaction crosses the borders of two jurisdictions with different *effective* rates of tax, or where one of the parties has carry-forward tax losses or usable tax credits. In more recent times, the introduction of dividend imputation systems has given rise to even greater interest in international profit-shifting as *foreign* tax paid will not generally give rise to imputation (or franking) credits usable in the home country.

Transfer pricing can be adopted in relation to almost any transaction between associated parties, but the most common instances relate to the pricing of property or services provided, such as interest on loaned moneys, trading stock, management fees, insurance, commissions on sales, licensing of intellectual property (such as royalties on trade marks, copyrights and the like), procurement or guarantee fees, the provision of personnel, rental of premises or equipment, freight charges and the provision of 'know-how'.

With the flattening of corporate tax rates, the principal area of operation for transfer pricing lies in the *international* arena, and so we will briefly look at the domestic laws of each country regulating international profit-shifting and then to the provisions of the Double Tax Treaty between Australia and New Zealand. However, it should be borne in mind that transfer pricing can also be utilised *onshore* where carry-forward or current-year losses exist (particularly where the levels of common ownership required for Australian s 80G and New Zealand s 191 are not satisfied) or where lower-rate taxpayers are able to be parties to transactions (eg, where a 33% marginal rate taxpayer can obtain goods or services—in a deductible manner—from a 24% taxpayer). Accordingly, the domestic provisions (such as s 31C of the Income Tax Assessment Act) should also be remembered, but they will not be canvassed here.

Nor will we be engaged in an examination of Australia's provisions (in Divisions 16F and 16G of that country's Act) concerning 'thin capitalisation' and debt creation, which can operate to negate interest deductions where one or more 'foreign controllers' exist. Even though such provisions do affect crossborder transfer pricing by way of interest charges (and must be taken into account in related tax planning and/or group structuring), it is not the transfer *price* which triggers their application. The actual level of interest charged is irrelevant, unless it is nil—in which case the *other* jurisdiction may attempt to apply its transfer pricing provisions.

In situations where transfer pricing is undertaken to shift profits *out* of either Australia or New Zealand by a corporate group effectively *controlled from within* that country, regimes for the 'accrual' taxation of the income of controlled foreign corporations may become as important as—or even more important than—specific transfer pricing sections.[1] In this regard, New Zealand has been blessed with a 'branch equivalent' taxing regime since December 1988 (effective from 1 April 1988). The equivalent Australian proposals (announced in May 1988) have been significantly revised in April 1989, now incorporating an 'active business' exemption (but not where such business income arises from transactions

1 See, eg, Langford-Brown and Scholtz, 'Division 13: Its current and future context' (1988/1989) 23 Tax in Aust No 6.

with associated parties).[2] At the time of writing only draft legislation has been introduced, and, in any event, space does not here permit any satisfactory analysis of the respective countries' CFC provisions and proposals.

Finally, although no topic related to tax planning should be regarded as concluded without reference to Part IVA of the Income Tax Assessment Act and s 99 of the Income Tax Act, those provisions will not be considered in this paper as they, too, warrant a more extensive treatment than is possible herein. It may be that the general anti-avoidance provisions of the two countries will come to be examined in a later issue of this journal.

International transfer pricing provisions—the Australian Income Tax Assessment Act

Prior to Act No 29 of 1982, Division 13 of Part III of the Income Tax Assessment Act comprised a single section which dated from the original 1936 statute. This was s 136, which provided as follows:

> Where any business carried on in Australia—
>
> (a) is controlled principally by non-residents;
>
> (b) is carried on by a company, a majority of the shares in which is held by or on behalf of non-residents; or
>
> (c) is carried on by a company which holds or on behalf of which other persons hold a majority of the shares in a non-resident company,
>
> and it appears to the Commissioner that the business produces either no taxable income or less than the amount of taxable income which might be expected to arise from that business, the person carrying on the business in Australia shall, notwithstanding any other provision of this Act, be liable to pay income tax on a taxable income of such amount of the total receipts (whether cash or credit) of the business as the Commissioner determines.

It will be evident that this provision did not seek to attack by express reference transfer pricing arrangements but rather the manipulation of Australian businesses controlled by non-residents of Australia (by means which may have included transfer pricing). The section was criticised by the Asprey Committee and found to contain a number of deficiencies, including those highlighted by the High Court decision in *FCT v Commonwealth Aluminium Corporation Ltd.*[3] When replacement provisions were introduced in 1982, the opportunity was taken to elaborate upon the types of international transactions specifically made the subject of Division 13. The provisions, being ss 136AA to 136AG, cover international transactions between different entities as well as Australian branch operations, and, accordingly, aim at transfer pricing arrangements with an ex-Australian element.

2 See the Federal Treasurer's Press Release No 30 of 12 April 1989, which includes the following passage:
'For example, by removing any benefit from shifting profits to controlled subsidiaries in tax havens, the comprehensive new rules will take some pressure off the enforcement of the existing transfer pricing provisions'.

3 (1980) 80 ATC 4371.

In the context of transfer pricing, the Division 13 provisions apply where there is an 'international agreement'. The term 'agreement' is defined in ss 136AA(1) in the sweeping terms which have become all too familiar in anti-avoidance provisions: 'any agreement, arrangement, transaction, understanding or scheme, whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings'.

By virtue of s 136AC, an 'agreement' will be an 'international agreement' if—

(a) a non-resident supplied or acquired property under the agreement otherwise than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia; or

(b) a resident carrying on a business outside Australia supplied or acquired property under the agreement, being property supplied or acquired in connection with that business.

The expression 'permanent establishment', best known in the context of Double Tax Treaties, is defined in ss 136AA(1) in terms somewhat similar to those applicable under the International Agreements. However, ss 136AA(1) expressly attracts the definition of 'permanent establishment' contained in ss 6(1) of the Income Tax Assessment Act and adds to it 'a place at which any property of the taxpayer is manufactured or processed for the taxpayer, whether by the taxpayer or another person'.

The ss 6(1) definition provides that 'permanent establishment' means

a place at or through which the person carries on any business and, without limiting the generality of the foregoing, includes—

(a) a place where the person is carrying on business through an agent;

(b) a place where the person has, is using or is installing substantial equipment or substantial machinery;

(c) a place where the person is engaged in a construction project; and

(d) where the person is engaged in selling goods manufactured, assembled, processed, packed or distributed by another person for, or at or to the order of, the first-mentioned person and either of those persons participates in the management, control or capital of the other person or another person participates in the management, control or capital of both of those persons—the place where the goods are manufactured, assembled, processed, packed or distributed;

but does not include—

(e) a place where the person is engaged in business dealings through a bona fide commission agent or broker who, in relation to those dealings, acts in the ordinary course of his business as a commission agent or broker and does not receive remuneration otherwise than at a rate customary in relation to dealings of that kind, not being a place where the person otherwise carried on business;

(f) a place where the person is carrying on business through an agent—

(i) who does not have, or does not habitually exercise, a general authority to negotiate and conclude contracts on behalf of the person; or

(ii) whose authority extends to filling orders on behalf of the person from a stock of goods or merchandise situated in the country where the place is located, but who does not regularly exercise that authority, not being a place where the person otherwise carried on business; or

(g) a place of business maintained by the person solely for the purpose of purchasing goods or merchandise.

So, an 'international agreement' will exist where a *non-resident* without such a 'permanent establishment' in Australia supplies or acquires property under an 'agreement' (as broadly defined), or where a *resident* carrying on an overseas business supplies or acquires property in connection therewith under the 'agreement'. In either of such cases, the operative provision of Division 13 is s 136AD, and particular attention must be directed to its first three subsections. Each of these is to apply where the Commissioner is satisfied that the parties to the international agreement (or some of them) are not dealing at arm's length, and the Commissioner makes a determination as to such application. Subsection 136AD(1) has potential application where the taxpayer *supplies* property for a consideration less than an arm's length consideration, ss (2) can apply where such *supply* is for *no* consideration, and ss 136AD(3) is relevant where the taxpayer *acquires* property for an *excessive* consideration. In all three cases, the Commissioner's determination will cause an arm's length consideration to be deemed to have applied and, where it is not possible or practicable for the Commissioner to ascertain the quantum of an arm's length consideration (eg, through not having sufficient information), ss 136AD(4) allows the Commissioner to determine that quantum himself.

It is important to note that the alternatives of control or majority shareholdings which were preconditions of the application of the former s 136 (and which were the subject of the *Commonwealth Aluminium* decision) form no part of s 136AD. Under Division 13 the Commissioner needs only to be satisfied that any two or more of the parties to the agreement are not dealing at arm's length, and he may do so 'having regard to any connection between any 2 or more of the parties to the agreement or to any other relevant circumstances'.

It will be clear from the above that the operation of Division 13 is limited to instances involving the supply or acquisition of '*property*', and so it is necessary to observe that ss 136AA(1) provides that 'property' includes a chose in action, any estate, interest, right of power (whether at law or in equity) in or over property, any right to receive income and also extends to services. Leaving no stone unturned, the subsection goes on to define 'services' as including,

> any rights, benefits, privileges or facilities and, without limiting the generality of the foregoing, includes the rights, benefits, privileges or facilities that are, or are to be, provided, granted or conferred under—
>
> (a) an agreement for or in relation to—
>
> (i) the performance of work (including work of a professional nature);
>
> (ii) the provision of, or the use or enjoyment of facilities for, amusement, entertainment, recreation or instruction;

(iii) the conferring of rights, benefits or privileges for which consideration is payable in the form of a royalty, tribute, levy or similar exaction; or

(iv) the carriage, storage or packaging of any property or the doing of any other act in relation to property;

(b) an agreement of insurance;

(c) an agreement between a banker and a customer of the banker entered into in the course of the carrying on by the banker of the business of banking; or

(d) an agreement for or in relation to the lending of moneys.

The width of these provisions is both impressive and daunting. In fact, it is so difficult to envisage a sensible transaction which would circumvent the combination of definitions in s 136AA that one is almost inclined to think that a court faced with such a transaction might feel obliged to 'dust off' the report of *Cooper Brookes (Wollongong) Pty Limited v FCT*[4] and judicially correct the draftsperson's omission.

Upon the application of s 136AD in substituting an arm's length consideration, the question may arise (eg, under para 25(1)(b)) as to the source or sources of the particular income which is deemed to have been generated by virtue of such application, or which is relevant to particular expenses. The various subsections of s 136AE provide that 'income or expenditure shall be deemed, for all purposes of this Act, to have been derived or to have been incurred in deriving income, as the case may be, from such source, or from such sources and in such proportions, as the Commissioner determines'. Subsection (2) invests the Commissioner with this discretion where the taxpayer is a partnership, ss (3) applies where the taxpayer is a trustee, and ss (1) is the operative provision for other taxpayers. In the event that these provisions may not catch resident taxpayers operating through a 'permanent establishment' overseas, or non-resident taxpayers carrying on business through a 'permanent establishment' in Australia, equivalent provisions covering such persons are found in ss (5), (6) and (4) respectively of s 136AE. Although ss 136AE(9) removes from consideration in this context ss 38 to 43 of the Act, the Commissioner's discretion is not entirely open as ss (7) requires him to have regard to—

(a) the nature and extent of any relevant business carried on by the taxpayer and the place or places at which the business is carried on;

(b) if any relevant business carried on by the taxpayer is carried on at or through a permanent establishment—the circumstances that would have, or might reasonably be expected to have existed if the permanent establishment were a distinct and separate entity dealing at arm's length with the taxpayer and other persons; and

(c) such other matters as the Commissioner considers relevant.

Section 136AF then allows the Commissioner to make fair and reasonable compensating adjustments to any taxpayer's assessable income and allowable deductions where s 136AD applies, and the Commissioner's determinations under ss 136AF(1) and (3) are described in similar terms

4 (1981) 81 ATC 4292.

to his Part IVA determination under ss 177F(3). The similarity extends further, in fact, as the provisions allowing a taxpayer to request such compensating adjustments and to object and appeal in relation thereto in ss 136AF(4)—(7) are in the same basic terms as ss (5)—(8) of s 177F.

As with the general anti-avoidance provisions in Part IVA, the question arises under ss 136AF(1) and (3) as to whether the Commissioner is *obliged* to take the relevant action. Subsection (1) of 136AF provides as follows:

> Where, by reason of the application of section 136AD in relation to the supply or acquisition of property by a taxpayer, an amount is included in the assessable income of the taxpayer of a year of income or a deduction is not allowable or is not, in part, allowable, to the taxpayer in respect of a year of income, the Commissioner may, in relation to any taxpayer (in this sub-section referred to as the 'relevant taxpayer')—
>
> (a) if, in the opinion of the Commissioner—
>
> (i) there has been included, or would but for this sub-section be included, in the assessable income of the relevant taxpayer of a year of income an amount that would not have been included or would not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income if the property had been supplied or acquired, as the case may be, under an agreement between independent parties dealing at arm's length with each other in relation to the supply or acquisition; and
>
> (ii) it is fair and reasonable that the amount or a part of that amount should not be included in the assessable income of the relevant taxpayer of that year of income,
>
> determine that that amount or that part of that amount, as the case may be, should not have been included or shall not be included, as the case may be, in the assessable income of the relevant taxpayer of that year of income; and
>
> (b) if, in the opinion of the Commissioner—
>
> (i) an amount would have been allowed or would be allowable to the relevant taxpayer as a deduction in relation to a year of income if the property had been supplied or acquired, as the case may be, under an agreement between independent parties dealing at arm's length with each other in relation to the supply or acquisition, being an amount that was not allowed or would not, but for this sub-section, be allowable, as the case may be, as a deduction to the relevant taxpayer in relation to that year of income; and
>
> (ii) it is fair and reasonable that that amount or a part of that amount should be allowable as a deduction to the relevant taxpayer in relation to that year of income,
>
> determine that that amount or that part of that amount, as the case may be, should have been allowed or shall be allowable, as the case may be, as a deduction to the relevant taxpayer in relation to that year of income, and the Commissioner shall take such action as he considers necessary to give effect to any such determination.

Subsection (3) is the equivalent provision in relation to withholding tax.

Thus, where s 136AD applies to a supply or acquisition of property and the Commissioner is of the opinion that it is fair and reasonable to exclude assessable income or to allow some deduction in relation to a relevant taxpayer he *may* determine that such should have been or shall be the case and he shall 'take such action as he considers necessary to give effect to any such determination'.

As was noted in passing earlier, a similar issue arises under Australian s 177F with the primary determination that Part IVA applies under ss (1) of that section. In Division 13, however, this problem with the primary determinations has been circumvented by locating them in para (d) of ss 136AD(1), (2) and (3). Additionally, in those subsections the determination is not preceded by any authorising word but is instead made a fourth precondition of the automatic application of the section. In such a case, it is submitted that the making of such a determination is clearly at the Commissioner's *discretion* rather than being mandatory.

This is not so clear, however, in the context of ss 136AF(1) and (3), and yet the outcome is even more important to the equitable treatment of taxpayers, as a failure on the Commissioner's part to make a compensating adjustment may produce a situation of multiple taxation of the same income. Although it might be possible to rely upon the legal presumption against such double taxation,[5] it is submitted that this should not be necessary in light of the fact that a number of authorities have held that the word 'may' can impose a *duty* on a statutory official to act. Perhaps the best-known example in the Australian tax arena related to the second half dividend rebate for private companies in ss 46(3), with the High Court holding in *Finance Facilities Pty Ltd v FCT*[6] that the Commissioner was *obliged* to grant the further rebate where the criteria were satisfied notwithstanding the presence of the word 'may'.

It could be argued that both ss (1) and (3) of s 136AF also use the word '*shall*' in relation to the Commissioner taking subsequent action, and that this might be seen as a legislative distinction between the permissive and the mandatory. However, this argument was put unsuccessfully in *Finance Facilities*, where 'may' was accompanied by the words 'is entitled to' as they appeared in ss 46(2).

As the various statements on the Part IVA provisions made by former Treasurer John Howard and (then) Second Commissioner Trevor Boucher seem somewhat inconsistent on the matter of the s 177F 'discretions', no real assistance can be gained from them. On balance, it is suggested that the Courts will adopt an approach akin to that in *Finance Facilities*, having regard to the context of the relevant words and the inequitable double taxation implications of holding to the contrary.

Finally, s 136AG excludes the deemed consideration in the application of ss 38 to 43 of the Act, being almost a mirror image of ss 136AE(9)

5 No interpretation of a Taxing Act should be adopted which results in the imposition of double taxation unless the intention to do so is clear beyond any doubt': per Dixon J in *Executor Trustee & Agency Co of SA Ltd v FCT* (1932) 48 CLR 26, 44.

6 (1971) 71 ATC 4225.

which operates to exclude those provisions from consideration in relation to inquiries under s 136AE.

It will probably have become apparent from the foregoing review of the provisions of Division 13 that—subject to one reservation—the writer considers them to be comprehensive and well-drafted (as anti-avoidance provisions), and potentially quite lethal to taxpayers who may seek to adopt 'aggressive' transfer pricing policies. The reservation is that no statutory guidance has been provided to the taxpayer or the Revenue (or a court) as to the manner in which an arm's length transfer price is to be determined, and this difficult issue will be addressed further later in this article. At this stage, however, it is sufficient to say that this omission is a serious deficiency. Taxpayers and tax officers alike are entitled to a reasonable degree of certainty as to the manner in which taxable income is to be computed.

International transfer pricing provisions—the New Zealand Income Tax Act

The principal provision of New Zealand's Income Tax Act concerning international transfer pricing is s 22. Subsection (3) of that section provides as follows:

> Where any business carried on in New Zealand:
>
> (a) Is controlled exclusively or principally by persons not resident in New Zealand; or
>
> (b) Is carried on by a company not resident in New Zealand, or by a company which is under the control of persons not resident in New Zealand; or
>
> (c) Is carried on by persons having control of a company not resident in New Zealand,—
>
> and it appears from the returns made to the Commissioner that the business produces no taxable income or less than the amount of taxable income which in the opinion of the Commissioner might be expected to arise from that business, the person carrying on the business in New Zealand shall, notwithstanding anything in this Act, be assessable for and liable to pay income tax on a taxable income of such amount as the Commissioner determines, being at the option of the Commissioner either such proportion as he determines of the total receipts (whether cash or credit) of the business or such proportion as he determines of the total purchase money paid or payable (whether in cash or by the granting of credit) in the conduct of the business:
>
> Provided that where the Commissioner is satisfied that any amount that would, but for this proviso, be included in the taxable income of any person pursuant to the foregoing provisions of this subsection has been included in a return made by any other person who is assessable for and liable to pay income tax on that amount, the Commissioner shall not apply the said foregoing provisions in respect of the first mentioned person in respect of that amount.

One is struck immediately by the provision's basic similarity to the former s 136 of the Income Tax Assessment Act—no doubt a consequence of the two having the same roots in United Kingdom legislation.[7]

7 See s 31 of the UK Finance (No 2) Act 1915.

The New Zealand provision begins by requiring that a business be carried on and, in this regard, ss 22(1) extends the concept of a 'business' to 'any profession, trade, manufacture or undertaking which is carried on in New Zealand . . . whether or not it is carried on for pecuniary profit . . .'.

It will be noted that ss 22(4) only provides for the adjustment of taxable income, but reference to ss (4) will reveal that the Commissioner of Inland Revenue is also empowered to adjust an 'excessive' loss in equivalent circumstances.

The most important aspect of ss 22(3)—and, indeed, of s 22 as a whole—is that, apart from non-resident companies trading here, it can only be triggered by 'control', ie the business must be carried on by a non-resident company or by a company *controlled* by non-residents, or by persons who *control* a nonresident company, or else the business itself must be (exclusively or principally) *controlled* by non-residents. This 'control' requirement is consistent with many equivalent provisions overseas, but, as we have seen, the Australian Parliament has seen fit to abandon such notions of control in favour of any connection or association between the parties. It is not beyond the realms of possibility that New Zealand could also adopt such an approach in the future, but, in the meantime, '*control*' it is.

The terms 'control' and 'controlled' are not expressly defined in s 22, or elsewhere in the Income Tax Act. However, ss 22(2) attracts the s 7 meaning of 'persons under whose control any company is' (an interesting turn of phrase for a legislative draftsperson!), and it follows, therefore, that s 7 is relevant to interpreting paras 22(3)(b) and (c). The issue of when a *business* is 'controlled' (under paragraph 22(3) (a)), however, falls to be determined according to the general law and ordinary meanings.

Section 7 of the Income Tax Act defines 'control' of a company in terms of 'more than 50 percent' of the shares, nominal capital, paid-up capital, voting power or profit entitlements. The reference to *greater than* half would seem to accord with ordinary legal conceptions of control. As an alternative, para 7(2) (b) of the existing section provides that a company is deemed to be under the control of persons 'who have by any other means whatsoever control of the company'—a rather amorphous, but otherwise unobjectionable, description. In each case, ss 7(5) adds any shares, voting power, entitlement to profits or other means of control held by a person's 'nominee' to that person's other such holdings.

The word 'nominee' is defined in ss 7(1) as meaning:

> any other person who may be required to exercise his voting power in relation to any company in accordance with the direction of that person, or who holds shares or debentures directly or indirectly on behalf of that person; and includes any relative of that person.

The use of the phrase 'may be required' in this definition clearly catches an *ability* to direct which is unexercised (but only in the context of *nominees*), and the unqualified inclusion of a 'relative' is highly relevant to natural persons ('relative' is defined in s 2 of the Act). However, there exists a drafting deficiency in relation to 'nominees' where a person has 'by any other means whatsoever control of the company' via other persons—if those persons are not 'relatives' or holders of voting power or shares or debentures in the company, they cannot be 'nominees' (as defined) in the first place, and no addition of holdings can occur under ss 7(5).

It is interesting to note that the draft legislation accompanying the *Report of the Consultative Committee on International Tax and Full Imputation (Part II)* proposed a redrafted s 7, under which the 'more than 50 percent' test was to be replaced by the words 'not less than 50 percent'—a change which would be quite important to any holders of exactly *half* of the relevant interests. Further, 'the voting power' was to be replaced with a much more carefully drafted series of alternatives (namely 'the rights to vote in any decision-making concerning' distributions, the corporate constitution or variations to issued capital), and the 'nominee' concept was to be widened so that amalgamation occurred between the holdings of any person and that person's 'nominee' *and* 'any person associated with that person'.[8] Finally, the proposed new s 7 contained no provision equivalent to existing para 7(2)(b).

As it turned out, the legislation enacted did not proceed with amendments to s 7 at all, but if the section is subsequently amended, it may be that 'control' will then require only *50 percent or more* of the relevant voting rights or rights to distributions of income or net assets. Such an approach would be consistent with the test enacted under s 245C of the Act, as part of the branch equivalent (or 'controlled foreign company') regime. Presently, however, 'control' under s 22 still requires *more than 50 percent of* the capacity to control.

If such non-resident 'control' exists, the Commissioner of Inland Revenue is empowered to adjust the taxable income or loss of the business. Subsections 22(3) and (4) refer to '*the opinion of the Commissioner*' that the taxable income is less than might be expected or that 'the loss is excessive', but it is clear that such statutory discretions can be challenged if they are exercised contrary to law or with manifest unreasonableness, or if it can be established that the Commissioner has regard to irrelevant matters or fails to take relevant matters into account.

With respect, it is this writer's view that the provisions are drafted in a relatively unsophisticated manner—again, due in most part to their dated origins. Subsection (3) refers to taxable income less than 'might be expected to arise from that business' (rather than to income less than would be expected to have been derived had the business not been controlled by non-residents) and to an adjustment to 'such amount as the Commissioner determines' (rather than to arm's length amounts). However, it is likely that this less-than-ideal drafting neither invalidates

8 Section 8 outlines the circumstances under which two persons are to be treated as being 'associated'—for companies the principal paragraphs refer to (non-corporate) persons holding *25 percent or more* of the paid-up or allotted capital or any companies 'which consist substantially of the same shareholders or are under the control of the same person or persons'.

the provisions nor empowers the Revenue to adjust beyond an arm's length quantum.

The High Court of Australia's decision in *FCT v Commonwealth Aluminium Corporation Ltd* is of some assistance in this context as the former s 136 of the Income Tax Assessment Act was somewhat similarly drafted, but it must be remembered that the two sections are not identical.

If New Zealand courts were to adopt the majority views in *Commonwealth Aluminium Corporation*, the following principles of interpretation might be established:

1 Paragraph 22(3) (a) requires actual or de facto control of the business rather than merely the capacity to exercise such control [see Barwick CJ at 4374-4375, Stephen, Mason and Wilson JJ at 4378];

2 Control of a *business* carried on by a company must be distinguished from control of a general meeting of shareholders, and generally the *business* of a company will be controlled by its directors [see Barwick CJ at 4375, Stephen, Mason and Wilson JJ at 4378-4379];

3 'Control' can be seen to be exercised via interposed companies [see Barwick CJ at 4374], and the use of the word 'principally' in para 22(3)(a) means 'chiefly or in the main', rather than referring to any principal/agent distinction [see Stephen, Mason and Wilson JJ at 4378]; and

4 Paragraphs 23(3) (b) and (c) are designed to amplify and extend the reach of para 22(3) (a), and they cannot operate to restrict the operation of the latter provision [see Stephen, Mason and Wilson JJ at 4378].

It should also be borne in mind that New Zealand courts may not choose to follow any or all of the conclusions reached by the majority of the High Court of Australia in *Commonwealth Aluminium Corporation*, and, for example, it is possible that the New Zealand courts would extend the notion of control beyond 'actual control' to encompass the 'right of control'.[9]

However, because paras 22(3) (b) and (c) are limited by the terms of ss 7(2) of the Act, it seems that s 22 may be circumvented by using two New Zealand companies, with the non-resident shareholders avoiding actual control of the New Zealand *business*. If a New Zealand resident company (RCo 1) was owned by a New Zealand resident holding company (RCo 2), which was itself owned by such non-residents, RCo 1's *business* would *not* be:

(a) 'controlled exclusively or principally by persons not resident in New Zealand' (para 22(3) (a)) [refer *Commonwealth Aluminium Corporation*];

(b) 'carried on by persons having control of a company not resident in New Zealand' (para 22(3) (c));

9 See, eg, *Lemmington Holdings Ltd (No 2) v CIR* (1983) 6 NZTC 61,576, 61,597 per Eichelbaum J.

(c) 'carried on by a company not resident in New Zealand' (para 22 (3) (b)—first limb); or

(d) 'carried on . . . by a company which is under the control of persons not resident in New Zealand' (para 22(3) (b)—second limb).

The only prospect the Commissioner might have of attacking RCo 1's business under s 22 would seemingly be under para 7(2) (b), but the Commissioner's abilities under that paragraph in such a situation are far from clear.

Before we leave the New Zealand Income Tax Act, we should briefly acknowledge the existence of s 21A of that Act, as it can impact upon transfer pricing payments made from New Zealand to an overseas party. Under s 21A, the Commissioner of Inland Revenue is empowered to give to any person 'an information requisition' in relation to any deduction claimed by a taxpayer in respect of an 'offshore payment'. Subsection 21A(1) essentially defines 'offshore payments' as being payments to a person 'outside New Zealand', to a person who is associated with such a person or acting as an agent or fiduciary for such a person, or to a person who may make a payment to any such people in consequence of the taxpayer's expenditure or loss. If the taxpayer to whom such a requisition is given fails to respond to it *within 90 days*, the Commissioner is empowered to deny or reduce the claimed deduction, and the taxpayer will be precluded from contesting this action by objection unless the taxpayer can establish that a response *was* made within the 90 day period. This is clearly a powerful weapon to assist the IRD in obtaining information or the production of books or documents, but (if the requisition is complied with) the provision adds nothing to the *substantive* tests of deductibility in such cases.[10]

The double tax treaty

The potential weakness of the New Zealand Commissioner's powers under s 22 of the Income Tax Act makes it particularly pertinent to examine the Double Tax Treaty provisions which apply to transfer pricing between New Zealand and Australia—namely the article providing for the adjustment of dealings between associated parties.

Article 6 of the Australia-New Zealand Double Tax Treaty provides as follows:

(1) Where—

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

10 For a similar, but even more aggressive, approach to the *disclosure* of information concerning offshore transactions, reference might be made to amendments made in 1988 to the Income Tax Act of Canada. From 13 September 1988, new ss 233.1 and 231.6 of that Act became law, with the former provision requiring the filing of an annual information return detailing non-arm's length dealings with non-residents (similar to US Form 5472). The latter provision, however, empowers the Minister to require any person to provide (to Revenue Canada) within 90 days any 'foreign-based information or document', being 'any information or document which is available or located outside Canada and which may be relevant to the administration or enforcement of [the Income Tax] Act'. A person can contest such a requirement if it is unreasonable, but this will *not* be the case merely because the document is under the control of, or available to, a non-resident who is *not controlled by* that person—if the non-resident is in fact 'related' to the person receiving the notice!

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State;

and in either case conditions are operative between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing at arm's length, then any profits which, but for those conditions, might have been expected to accrue to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise.

(2) Profits included in the profits of an enterprise of a Contracting State under paragraph (1) of this Article shall be deemed to be income of that enterprise derived from sources in that Contracting State and shall be taxed accordingly.

(3) If the information available to the competent authority of a Contracting State is inadequate to determine, for the purposes of paragraph (1) of this Article, the profits which might have been expected to accrue to an enterprise, nothing in this Article shall affect the application of any law of that Contracting State in relation to the liability of that enterprise to pay tax on an amount determined by the exercise of a discretion or the making of an estimate by the competent authority of that Contracting State. Provided that the discretion shall be exercised or the estimate shall be made, so far as the information available to the competent authority permits, in accordance with the principle stated in this Article.

It is convenient in this context to look at the Treaty provision under five subheadings, and the analysis is assisted by occasional comparisons with the terms of the Model Treaty adopted (subject to countries' specific reservations) by the OECD.

(a) *The test of association*

The Treaty adopts the OECD Model Treaty test of whether there is mutuality of participation (directly or indirectly) in the management, control or capital of the two enterprises.

(b) *The failure to deal at arm's length*

The equivalent provision of the OECD Model Treaty (Article 9) refers to conditions being 'made or imposed' between the enterprises in their commercial or financial relations which differ from those 'which would be made' between independent enterprises, and then provides for the inclusion of profits 'which would, but for these conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued'. The Treaty in place between Australia and New Zealand, however, adopts a rather more cautious (and technically satisfactory) approach.

Article 6 refers to conditions merely being 'operative' between the two enterprises (rather than 'made or imposed') and to those conditions departing from those 'which *might be expected to* operate between independent enterprises *dealing at arm's length*'. Similarly, the add-back is expressed to be of profits 'which might have been *expected* to accrue . . .'. In strict terms, this wording seems to assist the respective Commissioners a little as they need only to establish an adjustment which would be *expected* rather than a difference which would incontrovertibly be the case, and the test expressly adds an arm's length dealing assumption. Further, there is no requirement to show that the relevant conditions were 'made or imposed' by anyone. In practice, however, there may not be a great deal of difference in effect.

(c) *Adjustment of other taxpayers' income*

Article 9 of the OECD Model Treaty expressly provides for consequential adjustments to be made by the other jurisdiction to the tax position of the other party, and for the relevant competent authorities to consult, if necessary. The equivalent provision in the trans-Tasman Treaty is found in sub-article 18(4). In practice, the existence of such provisions is often of little assistance to taxpayers because different countries do not invariably adopt the same approach to 'resolving' such problems, and bilateral agreement is not always possible. The OECD Model uses the term 'appropriate adjustment', and in doing so it does not really specify *which* jurisdiction should give way. The Treaty between Australia and New Zealand is to be preferred in this regard, as sub-article 18(4) simply requires one country to give credit for any extra tax charged by the other country upon profits adjusted to equate to arm's length conditions.

(d) *Deemed income and source*

Article 6 of the Australia-New Zealand Treaty provides that profits included in the profits of an enterprise under the Associated Enterprises article 'shall be deemed to be income of that enterprise derived from sources in that Contracting State and shall be taxed accordingly'. This sub-article has the effect of *deeming a source* for such profits and, seemingly, also of *deeming* those 'profits' to be 'income' for the purposes of domestic taxation. In the absence of such a provision, ordinary rules as to source and the characterisation of the receipts would presumably apply.

(e) *Domestic discretions and inadequate information*

Article 6 also raises the issue of domestic discretions vested in the competent authorities, and the adequacy of information provided to them. It is a policy of the New Zealand government to propose such a provision, and the Australian Treaty sub-article 6(3) is also found in its Treaties with Japan, Singapore, Malaysia, Fiji, Sweden and Canada.

It will be noted that Article 6 is limited in its application to instances where there are dealings and connections between *two separate parties*. Where, instead, a single person (most commonly a company) trades across international boundaries via a 'permanent establishment' (usually a branch), it is necessary to consider the 'business profits' article of the relevant Double Tax Treaty—if one exists between the two jurisdictions. In the Treaty between New Zealand and Australia, that is Article 5, sub-articles (2)-(4) of which are in the following terms:

> (2) Where an enterprise of a Contracting State carries on trade or business in the other Contracting State through a permanent establishment situated therein, there shall be attributed to that permanent establishment the industrial or commercial profits which it might be expected to make if it were an independent enterprise engaged in the same or similar activities

under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment; and the profits so attributed shall be deemed to be income derived from sources in that other Contracting State and shall be taxed accordingly.

(3) In determining the industrial or commercial profits attributable to a permanent establishment in a Contracting State, there shall be allowed as deductions all expenses of the enterprise, including executive and general administrative expenses, which would be deductible if the permanent establishment were an independent enterprise and which are reasonably connected with the permanent establishment, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.

(4) If the information available to the competent authority of the Contracting State concerned is inadequate to determine the industrial or commercial profits to be attributed to the permanent establishment, nothing in this Article shall affect the application of the law of that Contracting State in relation to the liability of the enterprise to pay tax in respect of the permanent establishment on an amount determined by the exercise of a discretion or the making of an estimate by the competent authority of that Contracting State. Provided that the discretion shall be exercised or the estimate shall be made, so far as the information available to the competent authority permits, in accordance with the principle stated in this Article.

These provisions are similar in effect to ss 38 to 43 of the Income Tax Assessment Act, although sub-article 5(4) differs from subsection 43(2) in allowing the subtraction of *all* expenses 'which would be deductible if the permanent establishment were an independent enterprise and which are reasonably connected with the' taxable profits. Note also that the term 'permanent establishment' in Article 5 takes the meaning allocated in the relevant Double Tax Agreement—in the Australia-New Zealand Treaty, from Article 4.

Ascertaining an arm's length price

It will be evident that most specific transfer pricing provisions (either domestic or Treaty) essentially aim to allow the Revenue to substitute an *arm's length price or profit* and to tax accordingly. However, as a practical matter, it is often not easy to establish an arm's length price, particularly where international transactions are concerned.

It is indeed unfortunate that both the Australian and New Zealand provisions allow wide discretions to the revenue authorities and provide no guidance as to the determination of arm's length prices. This may be contrasted with the approach which has been adopted, to date, in the United States of America, where s 482 of the Internal Revenue Code provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses.

> In the case of any transfer (or license) of intangible property the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

It would seem at first (and second) glance that such a provision confers upon the revenue authorities a wide administrative discretion of the type referred to earlier with disapproval. However, the *regulations* under s 482 expressly set out three specific methods for determining the arm's length price in relation to sales between related persons, namely, what are called the comparable uncontrolled price method, the resale price method, and the cost-plus method. Where none of these are reasonably applicable, the regulations also provide for 'some appropriate method . . . other than those described' to be utilised.[11] These methods are not absolute alternatives, as the comparable uncontrolled price must be adopted if it can be located. If it cannot, the resale price method must be used, unless this is not practicable, in which case resort must be had to the cost-plus technique. The comparable uncontrolled price method is favoured by the Internal Revenue Service, but it is understood that the fourth method is most often applied in a process of negotiation between the taxpayer's representatives and the IRS.

This fact has given rise to concerns in the US Congress about the area of transfer pricing which may well lead to changes to the relevant legislation. In 1986, members of the Congress noted that comparable transactions had been increasingly difficult to identify and were subject to manipulation. The Congress determined that a new standard should be adopted in establishing a transfer price for *intangible property* (the 'commensurate with income', or 'superroyalty', standard which now forms the final sentence of s 482) and that a comprehensive study should be undertaken in order to see whether the existing regulations required amendment. The latter decision has given rise to the US Treasury's White Paper, the *Study of Intercompany Pricing*, which was released on 19 October 1988 (and was open for submissions and comment until 15 February 1989).

The White Paper[12] highlights three perceived weaknesses in the present US approach to transfer pricing between corporations:

- that there is little or no consistency or predictability where comparable uncontrolled prices do not exist;
- that taxpayers commonly use inappropriate 'comparables' in order to substantiate pricing levels; and
- that taxpayers frequently fail to supply information relevant to transfer pricing issues.

Accordingly, the US Treasury has recommended a complete overhaul of the transfer pricing area, and a requirement upon taxpayers to declare in their tax returns that suitable documentation supporting transfer prices adopted is contemporaneously available. It is also proposed that the

11 Regulations, s 1.482-2(e)(1)-(4).

12 Much has been written on the US White Paper, but, for a short commentary on the proposals, see Wachtel and Friezer, 'Transfer pricing—lessons from the USA' (1989) 23 Tax in Aust No 9 (April).

present market-based tests be supplemented by an alternative approach which looks to determine the *return* which the taxpayer's operation would earn in the marketplace.

Thus, the White Paper does *not* seek to abandon the provision of guidance to taxpayers and the IRS, but rather to direct that guidance so that an appropriate arm's length price can be more readily established. Resort to comparable transactions will still be the usual starting point for determining transfer prices, although greater emphasis is to be placed on 'exact' comparables than on 'inexact' ones. If an exact comparable uncontrolled price cannot be ascertained, the White Paper proposes that the other 3 present methods be replaced by the Basic Arm's Length Return Method (or 'BALRM'), and this new 'return' approach is likely to dominate future transfer pricing disputes in the USA. It necessitates a functional analysis of the taxpayer's business activities, the identification of the assets used in each function, and the fixing of market rates of return for those assets (with adjustments in some cases where the profits are generated via unique intangibles and greater than average business risks).

The US White Paper has been subject to much practitioner criticism since its release, with submissions expressing concerns relating to the potential for taxpayer uncertainty, the administrative burdens upon affected companies and the difficulties which can arise in distinguishing between tangible and intangible property. It is also understood that the revenue authorities of some other countries are worried that double taxation may result if the IRS adopts a transfer pricing standard which differs from the arm's length price test adopted by the authorities on the other side of the transaction. But changes in approach may well be occurring in any event, with a recent decision of the US Tax Court appearing to adopt a rate-of-return approach (of a somewhat different nature to the White Paper's methodology) without even having to resort to the 'superroyalty' words of s 482. In *Bausch & Lomb Inc v Commissioner*,[13] the Court increased the rate of royalty paid between associated companies fourfold by seeking to establish a commercial profit-split, notwithstanding the taxpayer's evidence of market comparables. The implications of this decision are still being digested by practitioners and commentators (and, no doubt, by the IRS).[14]

So, there are likely to be significant changes to the US approach to transfer pricing in the near future, but it is certain that the legislation, or the regulations made thereunder, will still give direction as to the manner in which transfer prices should be approached. As no such assistance is provided in the Income Tax Assessment Act or the Income Tax Act (or the Double Tax Treaty), what methods can be expected to be applied under provisions such as Division 13, s 22 and Article 6 of the Treaty in determining the appropriate amounts, considerations, profits and so on?

---

13 (1989) 92 TC 525.

14 For more detailed discussion of these issues, reference may usefully be made to Shanda, 'Royalties and Super-royalties' (1989) *Taxes* (September), and Mogavero, 'Intercompany pricing—US case raises questions of White Paper's validity' (1989) *International Tax Report* (September).

(1990) 1 Revenue L J

The leading Australian case on the matter[15] is the No 1 Taxation Board of Review reference in *Case N69*[16] on the old s 136. At page 279, the Board said that international tax literature recognised three broad classifications of adjustment methods, namely empirical methods (including the percentage of sales method, which compares profits and sales of similar enterprises), fractional apportionment methods (as with ss 41-43 of the Australian Income Tax Assessment Act and s 245 of the New Zealand Income Tax Act), and the separate accounting method (which assimilates the enterprise to an independent entity accounting on that basis). The Board went on to say that, in the absence of guidance from s 136, the Commissioner could adopt whatever method he chose provided that it does not produce a greater taxable income figure than permitted by the statutory objective. In general terms, these comments are likely to apply equally to Division 13, and to the New Zealand domestic and Treaty provisions now under consideration, although the wording of the provisions does not seem to be as readily compatible with an application of the fractional apportionment method.

So, again we might ask what rules will the tax collectors (and the courts) apply to transfer pricing cases? The Australian Taxation Office has traditionally been loathe to commit itself to any approach or approaches to this problem, and it has been suggested that the New Zealand Inland Revenue Department is not far advanced at all in its contemplation of this issue. In both countries, it is probable that the Revenue would generally accept the guidelines established by the OECD, but they may not regard those guidelines as providing the only acceptable methods for determining an arm's length price.

It is interesting to note that the three most common methods (those presently outlined in the United States Regulations under s 482 of the Internal Revenue Code) were referred to in the Explanatory Memorandum accompanying the Australian Income Tax Assessment Amendment Bill 1982 (which introduced the new Division 13), and that this Explanatory Memorandum also envisaged that some other more appropriate method may need to be adopted in some instances. The Australian Treasurer's Memorandum said:

> 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 uncontrolled 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 a group, no comparable uncontrolled price may be found. It would therefore be necessary to seek to establish the arm's length consideration for the particular property by some other method. [However, the Commissioner is to have under subsection 136AD(4), a residual power to determine an arm's length consideration where, for any reason, it is not possible or practicable to calculate an arm's length consideration under either paragraph (c) or (d)] . . . Turning to another aspect of section 136AD, there will be circumstances in which it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration

15 There are no reported New Zealand cases on the issue.

16 (1962) 13 TBRD; 11 CTBR (NS) *Case 53*.

in relation to a particular supply or acquisition of property in accordance with the defined meaning in paragraph 136AA(3) (c) and (d). Such circumstances might arise where, for example, the industry is so controlled and structured that there are no comparable arm's length dealings in relation to property of the same kin, or there are no comparable dealings in the same quantities as that supplied or acquired under the agreement. They could also arise if, though there are comparable dealings, details of them are held back from or otherwise not available to the Commissioner.

Similar (if not identical) problems and approaches are likely to be encountered in New Zealand.

It is likely that—in the short term—both Australia and New Zealand will largely adopt the tenor of the OECD guidelines contained in its 1979 Report *Transfer Pricing and Multinational Enterprises* and, to some extent, in its 1984 *Three Taxation Issues* Report. Interested readers will find much useful material in those reports.

However, both the ATO and the IRD will, no doubt, be watching the US developments with great interest, as the difficulties which led to the White Paper proposals are already being recognised and experienced in Australasia.[17] It was reported in June 1989 that the Australian House of Representatives' Standing Committee on Finance and Public Administration has already recommended, in its report on the Auditor General's efficiency audit of the ATO, that the ATO should examine functional analysis techniques as a method of detecting whether funds were being shifted to related companies in tax havens using transfer pricing mechanisms. The Committee has also recommended that US-style 'contemporaneous documentation' rules be introduced, requiring taxpayers to declare (in tax returns) that documentary evidence exists establishing the method(s) of fixing transfer prices adopted by them. Although a commencement date of 1 July 1990 has been proposed for this latter requirement, the wisdom of hastily adopting measures which are still being hotly debated as proposals in the United States must be seriously questioned. The future importance of international trade to both Australia and New Zealand makes it essential that anti-avoidance measures in this field are adopted in an orderly and carefully-reasoned manner, without unnecessarily hindering or discouraging genuine commercial transactions.

Future directions in transfer pricing?

It will be apparent that the foregoing discussion, and the content of the underlying provisions, leaves much room for uncertainty and argument in the ascertainment of arm's length considerations. This is the reason why, in the United States and Australia, the experience of practitioners has been that transfer pricing disputes have commonly tended to degenerate into a 'horsetrading' series of negotiations. In the light of this, it is interesting to note the following passage from an article by Michael

17 For a short discussion of possible implications for Australia of the US proposals, see Wallschutzky, 'Division 13 and International Profit Shifting' (1989) 18 *Australian Tax Review* No 2 (June).

D'Ascenzo (the Assistant Commissioner of the Complex Audit & International Branch of the Australian Taxation Office):[18]

> As yet there has been no litigation under the new Division 13, although there has been a plethora of administrative law based actions pertaining to such cases. Our experience has hitherto been negotiated settlements of transfer pricing issues. Settlements, however, are not a 'horse trade'. As administrators, we must abide strictly with the arm's length principle. Usually, any reduction in the tax payable by the taxpayer is the result of information finally provided to us by the company at this late stage of proceedings.

This statement may indicate a new approach by the ATO, but it is more likely to reflect a policy relating to the issue of notices of assessment, rather than the Commissioner's approach to the settlement of tax disputes. The experience overseas (with the seeming exception of Canada) has traditionally been that few transfer pricing cases go to court as both sides may have much to lose from litigation. Apart from the time and cost involved in a lengthy transfer pricing case, the Revenue may be keen to receive a reasonable payment of tax without running the risk of losing a landmark case which could weaken its position with other taxpayers. The taxpayer, on the other hand, may sometimes appreciate the opportunity to pay less tax than a Court might award after an exhaustive (and potentially embarrassing) review of its affairs, without the notoriety and media coverage which would accompany such a case.

The different trend in Canada may possibly be attributable to an aggressive stance by Revenue Canada, and a feeling on the part of some taxpayers and their advisers that the Courts will not always support the tax gatherers—a feeling which has been borne out by some of the recent decided cases.[19]

However, it is certain that things are already changing in Australia (quite apart from the recommendations of the Standing Committee). A significant number of tax officers were specifically allocated to international transactions following the establishment of the International Operations Branch of the ATO in 1983. In 1984, an ongoing International Enforcement Program was commenced, and Schedule 25A was introduced some time ago by the Australian Taxation Office to require disclosure by companies of the nature and levels of their overseas transactions.[20] The information gained from Schedule 25A disclosures will be used by the ATO to more accurately target promising candidates for tax audits emphasising dealings with parties offshore, apparently with the assistance of the Taxation Office's computer-assisted CWIT system ('companies with international transaction'). According to Mr D'Ascenzo's paper,[21] cases are 'ranked according to various criteria, including:

- size/amount of transaction,

---

18 'Developments in Transfer Pricing Enforcement and Complex Audit Strategy in the Australian Taxation Office' (1988) 5 *Australian Tax Forum* No 4.

19 See, eg, *Irving Oil Limited v The Queen* (1988) 88 DTC 6138, but contrast *Indalex Limited v The Queen* (1988) 88 DTC 6058.

20 It is noteworthy that the House of Representatives' Standing Committee on Finance and Public Administration has recommended that the requirement to file Schedule 25A be extended to *trusts* with overseas transactions.

21 See n 18 above.

- type of transaction (for example, goods, services, intangibles etc),
- industry/business of the company,
- use of low tax countries, and
- control by a non-resident'.

To underscore its seriousness about this area of investigation, at the beginning of 1989 the ATO issued Ruling IT 2514, which reminds taxpayers of the penalties which may apply to failures to disclose and proposes expansive meanings for the terms 'related overseas entity', 'transaction', 'tangible property', 'intangible property' and 'services'. A number of companies have also received comprehensive questionnaires concerning their international agreements and transactions, which go to such lengths as including formal definitions of terms used in the questionnaire and a listing of tax havens and other countries of interest by virtue of tax preferences.

All of this increased activity is highlighted by the rather nasty infighting which has occurred in *Nestles Australia Limited v DFCT*.[22] These hearings have so far involved only procedural matters—the substantive questions have yet to be argued—but Nestles' excitement is perhaps understandable as the company suffered a nine-year investigation and was then given one month in which to pay amended assessments totalling $19.5 million (Australian)!

In New Zealand, things are moving more slowly in relation to transfer pricing—principally because the avalanche of more fundamental tax reforms in the last 2 years has more than occupied the energies of politicians, the IRD and Treasury officials. Some more complex inspections of corporate taxpayers have raised transfer pricing issues, but no IRD staff have yet been allocated to any specialist group on international transactions. However, it is certain that the Inland Revenue Department will take a more active interest in these matters in the future when things have 'settled down' somewhat in the legislative arena, and the terms of s 22 will no doubt come under close scrutiny at that time. In this regard, it is noteworthy that the Valabh Consultative Committee on Full Imputation and International Tax Reform recommended (in its March 1988 Report) that 'the Government give priority to the introduction of interjurisdictional allocation rules, such as expense allocation rules and more effective transfer pricing provisions'.[23]

It is to be hoped that the introduction of any such amending legislation will also see the provision of some statutory *guidance* to taxpayers and the IRD as to the determination of appropriate transfer prices. Whatever happens in this regard, though, it is safe to predict that the issue of international transfer pricing will become a fruitful source of revenue for tax authorities and tax practitioners in the immediate future—on *both* sides of the Tasman.

22 (1986) 86 ATC 4130, 86 ATC 4760, and (1987) 87 ATC 4409.

23 *Consultative Committee Report on International Tax Reform*, Part 1, at p 60.