

INTERNAL REVENUE COMMISSION – TAXATION CIRCULAR

No. 2011/2

COMMISSIONER GENERAL'S INTERPRETATION AND APPLICATION OF
THE TAXATION LAWS ON:

DIVISION 15 OF THE *INCOME TAX ACT 1959* (the Act): TRANSFER
PRICING: DETERMINATION OF THE TAXABLE INCOME OF CERTAIN
PERSONS FROM INTERNATIONAL TRANSACTIONS

ISSUED BY
THE COMMISSIONER GENERAL
PAPUA NEW GUINEA INTERNAL REVENUE COMMISSION

Taxation Circular No 02 of 2011

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Taxation Circular No 02 of 2011

Contents

Introduction	4
What does this Circular deals with	4
Definitions and Terminology	5
Scope of Division 15	6
The Commissioner General's Approach to the Circular	7
Division 15 of the Act	8
Double Tax Agreements	11
The Arm's Length Principle	11
Principles of Comparability	12
Acceptable Methods for Determining an Arm's Length Price	16
The CUP method	17
The Resale Price method	19
The Cost Plus Method	21
Transactional Net Margin method (TNMM)	22
The Transactional Profit Split method	24
Performing a Comparability Analysis	27
Other Practical issues re Comparability	33
Documentation required to support Transfer Prices	36
The Commissioner General's Approach to Transfer Pricing Reviews and Audits	39
Interest and Penalties	42
Burden of Proof	42
Advance Pricing Agreements (APA's)	42
Intangible Property	43
Intra –Group Services	43
Cost Contribution Arrangements	44
Business Restructures	44
Effective Date	44
Conclusion	44
Annexure A – Characteristics of a Functional Analysis	44
B - The Four Step Process	49
C – Legislation and Treaty Extracts	53

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Introduction

1. The term “transfer pricing” describes the process by which entities determine the consideration at which they transfer goods or services between each other.
2. The transfer prices adopted by a MNE have a direct bearing on the proportional profit it derives in each country in which it operates. If a non arm’s length value (inadequate or excessive consideration) is paid for the transfer of goods or services between the members of a MNE, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will impact on the tax revenues of the relevant tax jurisdictions in which they operate.
3. For example, if a member of a MNE sells to an associated entity resident in another country at a consideration which exceeds the arm’s length consideration, the profit which the MNE earns in that other country is reduced. Similarly if the member of a MNE sells to an associated entity resident in another country at a reduced consideration, the profit the MNE earns in that other country is increased.
4. Papua New Guinea is presently experiencing a sustained period of economic growth driven mostly by an expansion of the energy and resource sector. With this growth has come a marked increase in international trade and commerce, with wide ranging changes in volume and complexity. An increasing proportion of this international activity is carried on between members of an MNE. As the globalisation of business activity continues to accelerate, protecting the Papua New Guinea’s tax base is vital to Papua New Guinea’s wealth and development.
5. Exchange controls have historically provided some protection against the more significant manipulation of transfer prices to transfer profits to lower tax jurisdictions. However, because of the significant increase in investment and trade with countries who may not be considered low tax jurisdictions in the traditional sense it is now deemed essential for the transfer pricing provisions in Division 15 to be actively administered to counter all forms of international profit shifting.
6. Division 15 enables the Commissioner General to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement between associated entities in accordance with the arm’s length principle. The Commissioner General may adjust the consideration, for tax purposes, if the actual consideration is either less or greater than the consideration that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm’s length basis.
7. The Commissioner General may use the amount so determined in the determination of the taxable income of either of the parties to the transaction but any adjustment would generally be to the PNG party.

What does this Circular deals with

8. This Circular is the first in a series of Circulars that will provide guidance on the operation of Division 15 of the *Income Tax Act 1959* (the Act) and the Associated Enterprises and Business Profit Articles of Papua New Guinea’s (PNG’s) double tax agreements¹ which deal with the requirement for taxpayers to ensure the taxation outcomes of their international dealings with each other are arm’s length.

¹ Such as Article 7 (i.e. Business Profits) and Article 9 (i.e. Associated Enterprise) of the Papua New Guinea/Singapore Double Tax Agreement.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

9. The Circular provides guidance on:

- a) The arms length principle underlying the operation of Division 15;
- b) The procedures to follow in determining the arm's length consideration in international dealings, including the selection of an appropriate transfer pricing method;
- c) The Commissioner General's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.

10. The guidelines provided in this Circular are relevant to the supply and acquisition of all forms of "property": Whilst they apply to the supply and acquisition of goods and other tangible assets they also apply to the provision of services and benefits and transfers of technology, trademarks and other intangible assets and financial transactions.

Definitions and Terminology

Property as per Division 15 of the Act

11. For the purposes of Division 15, the term "property" is defined in subsection 197A(1) in considerably broader terms than the common law definition, including such things as:

- (a) a chose in action;
- (b) any estate, interest, right or power, whether at law or in equity, in or over property;
- (c) any right to receive income; and
- (d) services.

The inclusion of "services" significantly extends the ordinary meaning of the term "property". The term "services" itself, is defined broadly in subsection 197A(1), to embrace not only the ordinary meaning, but also rights, benefits, privileges or facilities generally.

12. In the context of Division 15, the term property also includes:

- (a) trading stock;
- (b) work in progress and other business inputs;
- (c) futures contracts, hedging agreements and forward sale and purchase agreements;
- (d) cash and foreign exchange;
- (e) options, including the property in respect of which the option is given;
- (f) the provision of finance (whether by loan, the provision of credit or an advance or the purchase of commercial paper), including the terms of any such provision;
- (g) debts, including the factoring and forgiveness of debts;
- (h) financial products, including newly developed and developing financial products;
- (i) leases and licences, including the terms upon which a lease or licence is made;
- (j) hire-purchase agreements, including the terms of any such agreement;
- (k) the transport of any property or personnel;
- (l) service, management and administration fees;

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- (m) the provision of services such as administration, management, marketing, sales or distribution services by head offices or companies within a group of companies to other companies within the group;
- (n) intangible assets including their development and use and their royalty income flows;
- (o) gifts of money or plant and equipment;
- (p) the manufacturing or processing of goods or materials belonging to someone else

For the purpose of this Circular, the words below are defined as follows:

13. The expression “**associated enterprises**” used in this Circular refers to enterprises directly or indirectly connected through management, control or shareholding. It includes enterprises to which the Associated Enterprises Article of PNG's DTAs may apply (and to which Division 15 may also apply) and other enterprises whose dealings may be adjusted under Division 15 (i.e. independent enterprises that do not deal at arm's length with one another).

14. In this Circular, “**controlled transactions**” are transactions or arrangements between associated enterprises and “**uncontrolled transactions**” are transactions between or arrangements between independent enterprises that are dealing wholly independently with each other.

15. Similarly, the expressions “**dealings**” and “**international dealings**” have been selected to encompass all of the conditions that operate between associated enterprises in their commercial or financial relations across borders.

16. The term “**Multi National Enterprise group**” or “**MNE group**” used in this Circular refers to a group of associated companies with business established in two or more countries. The term “**Multi National Enterprise**” or “**MNE**” refers to a company that is part of an MNE group.

17. “The term “**associated enterprises**” or “**associated enterprises dealings**” can be used interchangeably with the expression “**related party**” or “**related party dealings**”.

Application of Division 15

18. The Commissioner General, in making a determination that Division 15 applies, makes this decision based not only on the connection between the parties but also on “any other relevant circumstances” to determine that the outcome of the dealings between the parties does not reflect the arm's length consideration that would have applied had the dealings been conducted on normal commercial conditions between unrelated parties. It is the type of transaction between the associated enterprises rather than their relationship to each other that is paramount.

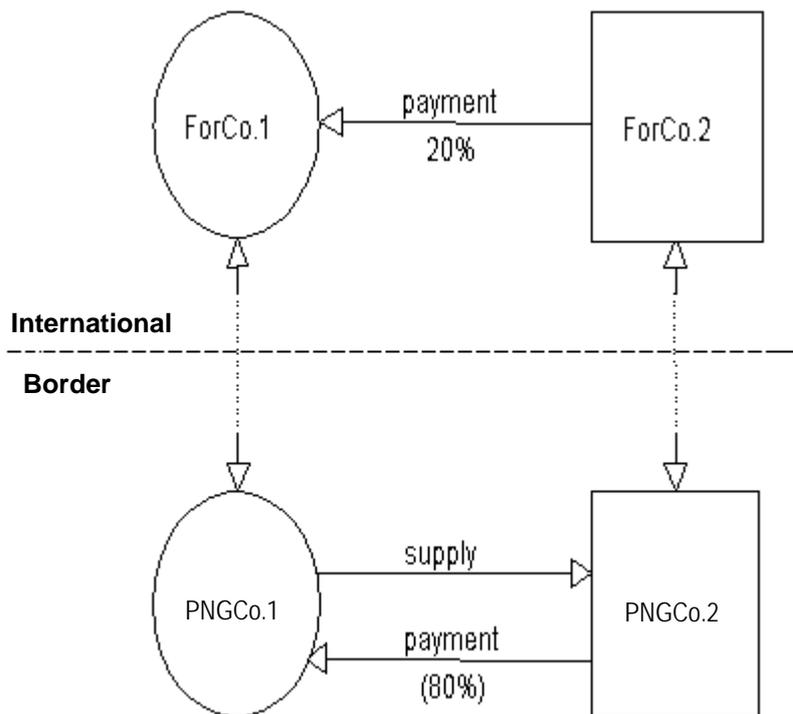
19. In addition, whilst Division 15 will normally apply to transactions between associated enterprises where the outcome are determined to be non arm's length it may also be applied to transactions between independent parties where the parties are not dealing with each other at arm's length.

20. The following example illustrates how two formally independent parties to an agreement for the particular supply or acquisition of property do not deal with one another on an arm's length basis. This could be a case where the particular transaction which reduces a taxpayer's PNG income is offset by benefits under

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

another seemingly unrelated agreement, which may accrue abroad, and perhaps to an associate of the taxpayer."



21. Two unassociated company groups comprising PNGCo.1 and ForCo.1 in one group and PNGCo.2 and ForCo.2 in the other group have agreed that PNGCo.1 will receive 80% of the arm's length consideration from PNGCo.2 in respect of the supply of property in PNG, while PNGCo.1's offshore associate, ForCo.1, will receive the balance of 20% of the arm's length consideration from ForCo.2.

22. This example shows how Division 15 can embrace what at first glance appears to be a totally domestic arrangement. In this example, a non-resident has supplied property (the payment by ForCo.2 to ForCo.1 either with or without other property being transferred between them) which gives the "agreement" (being the agreement between the two unassociated company groups) its international flavour and renders the "agreement" an "international agreement" for Division 15 purposes.

23. This example also illustrates why the legislation adopts the notion of an "agreement" and is not restricted to dealings involving the direct supply or acquisition of property to or from a non-resident. In this example, Division 15 requires that the consideration received by PNGCo.1 be adjusted upwards to the arm's length consideration for the property it supplied to PNGCo.2. This can be done by considering both sides of the back to back arrangement together.

The Commissioner General's Approach to the Circular

24. This Circular has been drafted as a practical guide and is not intended to be a prescriptive or an exhaustive discussion of every transfer pricing issue that might arise. Each case will be decided on its own merits, taking into account the individual taxpayer's facts and circumstances.

25. This Circular is stated in relation to dealings between separate legal enterprises, with a particular focus on dealings between companies (i.e. associated

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

entities). It does not address, in any significant detail dealings between different parts of the same legal entity (e.g. branch offices, divisions and permanent establishments of a single legal entity). While the main focus of the Circular is in respect of companies, the same principles apply where individuals, partnerships and trusts engage in dealings with separate legal entities.

Status of the OECD Guidelines

26. Because of the international importance of the OECD Guidelines², this Circular acknowledges those guidelines as well as guidance provided by the United Nations. Although Papua New Guinea is not a member country of the OECD, the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries that was reached after an extensive process of consultation with industry and tax practitioners in many countries. The OECD Guidelines are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard.

27. The OECD has issued a report entitled "Harmful Tax Competition – An emerging global issue"³. It has been recognised since the 1998 release of the report that the failure to adhere to international transfer pricing principles is a contributing factor to the proliferation of harmful preferential tax regimes. A tax authority's view on appropriate arm's length prices, if they impact on how an enterprise conducts its cross border activity, can directly affect the competitive position of that enterprise. Following the OECD Guidelines will thus promote tax equality and reduce the possibility of PNG contributing to the establishment of a harmful preferential tax regime.

28. The OECD Guidelines should be followed in the absence of guidance in terms of this Circular, the provisions of Division 15 or the Double Tax Agreements entered into by PNG.

Division 15 of the Act

History behind the introduction of Division 15

29. Division 15 was introduced into the Act with effect from 1 January 1983 in order to counter "non-arms length transfer pricing" or "international profit shifting arrangements" which may have adverse tax implications for the PNG revenue. It provides a mechanism by which PNG adopts the arm's length principle for taxation purposes as the basis for ensuring that PNG receives its fair share of tax by adjusting profits by reference to conditions that would have existed between independent parties under comparable circumstances.

30. Application of the arm's length principle requires that members of Multinational Enterprises ("MNEs") be treated as operating as separate entities rather than as inseparable parts of a single unified business (the separate entity approach).

31. The application of the arm's length principle for the purposes of Division 15 would have regard to:

- a) the economic value added by the functions performed,
- b) the assets and skills used, and

² OECD Transfer Pricing Guidelines for Multinational enterprises and Tax Administrators, July 2010, OECD ('the 2010 OECD Guidelines').

³ Harmful Tax Competition, An Emerging Global issue 1998, OECD ('the 1998 OECD Report').

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

c) the degree and nature of any business or financial risks involved, in the process of deriving income; in the same manner as independent parties would.

32. Application of the arm's length principle should, for taxation purposes, result in consideration being received or paid for the supply or acquisition of goods and services, or assets of a capital nature, that would have been charged or paid between independent entities for comparable products under comparable circumstances

The role and structure of Division 15 as it applies to separate legal entities

33. Division 15 is structured to achieve its legislative purpose in respect of non-arm's length dealings between separate legal entities by focussing on basic mechanisms through which PNG may be deprived of its fair share of tax through international profit shifting, whether undertaken for tax avoidance purposes or not. It covers:

- a) the under pricing of goods, services or other property supplied by companies;
- b) the over pricing of goods, services and other property acquired by companies; and
- c) the inappropriate allocation of global, headquarters or other expenses against PNG income.

34. Unless specific statutory provisions have been made, dealings between branches of the same entity or between a branch and its head office are not recognised under PNG general law or taxation law since under the general law an entity cannot deal with itself or make a profit out of itself. This is addressed in the concept of an "international agreement" on which section 197D is based and in the specific reference in paragraph (b) of subsections 197D(1), (2) and (3) to "two or more parties/entities."

35. Where international dealings between different parts of the same entity are concerned, section 197E of Division 15 then allows for the proper allocation of the appropriate part of the income, profits and expenses between the PNG and foreign operations.

The interaction between Section 46 and Division 15

36. The effect of making adjustments under Division 15 is that amounts that otherwise would not be derived under section 46 can be included in assessable income in accordance with the arm's length principle. Division 15 enables such amounts to be determined as having a PNG source or a foreign source, as appropriate. It also enables a determination of the extent to which expenses properly relate to the derivation of PNG income and the extent to which they relate to the derivation of foreign income.

37. The application of Division 15 will result in the adjustment for taxation purposes of the actual consideration to an arm's length consideration. The actual terms, conditions and prices agreed upon between the parties are not affected for any other purpose.

The interaction between subsection 68 (1) and Division 15

38. It may not be necessary to consider the application of Division 15 for the purpose of denying or reducing a deduction under subsection 68(1) of the ITA, in

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

respect of an acquisition of property under an international agreement, where the deduction, or the relevant part of it, is not allowable under subsection 68(1) because it:

- a) was not incurred in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income of the taxpayer but for some other purpose;
- b) is properly regarded as being incurred in producing the income of another party; or
- c) was incurred in relation to the gaining or production of exempt income

39. Where the operation of section 68(1) is not clear cut, consideration would need to be given to whether a determination should be made under section 197D:

- a) as an alternative basis upon which to support an adjustment under subsection 68(1); or
- b) to remedy the effect of profit shifting from PNG resulting from non-arm's length transfer pricing, where the preconditions for application of section 197D have been met.

40. Even where expenditure is not deductible under subsection 68(1) because it is incurred in deriving exempt income, Division 15 may still have to be applied to increase the amount of any exempt income where it would reduce a carry forward loss and where the preconditions for its application have been satisfied.

41. Where expenditure is otherwise deductible under subsection 68(1), Division 15 can apply to allow an adjustment to be made to the amount of that expenditure where the conditions for the application of the Division have been satisfied.

Outline of the basic concepts

42. Section 197D deems the consideration, in respect of the supply or acquisition of property, to be equal to the arm's length consideration, for all purposes of the application of the Act in relation to a taxpayer, if all the following conditions have been satisfied:

- a) the taxpayer has either supplied or acquired property under an international agreement;
- b) the Commissioner General is satisfied that, in respect of the agreement, any two or more of the parties were not dealing with each other at arm's length in relation to the supply or acquisition of property;
- c) the consideration in respect of the supply or acquisition of property was not the arm's length consideration, or no consideration was received or receivable; and
- d) the Commissioner General determines that the relevant subsection should apply to the taxpayer in relation to the supply or acquisition of property.

43. Where it is not possible or practical for the Commissioner General to ascertain the arm's length consideration, subsection 197D(4) allows the Commissioner General to determine an amount which is deemed to be the arm's length consideration in respect of the supply or acquisition of the property.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Financial Transactions

44. The definition of services, contained in Division 15, includes financial transactions and applies to interest, discounts and other payments for the use of money.

45. The consideration for the use of funds obtained from, or made available to, an associated person may be unacceptable to the Commissioner General for reasons other than a high debt / fixed capital ratio or a high rate of interest. For example, the amount of the loan or terms of the agreement may not reflect what would have been agreed if the persons had been not associated and dealing at arm's length. The Commissioner General may, in appropriate circumstances, apply the transfer pricing provisions to adjust or ignore such non-arm's length transactions for tax purposes.

46. The guidelines set out in this Circular will apply to all types of financial transactions between associated entities in terms of international agreements.

Double Tax Agreements

47. Article 7 of the OECD Model Tax Convention⁴ provides, among other things, for the attribution of profits to a permanent establishment of an enterprise. Article 9 of the OECD Model Tax Convention also stipulates that the profits that would have accrued to the one of the enterprises but for the conditions made or imposed between the enterprises in their commercial or financial dealings be so included and taxed accordingly. The arm's length principle underlying these articles is embodied in each of Papua New Guinea's Double Tax Agreements.

48. The Business Profits and Associated Enterprises articles in the PNG Double Tax Agreements do not specify priorities as to the methods to be used to determine the attribution of profits or an arm's length price. The Commissioner General holds the view that the treaties do not restrict or limit the application of Division 15 of the Act, regardless of the method selected to determine an arm's length consideration. The Commissioner General also takes the view that no inconsistency exists between domestic law and the Double Tax Agreements, as both embody the arm's length principle.

49. Paragraph 2 of Article 9 of the OECD Model Tax Convention provides that a contracting state must make an appropriate adjustment to the amount of tax it levies on profits, if the other contracting state has made an adjustment to the profits of a related enterprise and the profits would have accrued to the taxpayer in the other contracting state if the parties had been dealing independently. Furthermore, the competent authorities of the contracting states may consult each other over the transfer pricing adjustments. Although Papua New Guinea's treaties generally incorporate such adjusting mechanisms, the wording of the relevant article in the treaties may not oblige Papua New Guinea to make a corresponding adjustment in all cases.

The Arm's Length Principle

50. The first and overriding principle is that transactions between associated entities are to be conducted so that the outcomes of such transactions are arm's length. This means that the transaction should have the substantive commercial and

⁴ The OECD Model Tax Convention on Income and on Capital, 2010 ('The OECD Model Tax Convention')

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

financial characteristics of a transaction between independent parties, where each party will strive to maximise the benefit from the transaction.

51. Paragraph 1 of Article 9 of the OECD Model Tax Convention gives authority to the use of the arm's length principles as follows:

“[When] conditions are made or imposed between two [associated] enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

52. The problem to be resolved is how a MNE should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the MNE's prices (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.

53. PNG has adopted the arm's length principle, which is the international norm. The Commissioner General is of the opinion that application of this internationally accepted principle will minimise the potential for double taxation and provide a sound basis for administration of Division 15 and PNG's Double Tax Agreements.

54. Other than tax considerations, factors such as governmental regulations (for example price or exchange controls) may distort the consideration charged between associated entities. These factors are recognised by the Commissioner General and the OECD Guidelines. This Circular provides broad guidelines about the business and economic concepts which indicate what information, data and other evidence would support a taxpayer's contention that the outcomes of transactions between associates are arm's length.

55. The determination of an arm's length consideration is not an exact science but requires judgment on the part of both the taxpayer and the Commissioner General. Accordingly, taxpayers and the Commissioner General need to approach each case, having due regard for the unique business and market realities applicable to each individual case.

56. An arm's length outcome does not necessarily constitute a single outcome, but a range of outcomes and the facts of each case will determine where, within that range, a specific arm's length outcome will lie. See paragraph 170 to 174 of this Circular in this regard.

Principles of Comparability

Introduction

57. Comparability is fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices/margins achieved by associated entities in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

58. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable reliable adjustments cannot be made, then the dealings cannot be considered comparable.

59. The objective of comparability is to always seek the highest practical degree of comparability, recognising though that there will be unique situations and cases involving unique intangibles where it is not practicable to apply methods based on a high degree of direct comparability.

60. The practicable standard of comparability will be determined by the amount and reliability of data on which comparisons with uncontrolled situations and dealings in a particular case can be based. Comparisons with controlled dealings by other taxpayers cannot be regarded as arm's length comparisons.

61. The assessment of comparability can be affected, among other things, by:

- a) the characteristics of the relevant goods and services;
- b) the relative importance of functions performed assets used and risks assumed;
- c) the terms and conditions of relevant agreements;
- d) economic and market conditions; and
- e) business strategies.

Characteristics of the property or services

62. Differences in the specific characteristics of property or services account, at least in part, for differences in their value in the open market. Features that may be relevant in comparing two products includes:

- a) Tangible property: the physical features of the property, its quality and reliability, and the availability and volume of supply.
- b) Services: the nature and extent of services.
- c) Intangible property: form of the transaction, type of property (e.g. patents, trademarks or know how), extent of services, duration and degree of protection and anticipated benefits from use.

63. The significance of the actual characteristics of a product or services being transferred in determining an arm's length price depends on the method applied in determining an arm's length price. For example, in applying the Comparable Uncontrolled Price (CUP) method (see paragraph 90-96 of this circular), the actual characteristics of the goods or services are critical. On the other hand, when the Transactional Net Margin method is applied (see paragraph 112-123 of this circular), the characteristics of the goods or services transferred are not as important as the functions and risks undertaken by the relevant entities.

Functions, Assets and Risks

64. The compensation for the transfer of property or services between two independent enterprises will usually reflect the functions that each enterprise

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

performs, taking into account the assets employed and risks assumed. In determining whether two transactions are comparable, the functions, assets and risks undertaken by the independent parties should be compared to those undertaken by the associated entities.

65. Economic theory predicts that when various functions are performed by a group of independent enterprises, the enterprise that provides most of the effort and, more particularly, the rare or unique functions, and assumes the most risk should earn a greater portion of the profit/loss. For example, a subsidiary may be responsible for the entire assembly of a product. If the trademark, know-how and the selling effort rest with the parent and the subsidiary is only acting as a contract manufacturer, the subsidiary should be entitled to a relatively smaller portion of the profit (representing a fair return on the functions it performs, assets it uses and risks it assumes). The parent should receive the majority of the residual profit/loss.

66. Most of the recommended transfer pricing methods (Cost Plus, Resale Price, Transactional Net Margin and Profit Split methods) focus on functions performed, risks assumed and assets utilised rather than on the goods or services being transferred. When applying one of these methods in a transfer pricing analysis, the comparability of functions performed by the member of the MNE and the independent entity or entities to which it is compared is the most significant issue to consider. In contrast, the CUP method is based on a direct comparison of the price charged for goods or services and the characteristics of the goods or services are the significant issue to consider.

67. A functional analysis is a method of finding and organising facts about a business' functions, assets (including intangible property) and risks. It aims to determine how these are divided between the parties involved in the transaction under review.

68. A functional analysis identifies the economically significant activities (functions performed, assets employed and risks assumed) undertaken by the member of a MNE, and for which it should expect to be rewarded. This identifies the nature and characteristics of the related party dealings that have to be priced.

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

70. A functional analysis will help to highlight where such significant functional differences may exist. However, it must be noted that functional analysis is not a pricing method in its own right. Rather, it is a tool assisting in the selection of a transfer pricing method and the proper determination of an arm's length price. See **Annexure A** for detailed information on the preparation of a functional analysis.

Contractual Terms

71. In arm's length transactions, the contractual terms of a transaction generally define explicitly how the responsibilities, risks and benefits are to be divided between the parties. In addition these terms and conditions may be found in correspondence

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

and communication between the parties. Where no written contract exists, the contractual relationship between the parties may be deduced from their conduct and the economic principles that govern normal arms length relationships.

72. The OECD Guidelines at paragraph 1.53 highlight that in transactions between independent parties, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored and modified after the fact generally only if it is in the interests of both parties. This same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of parties conform to the terms of the contract, or whether such terms have not been followed or are possibly a sham.

Economic circumstances

73. Arm's length prices may vary across different markets, even for transactions involving the same product or service. To achieve comparability, it is important to ensure that the markets in which the parties operate are comparable. Any differences must either not have a material effect on price, or be differences for which appropriate adjustments can be made.

74. The OECD Guidelines at paragraph 1.55, identify a number of factors relevant for comparing markets, including:

- a) geographic location of the market;
- b) size of markets;
- c) extent of competition in the markets;
- d) availability of substitute goods and services;
- e) transport costs;
- f) the level of the market (retail or wholesale).

75. These factors may have particular relevance in the PNG situation. Because PNG is a small country, it may be difficult to obtain comparables from the PNG market. Refer to paragraph 1.55 to 1.58 of the OECD Guidelines for a discussion of this problem.

Business strategies

76. Business strategies are also relevant in determining comparability for transfer pricing purposes. Business strategies are a legitimate aspect of arm's length operations. The arm's length principle, therefore, acknowledges those strategies. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion and other factors having a bearing upon the daily conduct of business.

77. Business strategies could also include market penetration schemes. A taxpayer seeking to penetrate a new market or to expand (or defend) its market share might temporarily charge a lower price for its product than the price for otherwise comparable products in that market. Alternatively, it might temporarily incur higher costs (perhaps because of start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

78. The important issue is how one should appraise whether a business strategy that temporarily decreases profits in return for higher long-term profits is consistent

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

with the arm's length principle. The relevant question here is whether a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

79. The Commissioner General may consider a number of factors in evaluating a taxpayer's claim of following a strategy that temporarily reduces profits in return for higher long-term profits, for example, whether:

- a) the conduct of the parties is consistent with the professed business strategy;
- b) the nature of the relationship between the parties to the controlled transaction justifies that the taxpayer bears the costs of the business strategy;
- c) there is a plausible expectation that the business strategy will produce a return sufficient to justify its costs, within a period of time that would be acceptable in an arm's length arrangement.
- d) the longer the strategy is pursued, the greater the expected additional profits need to be recouped from that investment, and the more difficult it is to establish that a market penetration strategy is in place.

Acceptable Methods for Determining an Arm's Length Price

Introduction

80. Division 15 and the Double Tax Agreements entered into by Papua New Guinea do not prescribe any particular methodology for the purpose of ascertaining an arm's length consideration. Given that there is no prescribed legislative preference, the Commissioner General would generally seek to use the methods that have been set out below.

81. The **most appropriate method** in a given case will depend on the facts and circumstances of the case and the extent and reliability of information on which to base a comparability analysis. It should always be the intention to select the method that produces the highest degree of reliability.

The choice of the most appropriate method for a given case as per the OECD Guidelines at paragraph 2.2 should be made based on the respective strengths and weaknesses of the recognised methods, having regard to:

- a) the nature of the controlled transactions then being examined,
- b) the availability of reliable information (in particular on uncontrolled comparables), and
- c) the degree of comparability that exists between the controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences.

82. In cases where there are no comparables or there is insufficient information to determine an arm's length outcome, the method to be used should be a method that produces a reasonable estimate of an arm's length outcome. Such estimate must be based on the facts in hand.

83. The application of the principles set out in this Circular may require the exercise of judgment. After the identification of an independent benchmark or benchmarks

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

against which the pricing of a MNE is to be compared, it needs to be established to what extent the functions of the members of a MNE are similar to or differ from those of the independent benchmark(s). An element of judgment is required to determine the extent to which these similarities or differences have a material effect on the transfer price adopted by the MNE.

84. As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Taxpayers will not be required to undertake an intricate analysis of all the methodologies, but should have a sound basis for using the selected methodology. This could entail providing reasons why secondary methods are not appropriate.

The principle methods referred to in the OECD Guidelines

85. This section of the Circular considers the principles underlying each of the various transfer pricing methods. An understanding of these principles is useful for identifying the limitations of each method and applying the methods in practice.

86. Several transfer pricing methods have been developed in international practice for determining and appraising a taxpayer's transfer prices. These methods are based on measuring a MNE's pricing outcomes against a benchmark of the arm's length outcomes of independent entities in uncontrolled transactions.

87. The standard transfer pricing methods recognised by the OECD Guidelines, are:

- a) the comparable uncontrolled price method (CUP method);
- b) the resale price method (RP method);
- c) the cost plus method (CP method);
- d) the transactional net margin method (TNMM); and
- e) the transactional profit split method (TPSM).

88. The CUP, RP and CP methods are known as the traditional transaction methods and the TNMM and profit split method are referred to as transactional profit methods.

89. The Commissioner General endorses the CUP, RP, CP, TNMM and TPSM as acceptable transfer pricing methods, the most appropriate of these depending on the particular situation and the extent of reliable data to enable its proper application.

The CUP Method

Description

90. The CUP method compares the **price** charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

Application

91. The CUP method **is the** easiest and most direct way to apply the arm's length principle where it is possible to locate comparable uncontrolled transactions. In some

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

cases, however, sufficient data to apply the method reliably does not exist and another method would need to be considered. A comparable uncontrolled price can be determined by reference to the same or similar products or services transferred under similar circumstances by the taxpayer to an independent party (internal comparable) or by reference to similar products or services transferred under similar circumstances by one independent party to another (external comparable).

92. The two transactions being compared will only be truly comparable if there are no differences between the two transactions that will have a material effect on the price, or if reasonably accurate adjustments can be made to eliminate the effect of differences that may materially affect the price.

93. It is important to keep in mind that two transactions will not be comparable merely because the product or service transferred is comparable. Regard should also be had to the effect on price of broader business functions and economic circumstances other than just the product comparability. In this regard see paragraph 61 for the five principles of comparability. Listed below are examples of where adjustments may be necessary when comparable products or services are transferred between independent parties or the taxpayer and an independent third party:

- a) terms of a transactions may differ (for example, credit terms);
- b) volumes transferred may differ significantly e.g. sell 10 tonnes to an independent party vs. 1000 tonnes to a associated person
- c) shipping and delivery terms may vary (ie sell FOB to an associated person and at CIF to an independent party).

94. In addition certain adjustments could be very difficult to effect, such as where there is difference in the quality of the product, where goods are traded in different geographic markets or at different levels in the supply chain or where there are intangibles involved.

95. Therefore, in the absence of internal comparables, the CUP method may be considered most reliable for establishing an arm's length price for:

- a) sales of commodities traded on a market , subject to the controlled transaction and the comparable uncontrolled transaction taking place in comparable circumstances, including at the same level of the supply chain (e.g. sale to a secondary manufacturer, distributor, retailer etc)
- b) some common financial transactions, such as the lending of money.

In effect, market prices (such as commodity prices or rates of interest) may be publicly available for these types of transaction.

Practical Problems

96. The Commissioner General expects taxpayers to be aware of the following matters whenever the CUP method is selected:

- a) It is often difficult to find a transaction between independent enterprises which is sufficiently similar to a controlled transaction, without differences which have a material effect on price.
- b) Where differences exist between the controlled and uncontrolled transactions, or between the enterprises undertaking those transactions,

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

it may be difficult or impossible to determine reasonably accurate adjustments to eliminate the effect on price.

Example 1

A PNG enterprise - A, manufactures crocodile leather shoes and travel bags. The shoes are sold to a Solomon Islands subsidiary, B, which sells the shoes to unrelated exclusive boutiques. The credit terms to B are 90 days. A also sells the shoes to two independent distributors in Honiara, C and D. The credit terms to the independent parties are 30 days. C sells the shoes directly to end-users and D sells the shoes to expensive shoe shops in Port Vila, Vanuatu. A also sells the travel bags to an independent distributor in Solomon Islands.

Possible CUP's:

The shoes sold to D may be a valid CUP if the Honiara and Port Vila markets are comparable. It will, however, be necessary to adjust the price for the difference in credit terms.

The travel bags sold to the independent distributor in Solomon Islands will not constitute a CUP because the product is not similar to shoes and the price is not comparable.

The shoes sold to C would also not qualify as a CUP because the level of the market is different. B is at a higher level in the distribution chain than C and it is unlikely to be possible to quantify this difference and make reliable adjustments.

The Resale Price method

Description

97. The resale price method is based on the price at which a product, which has been purchased from an associated enterprise, is resold to an independent enterprise. This price (the "resale price") is then reduced by an appropriate gross margin (the "resale price margin"), determined by reference to gross margins in comparable uncontrolled transactions to cover the reseller's selling and other operating costs, and to provide an appropriate profit, depending on functions performed, assets used and risks assumed by the reseller. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties) as an arm's length price for the original transfer of property between the associated enterprises.

98. Thus, in a resale price method, the **resale price margin (i.e. the gross margin)** that the reseller earns from the controlled transaction is comparable with the gross margin from comparable uncontrolled transactions.

Application

99. The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the entity obtains on items purchased and sold in comparable uncontrolled transactions, or by reference to the resale price margin obtained by one independent party selling to another. Functional comparability is very important and it is essential that the functions performed by the independent entity are comparable to the functions performed by the member of the MNE selling to an independent enterprise. There should be no differences, which have a material effect on the price, for which reasonably accurate adjustments cannot be made.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

100. In applying the resale price method, fewer adjustments are normally required for product comparability than under the CUP method. Minor product differences are less likely to have an effect on profit margins than on prices, as profit margins for similar functions tend to be similar, but prices for different products will be similar only to the extent that the products are substitutes for one another. For example, a distributor performs the same function to sell toasters and blenders and is, therefore, likely to require similar profit margins on each product, but blenders are not comparable in price to toasters.

101. While less product comparability may be required in using the resale price method, it remains the case that closer comparability of product will produce a better result. For example where valuable intangibles (i.e. trade marks or trade names) are involved product similarity may assume greater importance. In these cases for comparability purposes appropriate weight must be given to the particular features of the product being transferred when evaluating the functions, assets and risks between the parties to the controlled and uncontrolled transactions.

102. The resale price method focuses on the external sale price to third parties and the gross margin required to reward the function performed by the reseller. These factors are not overly sensitive to differences between the cost structure of a member of a MNE and an independent firm. Thus, if the member of the MNE operates a more efficient distributorship than the independent firm, this will result in a higher net profit percentage when the resale price method is used, and will not influence the gross profit percentage. The resale price method is most appropriate where the reseller does not add substantially to the value of the product or does not possess valuable marketing intangibles.

Practical Problems

103. The Commissioner General expects taxpayers to be aware of the following matters whenever the Resale price method is selected

- a) The significant problem is to determine an arm's length resale price gross margin. It is usually difficult to find a transaction between independent enterprises that is similar to a controlled transaction and where differences do not have a material effect on the margin.
- b) Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The items of cost taken into account to arrive at a gross margin may differ from company to company
- c) The application of this method sometimes requires access to segregated product data. Whilst this information may be available in respect of the controlled party being examined, it will usually not be available in respect of uncontrolled entities used as benchmarks.

Example

A PNG company, manufactures plywood at its factory in Lae. Subsidiaries in Australia and Fiji distribute wood products in their relevant markets after treating them. The treating is not a very complicated process since the woods are already cut out in usable shapes and sizes.

Application of the resale price method:

A search on independent comparable distributors showed that these independent distributors obtain a gross profit margin of 37 per cent to 40 per cent. The only difference is that these distributors are not involved in treating the ply woods.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

The effect of the additional treating function on the gross profit margin earned by the subsidiaries should be evaluated. If material, an adjustment should be made. If not material, the subsidiaries would also be expected to earn a gross margin of between 37 per cent and 40 per cent.

The Cost Plus Method

Description

104. The cost plus method begins with the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated enterprise. An appropriate mark up, determined by reference to the mark up earned by suppliers in comparable uncontrolled transactions, is then added to these costs, to make an appropriate profit in light of the functions performed and the market conditions. In general the mark up in a cost plus method will be computed after direct and indirect costs of production or supply, but before the operating expenses of the enterprise (e.g. overhead expenses).

105. Thus, in a cost plus method, the **mark up on costs** that the manufacturer or service provider earns from the controlled transaction is compared with the mark up on costs from comparable uncontrolled transactions.

Application

106. This method is best suited to situations where:

- a) services are provided,
- b) semi-finished goods are sold between associated parties,
- c) associated entities have concluded joint facility agreements or long-term buy and supply arrangements

107. The mark-up should ideally be determined with reference to the mark-up earned by the same supplier in uncontrolled transactions. If this is not possible, the mark-up should be determined by using the mark-up earned in comparable transactions by an independent supplier performing comparable functions, bearing similar risks and employing similar assets to those of the taxpayer.

108. An uncontrolled transaction is comparable to a controlled transaction for purposes of the cost plus method if one of two conditions is met:

- a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or
- b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

109. Fewer adjustments are needed for product comparability than under the CUP and the same comparability principles as discussed under the resale price method will apply to the cost plus method.

Practical problems

110. The Commissioner General expects taxpayers to be aware of the following matters whenever the cost plus method is selected

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- a) The application of the cost plus method presents certain difficulties. In particular, the determinations of costs, as some companies are more effective than others and will incur lower costs. In addition there may be circumstances where there is no discernible link between the level of costs incurred and a market price.
- b) Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison.
- c) The types of cost included in cost of goods sold to arrive at a gross margin may differ from company to company.

111. The application of this method sometimes requires access to segregated product data. Whilst this information may be available in respect of the controlled party being examined, it will usually not be available in respect of the uncontrolled entities used as benchmarks.

Example

B Limited is a PNG holding company and is responsible for the publication and distribution of newspapers to be used by its subsidiaries in Solomon Islands and Vanuatu. It was clear from the beginning of its operations that there was a market for this kind of service in the Pacific. B also provides this service to other customers throughout the Pacific. The layout and structure of news being reported is unique, but the functions and processes to provide these services are comparable.

Application of the cost plus method

An analysis of the income and costs in respect of the services provided to the independent customers, indicates that costs are recovered and gross profit of between 22 per cent and 25 per cent is achieved.

B Limited should therefore charge its subsidiaries at cost plus between 22 per cent and 25 per cent for the performance of the information technology function.

Transactional Net Margin method (TNMM)

Description

112. The TNMM examines a net profit indicator, i.e. a ratio of net profit relative to an appropriate base (e.g. costs, sales, assets), that a taxpayer gets from a controlled transaction, (or from transactions that are appropriate to aggregate) with the net profit earned in comparable uncontrolled transactions.

113. In cases where the net profit is weighted to costs or sales, the TNMM operates in a manner similar to the CP and RP methods respectively, except that it compares the **net profit** arising from the controlled and uncontrolled transactions (after relevant operating expenses have been deducted) instead of comparing the gross profit on resale or gross mark up on costs.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Application

114. The TNMM is more closely aligned to the CP and RP methods. As a result functional comparability is generally of greater importance than product comparability as in the CUP method.

115. When applying the TNMM the net profit indicator of the taxpayers from the controlled transactions should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide.

116. The TNMM like the other one-sided methods (CP and RP) would appear most applicable in cases where one party makes all the unique contributions in the controlled transaction, whilst the other party does not make any unique contribution. In such a case the tested party will be the less complex one.

117. The net profit indicator that is usually tested in a TNMM is the operating profit (i.e. profit before interest, extraordinary items and income taxes). This net profit figure is then generally weighted to costs for manufacturing and service activities; to sales for sales activities and to assets for asset intensive activities.

Strengths and Weaknesses

118. The main strength of the TNMM is that the net profit indicator is less affected by transactional differences than is the case with price, as in the CUP method and usually more tolerant to some functional differences between controlled and uncontrolled transactions than gross profit margins (i.e. CP and RP). Differences in functions between enterprises are often reflected in variations in operating expenses. Consequentially this may lead to wide variations in gross profit margins but broadly similar levels of net operating profits.

119. Another perceived strength of the TNMM is that as with any one-sided method it is necessary to examine the financial indicator for only one of the associated enterprises (i.e. the tested party).

120. There are also a number of weaknesses with the TNMM. The net profit indicator can be influenced by a number of factors that would either not have an effect, or have less of an effect on price or gross profits margins between independent enterprises. This makes accurate and reliable determination of arm's length net profit margins difficult. For example, even achieving a mere similarity of functions between two enterprises under the TNMM will not ensure the net profit indicators are comparable. For example, the enterprises may carry on the same functions in different economic sectors or markets. (See OECD Guidelines at paragraphs 2.68 to 2.75 for guidance on establishing comparability with the TNMM).

121. In addition, application of the arm's length method requires information on uncontrolled transactions that may not be available at the time of the controlled transaction. This may make it particularly difficult for taxpayers that attempt to apply the TNMM at the time of the controlled transactions (although the use of multiple year data as discussed at paragraphs 178 to 179 may mitigate this problem).

122. However the OECD Guidelines at paragraph 2.74 states that the TNMM may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for the differences referred to above. Nevertheless it states that the TNMM should not be used unless the net profit indicators are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable uncontrolled transactions are

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

those of an independent enterprise, the differences between the uncontrolled and controlled transactions are taken into account.

Practical problems

123. The Commissioner General expects taxpayers to be aware of the following matters whenever the TNMM method is selected

- a) The net profit indicator of a taxpayer can be affected by a number of factors that do not necessarily have the same influence on price or gross margins, and even if these factors can be identified they may be difficult to eliminate.
- b) Information about the taxpayer, required to apply the TNMM may not be available at the time of determining an arm's length price. It may, for example, not be possible to determine the net profit margin that will result from the controlled transaction at that time.
- c) The level of information available on the factors affecting external comparable transactions with independent enterprises is often limited.
- d) The fact that many factors unrelated to transfer prices may effect net profits, in conjunction with the one sided nature of the analysis under this method can effect the overall reliability of the TNMM if an insufficient standard of comparability is applied.

Example

MAL Limited is a PNG company that manufactures spice products. Its products are distributed by subsidiaries throughout Asia. MAL Limited does not sell to independent distributors at all and no comparables could be located that would allow the application of the CUP, cost plus, or resale price methods. The profit split method is not applicable and the only remaining method is the TNMM.

Research on comparable independent companies resulted in the determination of an arm's length range of 15 per cent to 18 per cent. This percentage is determined by expressing operating profit as a percentage of assets. After adjustments were made for differences between MAL Limited and comparable independent companies, in respect of stock holding and debtor days outstanding, the range of arm's length margins is 17.5 per cent to 19 per cent. The transfer price for the sale of spices from MAL Limited to its subsidiaries should be set at a level that will result in operating profit as a percentage of assets of between 17.5 per cent and 19 per cent.

*There were no high value intangibles attributable to any of the entities involved in this example.

The Transactional Profit Split method

Description

124. The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in the controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions.

125. The first step in the profit split method is to identify the combined profit to be split between the associated entities in a controlled transaction. In general, combined operating profit is used, ensuring that both income and expenses of the MNE are

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

attributed to the relevant associated entity consistently. The profit is then split between the parties according to an economically valid basis approximating the division of profits between independent enterprises.

Application

126. The transactional profit split method may be the most appropriate method in cases where both parties to the transaction make unique and valuable contributions to the transaction, because in such cases independent parties might wish to share the profits of the transaction in proportion to their respective contributions and a two-sided method maybe more appropriate in these circumstances than a one-sided method. In addition, in the presence of unique and valuable contributions, reliable comparable information might be insufficient to apply another method.

127. Where comparables data are available; they can be relevant in the profit analysis to support the division of profits that would have been achieved between independent parties in comparable circumstances. Comparables data can also be relevant in the profit split analysis to assess the value of the contributions that each associated enterprises makes to the transaction.

128. However in those cases where there is no more direct evidence of how independent parties in comparable circumstances would have split the profits in comparable transactions, the allocation of profits may be based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises themselves (i.e. internal data).

129. This is also the weakness of the transactional profit split method identified in paragraph 2.114 of the OECD Guidelines in that it often relies less on information concerning independent third parties and more on internal data analysis in the division of profits between associated enterprises.

130. Two alternative approaches to the profit split method are outlined in the OECD Guidelines. Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction. The combined profit is then allocated as follows:

- a) Under the residual profit split approach, each of the parties to the transaction is assigned an initial profit according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.
- b) Under the contribution analysis approach, it is generally the combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party to that combined profit

131. However, note that these two approaches are not necessarily exhaustive or mutually exclusive. There may be alternative ways to split a profit to achieve a reliable arm's length result.

132. In addition as is explained in paragraph 2.131 of the OECD Guidelines it may, in some circumstances, be appropriate to split gross profits (as opposed to operating profits) between the associated entities and then deduct the operating expenses incurred by or attributable to each relevant enterprise. The example used is the case of a MNE that engages in highly integrated world-wide trading operations involving various types of property. It may be possible to determine the enterprises in which

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

expenses are incurred or attributed, but not to accurately determine the particular trading activities to which those expenses relate. In such a case it may be appropriate to split the gross profit from each trading activity and then deduct from the resulting overall gross profit the operating expenses incurred by or attributable to each enterprise.

133. The allocation of gross profit should be consistent with the location of activities and risks. Care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the activities performed and risks assumed by the relevant entities.

(a) Residual Profit Split Analysis

134. The residual profit split approach first provides both the parties to the transaction with a basic return, based on what independent firms would obtain for performing similar functions and undertaking similar risks. This basic return can be achieved by applying either a traditional transaction method (i.e. CP or RP) or a TNMM by reference to the basic return of comparable transactions between independent enterprises. The residual profit remaining after the first stage division would be allocated among the parties, in accordance with the way in which this residual would have been divided between independent enterprises.

135. This requires a judgment about what factors contribute to the residual profit, and their relative contribution. For example, it may be determined that the process development and the marketing are the only relevant contributors to the residual profit and that each contributes 50 per cent to that profit. A 50:50 split of the residual profit between the manufacturer and the retailer would then be justified.

136. There is no definitive guide on how the relative contribution of the parties should be measured. It is quite likely that the transaction between the parties will be unique, so there will be no external benchmark against which to test the reliability of the assessment of relative contributions. See paragraph 1.32 to 2.145 of the OECD Guidelines for a detailed discussion on how to split the residual profits.

(b) Contribution analysis

137. Under the contribution analysis, the combined profits, which are the total profits from the controlled transactions under review, would be divided between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realise from engaging in comparable transactions. This division can be supported by comparable data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transaction, taking account of their assets used and risks assumed.

138. It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transaction, and the approach will often depend on the facts and circumstances of the case. See paragraphs 2.132 to 2.145 of the OECD Guidelines for a detailed discussion of how to split the combined profits.

Practical problems

139. The Commissioner General expects taxpayers to be aware of the following matters whenever the Transactional Profit Split method is selected

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- a) The transaction profit split method relies less on information on external enterprises to carry out a division of profits and more on internal data to support the division.
- b) The application of the transaction profit split method relies on access to world-wide group data, which may be difficult to obtain even between associated enterprises.
- c) It may be difficult with an MNE Group to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions.
- d) The Financial Statements and records of all associated enterprises participating in the controlled transactions may need restating on a common basis.

Example

A Limited is a PNG tea producer. A Limited, acquired B Limited which is a company located in Fiji. B Limited has an established distribution network in Fiji and the rest of the Pacific and has good contacts with businesses in the region. A Limited would not have been able to sell its product without involving B Limited's contacts.

Before the acquisition of the B Limited, A Limited and B Limited had considered entering into a joint venture agreement and were negotiating a profit split of 40 per cent for A Limited and 60 per cent for B Limited. The profit split is based on the Functions, Assets and Risks analysis prepared by the parties based on their relative contributions.

Application of the profit split method

There are no comparables which would allow the application of the CUP, resale price or cost plus methods. Based on the negotiations before the acquisition of B Limited by A Limited, it was decided to apply the profit split method to arrive at arm's length prices. Because of the importance of B Limited's contacts and distribution network, and the other factors taken into account during the negotiation phase, it was decided that the transfer price at which the product should be sold to the B Limited should be set at a level that will result in a 40 : 60 profit split if the relevant factors remain unchanged.

Performing a Comparability Analysis

Introduction

140. The general principles of comparability have been covered in paragraphs 57 to 79 of this circular. By definition a comparison implies examining two terms: the controlled transaction under review and the uncontrolled transaction that are regarded as potential comparables. However this search for comparables is only part of a comparability analysis.

141. A comparability analysis for transfer pricing purposes is part of the whole process that starts with the preliminary analysis of the conditions of the controlled

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

transaction, to the selection of the transfer pricing method, through to the identification of potential comparables and ultimately a conclusion about whether the controlled transactions being examined are consistent with the arm's length principle.

142. There are a number of models that a business can follow when performing a comparability analysis to reach a conclusion that its related party dealings are consistent with the arm's length principle. The choice of a particular model is not compulsory and the extent of the analysis required will depend on factors such as the significance of the related party dealings compared to total business dealings.

143. The Australian Taxation Office (Taxation Ruling 98/11, Chapter 5) has designed a four-step approach as a useful tool for taxpayers to develop the methodology and documentation needed to test the outcomes of their related party international transactions. The Commissioner General endorses the four step process as a practical tool for businesses to follow to reach a conclusion that their controlled transaction are consistent with the arm's length principle as follows:

Step 1: Accurately characterise the international dealings between the related parties in the context of your business and document the result;

Step 2: Selecting the most appropriate transfer pricing method and document the choice;

Step 3: Applying the most appropriate method, determine an arm's length outcome and document the result;

Step 4: Implement support processes, including a review process to ensure adjustment for material changes, and document the process.

A summary of the Four-Step approach is set out in **Annexure B**. Taxpayers are, however, not obliged to use it to determine their transfer pricing and should be aware that it is most appropriate where international dealings are extensive and necessitate a thorough analysis.

144. Whichever process a business selects for its comparability analysis purposes it should be conducted in accordance with the guidelines provided between paragraphs 3.1 and 3.66 in the OECD Guidelines under the following steps

- a) Review the controlled transaction;
- b) Search for comparable uncontrolled transactions;
- c) Select or reject potential comparables;
- d) Comparability adjustments if required;
- e) Determination of an arm's length range.

Review of the Controlled Transactions

Evaluation of separate and combined transactions

145. Ideally, to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated separately. The OECD Guidelines, at paragraph 3.9 cite the following examples:

- a) some long-term contracts for the supply of commodities or services
- b) rights to use intangible property

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- c) pricing a range of closely-linked products (for example in a product line) when it is impractical to determine pricing for each individual transaction
- d) the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer.

146. In such cases, it may be appropriate to determine the arm's length price based on some "basket of goods" or combination of transactions.

147. However, the converse may also be true. There will be cases where a MNE packages as a single transaction and establishes a single price for a number of benefits, such as licences for patents, know-how and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as a package deal. In these cases, it may be necessary to consider separately the component transactions of the package deal. This may occur when it is either inappropriate or not feasible to evaluate the package as a whole.

148. The OECD Guidelines note, at paragraph 3.12 that a key principle to be followed in considering whether the transfer pricing should be determined for a combination of transactions or on a package basis is that the Revenue Authority should treat the transaction between associated entities in the same way that it would treat a similar deal between independent enterprises. Taxpayers should therefore be prepared to show that any package deal or combination of transactions reflects appropriate transfer pricing. Functions actually performed and all aspects of the transaction must, however, be taken into account in substantiating the transfer price.

Intentional Set Offs

149. Intentional set-offs may vary in size and complexity. Such set offs may range from a simple balance of two transactions (such as a favourable selling price for manufactured goods in return for a favourable purchase price for the raw materials used in producing the goods) to an arrangement for the general settlement balancing all benefits accruing to both parties over a period.

150. The Commissioner General recommends taxpayers document the existence of set-offs intentionally built into two or more transactions between associated enterprises so that they can demonstrate that, after taking account of the set-offs, the conditions governing the transaction are consistent with the arm's length principle.

Choice of tested party

151. The Commissioner General supports the general rule in the OECD Guidelines at paragraph 3.18 that the tested party should be the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found.

152. There may be instances where, based on a taxpayer's circumstances and the information available, it would be appropriate for the foreign party to a transaction to be evaluated in determining the most reliable measure of the arm's length price. This would be the case where the foreign party does not own intangible property, or does not perform any unique functions. For example, if the other party were a contract distributor, the appropriate choice of method, based on the activities of that distributor, would seem to be the resale price method. In such instances the taxpayer will need to consider its ability to obtain reliable information about comparable transactions from which to determine an arm's length price.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

153. From the Commissioner General's perspective, the important point is that a pragmatic approach is required. In determining which party to a transaction should be used as the party to be evaluated, taxpayers should seek a practical solution that leads to a reliable determination of the arm's length amount.

154. However, taxpayers should be aware that the Commissioner General would generally prefer to use the PNG party as the party to be evaluated, in appraising whether a taxpayer's transfer prices are arm's length. It is, therefore, important that if a taxpayer uses a foreign party as the party to be evaluated, the price determined is also considered in relation to the PNG operations, to ensure that it results in an appropriate return for those operations.

Information on the controlled transaction

155. In order to select and apply the most appropriate transfer pricing method information is needed on the comparability factors in relation to the controlled transaction under review. This usually will involve the functions, assets and risks of all parties to the controlled transaction including the foreign associated enterprise.

156. The OECD Guidelines at a paragraph 3.20 state that whilst one-sided methods (e.g. CP, RP & TNMM) only require an examination of a financial indicator or profit level indicator of one of the parties to the transaction (i.e. the tested party) some information on the comparability factors of the controlled transaction and in particular on the functional analysis of the non tested party is also needed in order to appropriately characterise the controlled transactions and select the most appropriate transfer pricing method.

157. However where the most appropriate transfer pricing method in the circumstances of the case is a transactional profit split method, financial information on all the parties to the transaction, foreign and domestic is needed. Being a two-sided method information will be needed across the five comparability factors in order to appropriately characterise the relationship between the parties and demonstrate the appropriateness of the transactional profit split method.

Comparable Uncontrolled Transactions

158. A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under review. It can be either a transaction between one party to the controlled transaction and an independent party (i.e. an internal comparable) or between two independent enterprises, neither of which is a party to the controlled transaction (i.e. external comparable).

Internal Comparable

159. Internal comparables should as a rule have a closer relationship to the transaction under review than an external comparable. This is because of such factors as the identical accounting standards and practices for the internal comparables as for the controlled transaction. Access to information may also be more complete and less costly.

160. However internal comparables may not always be more reliable. In the PNG context internal comparables where they exist must still satisfy the five comparability factors in the same way as external comparables.

External Comparables

161. The OECD Guidelines at paragraph 3.29 recognises there are various sources of information that can be used to identify potential external comparables. This

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

section discloses particular issues with databases and foreign sourced information. Additionally whenever reliable internal comparables exist, it may be unnecessary to search for external comparables.

Databases

162. A common form of information in some countries is commercial publically available databases, which have been developed by editors who compile accounts lodged by companies with the relevant regulators and present them for searches and statistical information. These are often accessible only by paying a subscription. In the PNG context the use of data bases for comparability analysis purposes may be very limited. The Commissioner General does not intend to subscribe to a commercial database to examine the taxpayer's contentions. Any taxpayer advancing the use of this method would be expected to provide the Commissioner General sufficient access to the database and/or information from the database to substantiate its contentions.

Foreign Source data

163. In the light of the difficulties which may be encountered in obtaining information on uncontrolled transactions in PNG, the Commissioner General will accept the use of foreign country comparables (e.g., data from the Australian, United Kingdom and United States markets) in taxpayers' transfer pricing analyses. However, taxpayers using such comparables would be expected to assess the expected impact of geographic differences and other factors on the price.

164. For example, data may be available to indicate that the gross margin paid to distributors of a particular product in the United Kingdom is 20 per cent. This does not mean that 20 per cent will necessarily be an appropriate gross margin for Papua New Guinean distributors. There are a number of factors, which may indicate that, an alternative gross margin to be more appropriate. For example:

- a) Consumer preferences may result in different retail prices for a product in the two countries. This raises the question of which party to the transaction should capture any premium in price.
- b) Higher transport costs may be associated with one of the markets. The relative gross margins may be affected by who bears this cost.
- c) The relative competitiveness of the distribution industries in Papua New Guinea and the United Kingdom may differ. This could result in lower gross margins being paid in the more competitive market.
- d) There may be differences in accounting standards that, if not adjusted for, could distort the relative margins of the parties being compared.

165. Thus, while foreign comparables may be useful, taxpayers will need to exercise caution to ensure that appropriate adjustments reflect differences between the Papua New Guinean and foreign markets.

Selecting or rejecting potential comparables

166. There are basically two methods in which the identification of potentially comparable third party transactions can be conducted.

167. The first one, the "additive approach" consists of making a list of third parties that are believed to carry out potentially comparable transactions. Information is then gathered on the transactions conducted by the third parties to confirm whether they

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

are in effect acceptable comparable, based on the predetermined comparability criteria. It is important that this process be transparent, systematic and verifiable.

168. The second method, the deductive approach, starts with a wide set of companies in the same sector, or performing similar broad functions that do not present economic characteristics that are obviously different. The list is then refined using selection criteria and publicly available information (e.g. from databases, internet sites and information on known competitors). This approach is not appropriate in all cases and with all methods and should not be interpreted as effecting the criteria for selecting a transfer pricing method set out in paragraph 80 of this Circular.

Comparability Adjustments

169. The need to adjust comparables and the requirement for accuracy and reliability are pointed out a number of times in the OECD Guidelines, both for the general application of the arm's length principle and more specifically in the context of each method. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the conditions being examined in the methodology or that reasonable accurate adjustments can be made to eliminate the effects of such differences.

Determination of an arm's length range

170. As transfer pricing is not an exact science, the application of the most appropriate method or methods will often result in a range of justifiable transfer prices.

171. In these cases, differences in figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in the range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish the exact same price.

172. In some cases not all comparable transactions examined will have a relatively equal degree of comparability. Where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated.

173. It may be the case that, whilst every effort is made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitation in information available on comparables, that some comparability defects cannot be identified, and are therefore not adjusted. In such a case if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. interquartile range or other percentile) might help to enhance the reliability of the analysis.

174. There would be more confidence in ranges that are established by the use of different methods if those ranges, when compared, reflect common results or overlap.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Other Practical issues of Comparability

The fixing of transfer prices is a complex process. Many factors will have an impact on an arm's length transfer price. The purpose of this Circular is to highlight some of the practical issues that may arise in the fixing arms length prices for the transfer of goods and services between associated enterprises in transactions as envisaged under Division 15 of the Act.

Recognition of actual transactions undertaken

175. As a general point of departure an examination of controlled transactions will be based on the transactions actually undertaken by the associated entities.

176. In accordance with paragraph 1.65 of the OECD Guidelines it will, in certain circumstances, be appropriate to disregard the structure of the controlled transaction entered into by a taxpayer. This will be the case where the economic substance of a transaction differs from its form. The Commissioner General will evaluate the substance of actual transactions to determine whether the transactions were structured in a way that would not have taken place between independent enterprises. An arm's length price should reflect the actual functions performed, risk assumed and assets used.

177. In terms of paragraph 1.65 above, the structure adopted by a taxpayer may also be disregarded where the form and substance of the transaction agree, but viewed in their totality, the arrangements made in relation to the transaction differ from those which would have been adopted by unrelated entities behaving in a commercially rational manner and the actual structure impedes the Commissioner General from determining the appropriate transfer price.

Use of multiple year data

178. In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it would be useful to examine data from the year under examination as well as prior years.

179. In the case of both the tested party and the uncontrolled comparables, multiple year data should be used, to take account of the effect of product and business cycles and short-term economic conditions.

Confirming transfer prices through multiple methods

180. There are conceptual links between each of the transfer pricing methods. This means that there should be a general consistency between transfer prices determined under each of the methods.

181. One of the taxpayer's key aims in transfer pricing is to convince the Commissioner General that its transfer prices are set at arm's length. To this end, a taxpayer's transfer pricing practices may be more credible if they are supported by analyses under one or more secondary methods. However, the Commissioner General does not as a rule require the application of more than one method, as this could place a significant burden on taxpayers. This approach is in accordance with paragraph 2.11 of the OECD Guidelines.

182. A taxpayer need not go to the same level of detail to demonstrate a price under more than one method. A brief analysis under one or more alternative methods that supports a well established and documented transfer pricing policy, determined

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

under a primary pricing method, will add further credibility to that transfer pricing policy.

183. The decision to apply more than one method will depend on circumstances such as the availability and reliability of comparables and the taxpayer's assessment of the risk and degree of security required in its transfer pricing policies. The complexities of real life business situations may also force a taxpayer to apply more than one method, or even a mixture of methods, to determine an arm's length price. Therefore, the use of more than one method will be justified in the case of very complicated transactions.

The use of hindsight

184. The use of hindsight is inconsistent with the arm's length principle in setting or reviewing a transfer price. At arm's length, an event occurring after a taxpayer has determined its prices would not affect the determination of those prices, unless they could be reasonably predicted at the time those prices were set.

185. The Commissioner General's appraisal of a taxpayer's transfer prices will, as a starting point, focus on the conditions under which the taxpayer was operating at the time the relevant transaction occurred. An examination of relative profits from a controlled transaction over a period of time will, in itself, not form the basis for a transfer pricing adjustment, but may, however, form the basis for the Commissioner General to identify cases for potential audit.

186. The appropriate use of data from periods subsequent to a transaction being examined is discussed in the OECD Guidelines at paragraph 3.74:

"Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight.

For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions, for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties."

187. Hindsight may be valuable for appraising the reliability of comparables used by a taxpayer in its transfer pricing analysis. However, this does not only benefit the Commissioner General. It may be that a taxpayer's transfer pricing policy is more persuasive if data of actual transactions supports the taxpayer's comparables. Hindsight is also a valuable tool in the periodic review of the continuing applicability of methods used to determine arm's length prices.

188. The availability and use of contemporaneous documentation in a taxpayer's transfer pricing analysis will also reduce the likelihood of the Commissioner General using hindsight in an appraisal of the taxpayer's transfer prices.

The effect of government policies

189. As a general rule, government interventions such as price control, interest control and exchange control should be treated as conditions of the market in a particular country. Government policies should be taken into account in evaluating a transfer price in a particular market, to the extent that the policies affect the manner in which prices are determined by comparable independent enterprises.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Evidence of real bargaining at the time of the transaction

190. The arm's length principle is modelled on notions of comparison and predication about what independent parties dealing at arm's length either did or might reasonably be expected to have done in the taxpayer's circumstances. It is therefore relevant to consider whether any comparative analysis was done and to what extent the taxpayer relied thereon. This necessarily involves examination of the outcome of the transaction and is not confined to an examination of the process. One of the many factors to be taken into account to determine whether a transfer price is an arm's length price is to establish whether the associated entities actually entered into a bargaining process before fixing the relevant transfer prices.

191. Real bargaining between associated enterprises would be expected to be achieved where the conditions in which the bargaining is undertaken are similar to those that would exist between unrelated parties dealing at arm's length. Members of company groups sometimes fulfil conditions for arm's length dealings where the members have a considerable amount of autonomy so that they can, and indeed often do, bargain with each other in a manner similar to that of independent entities.

192. Listed below are some of the factors which, depending on the particular case, may support to arguments that conditions for real bargaining between associated enterprises were similar to those existing between unrelated parties dealing with each other at arm's length:

- a) members of MNEs being allowed to acquire goods and services from unrelated persons where the price is lower;
- b) members of MNEs being allowed to supply goods and services to unrelated persons where the price is higher;
- c) each entity having its own profit and cost responsibility and "user pays" principles applying in relation to goods and services provided between the entities;
- d) manager remuneration is either significantly or wholly connected to the economic performance of the individual entity and there is no scope for rewarding performance detrimental to the individual entity, but which is of overall advantage to the group; and
- e) the parties prepared documentation during the negotiation phase similar to the documentation independent parties dealing at arm's length would have used in comparable circumstances.

193. Real bargaining between associated parties would not usually be expected to be achieved where:

- a) the same directors, officers or representatives handled the negotiations on behalf of all the associated entities; or
- b) one party may have directed the negotiations or determined the outcome of the dealings of the associated entities.

Safe harbours

194. It may be argued that the difficulties in applying the arm's length principle would be alleviated by providing circumstances in which taxpayers could follow a simple set of rules under which transfer prices would be automatically accepted by the Commissioner General. Such provisions would constitute safe harbours.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

195. In this context, taxpayers may also erroneously be of the opinion that the adoption of an arm's length principle implies that members of groups need only cover their variable costs and make some contribution to fixed costs, or return a profit (however marginal) from their activities to avoid transfer pricing challenges from the Commissioner General.

196. Various factors such as administrative simplicity, certainty and compliance relief support the use of safe harbours. However, there are various disadvantages to the setting of safe harbours. Most importantly, the introduction of safe harbours can produce results that may be inconsistent with the arm's length principle.

197. In paragraph 4.102 the OECD Guidelines warn against the use of safe harbours. The Commissioner General supports this view.

Documentation required to support Transfer Prices

The Income Tax Act

198. Sections 364, 365 and 366 of the Act deal comprehensively with the information and documents of the taxpayer and the access of IRC to such information and documents, as well as the supporting documentation required when submitting returns. These provisions are also applicable to transfer pricing audits.

199. The Commissioner General, for the purpose of obtaining full information in respect of the income of a taxpayer or of any part thereof, may require the taxpayer or any other person to produce for examination by the Commissioner General, or by any person appointed by him, at such time and place as may be determined by the Commissioner General, any "documents" or "information" (as defined in Section 366 (1) (a) & (b)) which the Commissioner General may require.

200. Section 364 requires all records (namely ledgers, cash-books, journals, cheque-books, bank statements, deposit slips, paid cheques, invoices, stock lists, all other books of account and data created by means of a computer relating to any trade carried on by the taxpayer), as well as recorded details from which the taxpayer's returns were prepared, for assessment of taxes, to be retained for a period of seven years from the date on which the return relevant to the last entry in any of the above-mentioned records were received by the Commissioner General.

201. The purpose of this section of the Circular is to cover the broad issues relating to the types and extent of documentation which taxpayers are advised to keep, to be able to demonstrate how their methods and prices satisfy the arm's length principle.

The need for documentation

202. The general requirements of the Act that the taxpayer maintains proper records set out in paragraph 198 requires taxpayers to keep proper records relating to their transfer pricing. There is no specific statutory requirement to prepare and maintain transfer pricing documentation.

203. However, it is in the taxpayer's best interest to document how transfer prices have been determined, since adequate documentation is the best way to demonstrate that transfer prices are consistent with the arm's length principle, as required by Division 15.

204. A taxpayer that does not prepare transfer pricing documentation is at risk on two counts. Firstly, it is more likely that the Commissioner General will examine a taxpayer's transfer pricing in detail if the taxpayer has not prepared proper

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

documentation (see paragraph 232 in this regard). Secondly, if the Commissioner General, as a result of this examination, substitutes an alternative arm's length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Commissioner General or in the Courts.

205. Also, if taxpayers have not maintained appropriate records, the process of checking compliance with the arm's length principle becomes far more difficult and the Commissioner General's officials are forced to rely on less evidence on which to apply a method, thus requiring a greater degree of judgment.

206. In addition there are practical reasons why taxpayers would be well advised to keep contemporaneous (at or close to the time the transaction occurs) documentation. The income tax return for companies requires taxpayers to supply certain specific information regarding transactions entered into between associated entities. It is not possible for a taxpayer to comply with these requirements if the taxpayer has not addressed the question of whether its dealings comply with the arm's length principle.

207. Thus, if a taxpayer can demonstrate that it has developed a sound transfer pricing policy in terms of which transfer prices are determined in accordance with the arm's length principle by documenting the policies and procedures for determining those prices, the Commissioner General is more likely to conclude that its transfer pricing practices are acceptable and the risk of possible adjustments will be diminished.

208. On the other hand, preparing documentation is time-consuming and expensive. It will therefore not be expected of taxpayers to go to such lengths that the compliance costs related to the preparation of documentation are disproportionate to the nature, scope and complexity of the international agreements entered into by taxpayers with associated entities.

Documentation guidelines

209. The documentation guidelines set out below broadly follow Chapter V of the OECD Guidelines. According to paragraph 5.4 of the OECD Guidelines, the taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. The Commissioner General expects taxpayers to have created, referred to and retained documentation in accordance with this principle.

210. An important question is what documentation should taxpayers prepare if they are to demonstrate compliance with the arm's length principle. Unfortunately, it is not possible to specify a comprehensive pre-defined set of documentation requirements that meet the requirements of all taxpayers, because appropriate documentation depends on each taxpayer's specific facts and circumstances. This Circular sets out factors that should be considered by taxpayers in determining an appropriate level of documentation for their specific circumstances.

211. In determining an arm's length price, a taxpayer would generally go through a process which will usually include some form of a functional analysis and information gathering on relevant comparables. This would be expected to point to some appropriate method under which the arm's length price would be determined. Once

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

the appropriate method has been determined, the process becomes one of applying the relevant data to determine the arm's length price.

212. As a general rule the Commissioner General considers that taxpayers should **contemporaneously document** the process they have followed and their analysis in determining transfer prices, in their efforts to comply with the arm's length principle. This should include some justification of why those transfer prices are considered to be consistent with the arm's length principle.

213. The arm's length principle imposes requirements on associated entities that independent parties dealing at arm's length would not have. For example, independent firms are not required to justify the price of their transactions for tax purposes, but members of MNEs are required to justify the price adopted in their controlled transactions, to evidence compliance with the arm's length principle. Taxpayers may therefore have to prepare or refer to written materials which they would not otherwise prepare or refer to, such as documents from foreign associated entities.

214. The Commissioner General will rely as much as possible on documentation that should be created in the ordinary course of business and of setting a transfer price. This documentation will generally address the following:

- a) identification of transactions in terms of international agreements entered into with associated entities and the extent of any other commercial or financial relations with associated entities which fall within the scope of Division 15;
- b) copies of the international agreements entered into with associated entities;
- c) a description of the nature and terms (including prices) of all the relevant transactions (including a series of transactions and any relevant off-setting transactions);
- d) the method that has been used to arrive at the nature and terms of the relevant transactions (including any functional analysis undertaken and an appraisal of potential comparables);
- e) the reasons why the choice of method was considered to be the most appropriate to the relevant transactions and to the particular circumstances;
- f) an explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's length principle;
- g) information relied on in arriving at the arm's length terms such as commercial agreements with third parties, financial information, budgets, forecasts etc;
- h) details of any special circumstances that have influenced the price set by the taxpayer.

215. At the outset of a transfer pricing review the Commissioner General expects the taxpayer to identify:

- a) which goods or service, if any, are considered most comparable to the goods or services being reviewed;
- b) its major competitors;

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- c) the competitors the taxpayer considers most comparable; and
- d) the methodologies used and why they should be considered appropriate in the taxpayer's particular circumstances.

Contemporaneous Documentation

216. Taxpayers may be asked to provide the Commissioner General with relevant documentation created when the international agreement was contemplated and at the time when the agreement was entered into and/or when they are reviewing the outcomes of those decisions prior to lodgement of the relevant taxation return. Where there is **inadequate contemporaneous documentation** of international dealings between associated entities, it will clearly be more difficult for companies to convince the Commissioner General that the dealings took place on an arm's length basis.

217. Taxpayers under audit would be expected to provide relevant documents, explanatory material and other information to which the company has access or could reasonably be expected to have access. The nature of the documentation likely to be sought includes relevant pricing policies, product profit abilities, relevant market information (such as sales forecasts and market characteristics), the profit contributions of each party and an analysis of the functions, assets, skills and the degree and nature of the risks involved for the various parties.

218. In the event that contemporaneous documentation does not exist, companies should review their pricing policies against the guidelines set out in this Circular and satisfy themselves that they accord with the arm's length principle and that dealings with associated entities have been carried out on that basis. This is particularly pertinent for companies that have been in overall losses for extended periods of time or have consistently returned losses from their international dealings segment. Companies in these categories without contemporaneous documentation would be expected to be able to justify their position taken on transfer pricing when called upon by the Commissioner General to do so.

219. It is recommended that contemporaneous documentation be prepared for all future transactions that are entered into after the release of this Circular by a date no later than the date of lodgement of the tax return affected by those transactions.

The Commissioner General's Approach to Transfer Pricing Reviews and Audits

Introduction

220. Depending on the facts applicable to each individual case, the Commissioner General intends to follow the general guidelines set out in this Circular. The discussion below focuses on various practical issues that have not yet been addressed above.

The Commissioner General's access to and use of information

221. There are various sources from which the Commissioner General can obtain information. The first is from the taxpayer, by way of enquiries into its transfer pricing practices. Alternatively, information may be sought from sources external to the taxpayer, such as:

- a) other taxpayers within the same or similar industry;

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- b) financial databases, publicly available industry information, the Internet, etc. This includes
- c) information on comparable foreign entities;
- d) other jurisdictions (through the exchange of information provisions contained in Double Tax Agreements and Tax Information Exchange Agreements).

Use of publicly undisclosed information

222. In the context of a review of a taxpayer's voluntary compliance with the transfer pricing rules, the Commissioner General's primary source for obtaining information will be from the taxpayer itself. However, it should be remembered that the Commissioner General, when applying any method, may have more information available than a taxpayer has, or can through its own efforts have reasonable access to.

223. The Commissioner General does not intend as a matter of course to use publicly undisclosed information in an attempt to substitute an alternative measure of the arm's length amount. There are procedural problems in using such information, such as the likelihood that such information could not be provided to taxpayers whose transfer prices are under review or as evidence in court due to the secrecy provisions of the Act.

224. Nevertheless, the Commissioner General does not rule out the possibility that publicly undisclosed information will be used in administering the transfer pricing rules.

Requesting information from foreign associated entities

225. Where a non-resident parent dictates the transfer price adopted by its PNG subsidiary (e.g. through the use of "standard price lists for all dealers in a region etc"), the parties may not be considered to be dealing at arm's length. Where the subsidiary has limited or no documentation to demonstrate that its transfer prices comply with the arm's length principle, it may be necessary to have recourse to documentation held by non-resident associated entities, if the taxpayer's transfer prices are to be reviewed.

226. The Commissioner General acknowledges that taxpayers may face difficulties obtaining information from foreign associated entities. Such difficulties would not be encountered if taxpayers were required to produce only their own documents. However, due to the relationship between the parties the Commissioner General considers it reasonable to expect taxpayers to obtain such information where necessary.

Acceptability of analyses prepared for a foreign tax administration, global pricing policies and Advance Pricing Agreements (APA's) entered into with foreign tax jurisdictions

227. In determining whether an analysis prepared for a foreign tax jurisdiction is likely to be acceptable to the Commissioner General, taxpayers should consider the effect of the transfer prices on the PNG operations. Whether the analysis results in the most reliable measure of the arm's length price from the perspective of the PNG taxpayer, should also be taken into account.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

228. Most analyses under the accepted pricing methods focus directly on only one side of a transaction (in the case of an analysis prepared for another tax jurisdiction, this is likely to be the foreign party to the transaction). In applying all but the profit split method, it is not necessary to consider the implications of the transfer price determined for the other party to the transaction.

229. The Commissioner General expects an arm's length price to result in a return for the PNG operations, commensurate with its economic contribution and risks assumed.

230. If, for example, an analysis favouring the foreign jurisdiction over PNG has been prepared (perhaps because the other jurisdiction is more aggressive than PNG in administering its transfer pricing rules), that analysis is unlikely to be acceptable to the Commissioner General. However, if the analysis represents a fair application of the arm's length principle and from the PNG operations' perspective results in a return that is prima facie commensurate with that operations' economic contribution and risk assumed, that analysis is more likely to persuade the Commissioner General that the transfer prices are arm's length.

Method of Selection of Transfer Pricing Reviews and Audits

231. The Commissioner General as a rule allocates resources on transfer pricing cases according to the perceived risk to the revenue of taxpayer non-compliance with the arm's length principle. The more significant and the broader the scope of the dealings, the more likely it is that a taxpayer will be subject to a transfer pricing review. Businesses with significant levels of international dealings who are constantly returning losses are at the greatest risk of a transfer pricing review.

232. A transfer pricing review may involve officers from the IRC attending at the taxpayer's business premises or their professional adviser's offices to establish a taxpayers compliance with the arm's length principle in regard to their associated enterprise dealings by an examination of the following:

- a) the nature and extent of a business's international dealings with related parties;
- b) the quality of the processes established by the business to demonstrate compliance with the arm's length principle for tax purposes; and
- c) the quality of the business's documentation of those dealings and the outcome of those dealings.

As part of the review process, the IRC will assess the quality of the business's processes and documentation as well as the commercial realism of the outcome of its dealings. The taxpayer will then be advised of the likelihood of proceeding to a full transfer pricing audit.

233. Taxpayers should be aware that the Commissioner General may pay closer attention to a transaction involving an associated entity resident in a country with lower tax rates than PNG. The perception exists that transactions involving low tax jurisdictions are often motivated by tax, rather than strictly commercial, reasons. This will particularly be the case where the PNG entity has ongoing tax losses as a result of its dealings with a related party in a lower tax jurisdiction.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

General anti-avoidance provisions

234. Taxpayers should be aware that the exercising of the discretion by the Commissioner General in terms of Division 15 will not limit or exclude the application of the general anti avoidance provisions contained in section 361 of the Act.

Interest and Penalties

Penalties

235. The penalty, additional tax and offence provisions applicable in the event of default or omission in the completion of the tax return or evasion of taxation are contained in sections 316, 317, 320 and 321 of the Act and will also apply to default, evasion or omission relating to transfer pricing. The Act does not impose specific penalties in respect of non-arm's length pricing practices.

Interest

236. Section 262 for interest on the underpayment of tax and will also apply if the underpayment of tax results from non-compliance with Division 15 of the Act.

Burden of Proof

237. In terms of Division 15, the discretion to adjust the consideration in respect of a transaction rests with the Commissioner General. In the discharging of its burden of proof it is clearly in a taxpayer's best interests to:

- a) develop an appropriate transfer pricing policy;
- b) determine the arm's length amount, as required by Division 15; and
- c) voluntarily produce documentation to evidence their analysis.

238. A taxpayer that has prepared little or no documentation to show that its transfer pricing with associated entities reflects arms length dealings will be in a poor position to discharge the onus of proof that an amended assessment raised by the Commissioner General under Division 15 is excessive.

Advance Pricing Arrangements (APA's)

239. APA's are described in detail in the OECD Guidelines (See Paragraph 4.123 to 4.138). In brief, an APA program aims to give taxpayers the opportunity to reach agreement with a Taxation Administration Office on the method of application of the arm's length principle to their international related party dealings on a prospective basis, thereby resolving any uncertainty about those dealings.

240. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (for example transfer pricing method, comparables and appropriate adjustments thereto and critical assumptions about future events) for the determination of the transfer pricing of those transactions over a fixed period of time.

241. An APA will generally apply for three to five years but may be longer, for example where the covered international related party dealings continue for a period in excess of five years. An APA process can be conducted unilaterally, bilaterally or multilaterally.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

242. The Commissioner General supports having an APA program operating in PNG and will be issuing guidelines shortly of the type of APA program proposed for PNG and the circumstances in which taxpayers may be eligible for this arrangement.

Intangible Property

243. Chapter VI of the OECD Guidelines deals specifically with intangible property. The Commissioner General considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with associated entities involving intangible property. Where appropriate, the Commissioner General will publish future guidance on this issue.

Intra-Group Services

244. Chapter VII of the OECD Guidelines deals specifically with intra-group services. The Commissioner General considers the guidance provided in this chapter relevant and recommends that taxpayers follow the guidance in establishing the arm's length conditions in international agreements with associated entities involving intra-group services.

245. However in regard to intra-group services in the nature of management fees there is currently a statutory limit on deduction under the domestic law provisions of the Act. The limits on deduction for management fee payments under the general provisions in section 68AD is the greater of either 2% of assessable income or 2% of allowable deductions and under section 155M for mining entities 2% of operating expenditures.

246. Under PS 01/2005 the IRC has stated that where the offshore associate in receipt of the management fees is a resident for tax purposes of a country with which PNG has a double tax agreement it will not automatically impose the limits on deduction. The reason for this is that under the Business Profits and Associated Enterprises Article as a general rule, inter-group service charges will generally be deductible for tax if calculated in accordance with the arm's length principle.

247. In these cases, taxpayers under PS 01/2005 are required, before the end of the year in which expenditures are claimed, to seek formal approval from the IRC of the particular management fee structure, provide the identity and location of the entity to which they are paid and the reasons the payments legitimately reflect an arm's length amount.

248. The Commissioner General has decided that as the publication of this Circular now formalises the arm's length principle and associated record keeping requirements regarding all intra-group services, there is no need for separate guidelines to exist in the case of management fees that may exceed the statutory limits on deductions under either sec 68AD or sec 155M. Therefore, there is no longer a requirement for annual management fee approvals prior to the lodgement of an Income Tax Return and PS 01/2005 is withdrawn with effect from 1 January 2012. However, documentation to support management fees in excess of the statutory limits as being at arm's length must now be enclosed with the Income Tax Return at the time of lodgment. In all other respects, payments for services including management fees will be subject to the standard risk assessment and audit processes as set out in paragraphs 231 to 234 of this Circular.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Cost Contribution Arrangements

249. Chapter VIII of the OECD Guidelines deals specifically with cost contribution arrangements. The Commissioner General considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arms length conditions in international agreements with associated entities involving cost contribution arrangements. Where appropriate, the Commissioner General will publish future guidance on this issue.

Business Restructures

250. Chapter IX of the OECD Guidelines deals specifically with Business Restructures. The Commissioner General considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arms length conditions in international agreements with associated entities involving business restructures. Where appropriate, the Commissioner General will publish future guidance on this issue

Effective Date

251. This Circular sets out the current practice of the Internal Revenue Commission and is generally not concerned with a change in interpretation. It applies to years commencing both before and after its date of issue.

Conclusion

252. Taxpayers should make conscientious efforts to establish transfer prices that comply with the arm's length principle and prepare documentation to evidence that compliance.

253. Where such steps have been taken the Commissioner General is likely to determine at an early time that the taxpayers' transfer pricing practices represent a lower tax risk and that the possibility of an in depth review of those practices is likely to be diminished accordingly. In contrast, taxpayers who give inadequate consideration to their transfer pricing practices are likely to receive greater scrutiny from the Commissioner General.

Authorised by

Commissioner General of Internal Revenue Commission

21 December 2011

References

Division 15 of the Income Tax Act 1959 (as amended)

OECD Transfer Pricing Guidelines for Multinational enterprises and Tax Administrators, July 2010, OECD ('the 2010 OECD Guidelines').

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Introduction

1. A taxpayer's main aim in determining and documenting its transfer prices should be to convince the Commissioner General that its transfer prices are arm's length. A functional analysis can serve two important purposes in this regard:
2. Firstly, the functional analysis should provide a quick overview of the organisation for those evaluating the transfer pricing policy of the MNE, to assist them in familiarising themselves with the general operations of the MNE. Secondly, the functional analysis should seek to identify the functions performed by each member of the MNE and assess the importance of each function to the overall operations of the MNE.
3. A comprehensive functional analysis is considered an important part of documentary evidence for an MNE to support its claims of achieving arm's length outcomes.

Outline of the MNE's Operations

4. The overview of the MNE will outline the overall structure and nature of the business undertaken by a MNE. Some internal documentation, such as organisational charts, may be useful in this regard.
5. General commercial and industry conditions affecting the MNE may also be relevant. Such conditions could include information such as:
 - a) an explanation of the current business environment and its forecasted changes; and
 - b) how forecasted incidents influence the MNE's industry, market scale, competitive
 - c) conditions, regulatory framework, technological progress and foreign exchange market.
6. The MNE itself is not necessarily the only source of such information. Trade associations, for example, may publish trade journals or other documents, or may have conducted studies of the market, or have access to industry experts, which may provide valuable information. Competitors and academics may also provide useful information for describing the environment in which the MNE operates.

Characterisation of the Transaction

7. The next step in the process would be to provide some more direct consideration to the transaction under review. Relevant information here could include:
 - a) the nature and terms of the transaction;
 - b) economic conditions and property involved in the transaction;
 - c) the flow among the related parties of the product or service that is the subject of the controlled transaction in question; and
 - d) information that might indicate whether independent firms dealing at arm's length under comparable circumstances would have entered into a similarly structured transaction.

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

Contractual Terms

8. The actual contractual terms of the transaction will also be relevant. The explicit contractual terms of a transaction involving members of a MNE may provide evidence about the form in which the responsibilities, risks and benefits have been assigned among those members.

9. For example, the contractual terms might include:

- a) the form of consideration charged or paid;
- b) sales or purchase volume;
- c) the scope and terms of warranties provided;
- d) rights to updates, revisions or modifications;
- e) the duration of relevant licences, contracts or other agreements, as well as termination or renegotiation rights;
- f) collateral transactions or ongoing business relationships between the buyer and the seller (including arrangements for the provision of ancillary or subsidiary services);
- g) credit and payment terms; and
- h) any other key element of the contract that allocates risk.

10. The contractual terms will be relevant in determining the comparability of a controlled and uncontrolled transaction. Any material differences between the contractual terms of the transactions being examined would need to be reflected in the outcomes of the comparable dealings in arriving at an arm's length price.

11. However, there may be a limit to the usefulness of the contractual terms. In dealings at arm's length, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract. The contractual terms will be ignored or modified after the fact, generally only if it is in the interests of both parties.

12. The same divergence of interests may not exist for related parties. It may, therefore, be necessary to evaluate whether or not the conduct of the parties conforms to the terms of the contract. In some cases the conduct of the parties may imply that the contractual terms are a sham, or that they have been amended or superseded by a subsequent oral agreement.

13. Thus, even if members of a MNE enter into explicit contractual arrangements with each other, they should still examine the actual functions performed by each member as part of their transfer pricing analyses. This requires an identification of the critical functions in the MNE's operations, as well as a determination of which member (or members) is responsible for performing that function.

Examples of Relevant Functions

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

- a) research and development;

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

- b) product design and engineering;
- c) manufacturing, production and process engineering;
- d) product construction, extraction, and assembly;
- e) purchasing and materials management;
- f) marketing and distribution (for example selling, inventory management, warranty administration and advertising);
- g) transport and warehousing;
- h) managerial, legal, accounting and finance, credit and collection, training and personnel management services.

15. Even so, dividing functions performed by a MNE into such broad category descriptions will, generally, not be sufficient. Activities within these categories may be divided between members of the MNE. It is, therefore, also necessary to take into account more specific functions performed within these general categories.

16. The sheer weight of functions performed by a particular member of a MNE is not decisive in determining whether that member should derive the greater share of the profit. It is the relative importance of each function that is relevant. The functions performed by a member of a MNE may be relatively few in comparison with those performed by the other members, but if they are the most significant functions in the MNE's operations that member should be entitled to the major share of the profit.

Assets Employed

17. In identifying and comparing the functions performed it is, therefore, also relevant and useful to consider the assets that are employed or to be employed. This analysis should consider the type of assets used (whether they are plant and equipment, or valuable intangibles). The analysis should also consider the nature of the assets used (such as their age, market value, location and property right protections which are available).

18. When intangibles are identified, it is necessary to clearly establish their ownership, nature, and levels of contribution (if any) before attempting to attribute to them any value or to take them into account in applying a transfer pricing method. Intangibles with different strengths will need to be rewarded differently. For example, a patented production process may be useful, but it may be fairly simple to design around the patented aspects in order to achieve a similar outcome. This type of intangible should not generally receive the same level of relative reward as a breakthrough patent that uniquely reduces production costs and improves the product so that there is greatly improved customer demand.

19. A functional analysis can assist in identifying the intangibles and the way in which they are used. While judgment will still be needed to determine an appropriate reward for their use, a better decision is likely to be made once the nature of the intangibles and their role in the profit-earning process are properly understood.

20. For example, an enterprise may be the legal owner of a trademark and the name that it legally protects. It may attribute to these trademarks a high value for which it seeks a direct reward. Under licence, subsidiary enterprises in different countries may separately produce, market and support goods bearing this name and trademark. A functional analysis should identify each party's contribution to any manufacturing intangible or marketing intangible. If the economic contribution to the

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

intangible is shared between the parties, but only one party enjoys legal ownership of the intangible, the other party would, at arm's length, be expected to seek some form of reward for its contribution. This would need to be taken into account in determining the arm's length price, and could influence the selection of a transfer pricing method or the manner by which comparability is assessed against uncontrolled licence agreements.

Treatment of Risk

21. A significant portion of the rate of return earned by a company reflects the fact that the company is bearing risks of various kinds. In the open market, this assumption of increased risk will be compensated by an increase in the potential expected return (although this does not mean that the actual return must necessarily also be higher, because this will depend on the degree to which the risks borne are actually converted into realised profits).

22. An appraisal of risk is also important in determining arm's length prices. For example, controlled and uncontrolled transactions will not be comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made.

23. The possible risks assumed that should be taken into account in the functional analysis include:

- a) risks of change in cost, price, or stock;
- b) risks relating to success or failure of research and development;
- c) financial risks, including change in the foreign exchange and interest rates;
- d) risks of lending and payment terms;
- e) risks for manufacturing liability; and
- f) business risk related to ownership of assets or facilities.

24. The functions carried out will, to some extent, determine the allocation of risks between the parties and, therefore, the conditions each party would expect in arm's length dealings. For example, a distributor taking on the responsibility for marketing and advertising is risking its own resources in these activities. It would, therefore, be expected to have a commensurately higher anticipated return from the activity than if it did not undertake these functions. This is in contrast to a distributor acting merely as an agent and who is reimbursed for its costs and receives the income appropriate to that lower risk activity.

25. Similarly, a contract manufacturer or a contract research provider that takes on no meaningful risk would be entitled to a smaller return than if it had assumed the risk.

Consistency of risk allocation with economic substance:

26. It must also be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. A manufacturer may, for example, sell property to a related distributor in another country and claim that the distributor assumes all of the exchange rate risk. However, if the transfer price appears to be adjusted to insulate the distributor from the effects

Taxation Circular No 02 of 2011

Annexure A - Characteristics of a Functional Analysis

of exchange rate movements, the purported allocation of exchange rate risk may be challenged on the basis that it is inconsistent with the conduct of the parties.

27. An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes commercial sense for parties to be allocated a greater share of those risks over which they have relatively more control, and from which they can insulate themselves more cheaply than the other party can.

28. There are many risks, such as general business cycle risks, over which normally neither party has significant control. At arm's length, these risks could be allocated to either party to a transaction. Analysis is required to determine to what extent each party bears such risks in practice.

29. For example, when considering who bears any currency exchange or interest rate risk, it will be relevant to consider the extent to which the taxpayer or the MNE has a business strategy that deals with the management of such risks. Financial arrangements such as hedges, forward contracts, as well as put and call options, both "on-market" and "off-market", are now in common use. Where, as a result of the MNE's business strategy, the taxpayer bearing the currency and interest rate risk fails to address such exposure, it will be evident that the taxpayer is not actually bearing the economic currency and interest rate risk. Such a practice, if not accounted for appropriately, could lead to significant profits or losses being made which are capable of being inappropriately sourced in the most advantageous place to the MNE.

Concluding Comments

30. The preparation of a functional analysis is an important tool that can assist in ensuring that an arm's length consideration is determined in accordance with internationally accepted principles. The analysis can be performed with varying levels of detail and can serve a variety of purposes. The scope of the analysis will be determined by the nature, value and complexity of the matters covered by international dealings and the nature of the taxpayer's business activities. These include the strategies that the enterprise pursues and the features of its products or services. Also, factors such as the pricing method that is used and availability of data will affect the extent to which the analysis can be conducted.

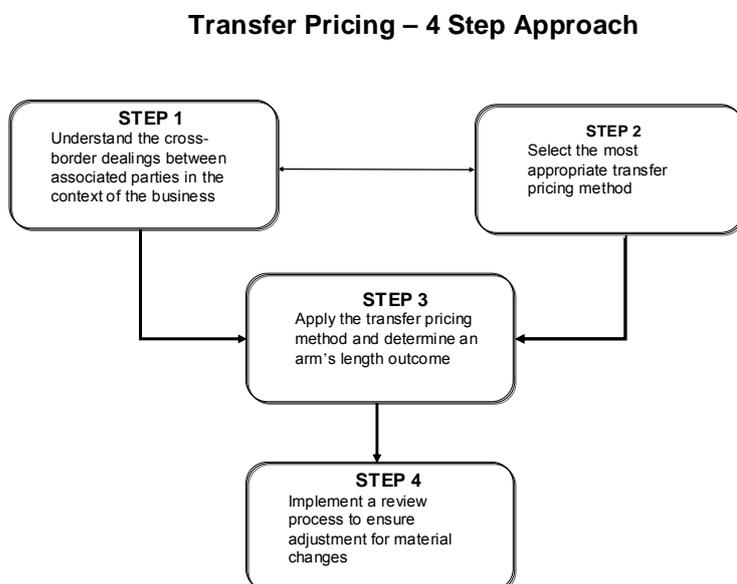
31. By determining the relevant functions to be priced, the functional analysis can assist in the selection of a transfer pricing method. It can also assist in the analysis of the level of comparability present in controlled and uncontrolled dealings and in an assessment of the relative contribution of the parties when a profit-split method is used.

32. It is important, however, not to confuse the use of functional analysis with the determination of a transfer price. Functional analysis is not an alternative to searching for comparables. It is a means to establish what sort of comparables should be sought.

33. **Annexure B** sets out a four-step practical approach for determining transfer prices. The discussion in that annexure further considers functional analysis in a practical context.

Annexure B - The Four Step Approach

1. The four step approach to Transfer Pricing is summarised in the diagram set out below.



In suggesting these four steps, we make the following points:

1 The four steps and the data collection and analysis discussed are neither mandatory nor prescriptive and, importantly, may need to be tailored to the facts of your case.

2 The approach outlined below assumes that your international dealings are fairly extensive and necessitate a thorough analysis. For many small businesses that have relatively simple and/or low-value international dealings with related parties, the extent of data collection and analysis may be minimal.

3 Properly applying the four steps to the facts and circumstances of your case should normally be sufficient to establish the arm's length consideration.

4 The information needed in the process may be within the knowledge of a limited number of key personnel not confined to the tax or accounting areas of your business. Much of it may already be recorded in a variety of documents you have prepared in the ordinary course of business (for example, marketing reports and analyses). If so, you can simplify the task by collating and indexing existing material rather than doing further research and creating additional documentation.

In assessing compliance with the arm's length principle, you need to exercise commercial judgment about the nature and extent of documentation appropriate to your particular circumstances. Both the Internal Revenue Commission and the OECD have stated that businesses should not be expected to prepare or obtain documents beyond the minimum needed to reasonably assess whether their dealings with related parties comply with the arm's

STEP 1:

Accurately characterise the international dealings between the related parties in the context of your business and document that characterisation

Data collection/organisation

Identify the scope, type, value and timing of the international dealings with related parties in the context of your business. This *may* require understanding the context of the dealings, including:

- organisation, decision processes and systems, and incentive structures
- the conditions affecting the industry, the nature of the competition experienced, economic and regulatory factors
- the business objectives, strategies adopted and financial performance
- the intellectual assets used, their contribution, ownership and reward, and
- the economically important activities undertaken by each of the related parties, resources used and risks assumed by each.

Action/evaluation

Identify the specific elements of the international dealings that are to be considered.

- Prepare a preliminary functional analysis.
- Explain the conditions affecting the industry and the business strategies available to you as these affect the functional analysis. A critical part of the analysis is to ascertain which are the most economically important functions, assets and risks and how these might be reflected by a comparable price, margin or profit on the dealings.
- Determine if intangibles have been appropriately rewarded in light of contribution and ownership.
- Document the processes adopted.

Within step 1 the most important aspects are:

- identifying the scope, type, value and timing of international dealings with related parties in the context of your business, and
- preparing the preliminary functional analysis, a critical part of which is to ascertain the most economically important functions, assets and risks and how these might be reflected by a comparable price, margin or profit on the dealings.

Taken together, these points should enable you to accurately characterise your international dealings with related parties. This information is important because it enables you to select reliable comparables that truly reflect these dealings.

STEP 2:

Select the most appropriate transfer pricing methodology or methodologies and document the choice

Data collection/organisation

- Identify the available data that may establish an arm's length consideration for each of the dealings and for the dealings taken in their entirety

Action/evaluation

- Determine the most appropriate methodologies based on the facts and circumstances of your particular case.

- Document your choice of methodologies.

Select the most appropriate method

There are various internationally accepted methods for determining an appropriate arm's length consideration. We aim to adopt the method that is the most appropriate or best suited to the circumstances of each particular case. Your choice of the most appropriate transfer pricing method or methods should be based on a practical weighing of the evidence having regard to:

- the nature of the activities being examined
- the availability, coverage and reliability of the data
- the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings, including all the circumstances in which the dealings took place, and
- the nature and extent of any assumptions.

The method you choose must be able to be applied in practice and must produce an arm's length result that is a reasonable estimate of what would have resulted if the dealings had been undertaken on an arm's length basis.

Simply establishing the market terms and conditions may not be sufficient. When dealing at arm's length, parties generally have the option not to proceed with the dealings if the market prices do not satisfy their profit expectations or business strategies. For example, if the prevailing market prices lead to unsatisfactory profit levels, then dealings may ultimately not be concluded or may be conducted differently or on different terms.

STEP 3:

Apply the most appropriate method, determine the arm's length outcome and document the process

Data collection/organisation

■ Refine, examine and organise the data on comparable dealings or comparable enterprises so that you can properly assess comparability.

To improve comparability you may have to:

- adjust the data to account for material differences in comparability
- group or aggregate data
- extend the analysis over a number of years.
- data points or a range of results may appear.

Action/evaluation

- If necessary, broaden and refine the preliminary functional analysis.
- Prepare a comparability analysis.
- Establish what level of reliability you can place in the answers derived from applying the selected method and the conclusions drawn.
- You may have to apply several methods.
- Decide on the arm's length outcome.

Document practical considerations such as:

- your assumptions and judgments

Annexure B - The Four Step Approach

- how you interpreted data points or ranges, and
- how you used results from different methods.

The aim of step 3 is to apply the methodology you selected in step 2 to determine the arm's length outcome. You may have to refine, examine and organise the data on comparable dealings or enterprises to be able to properly assess comparability.

STEP 4:

Implement support processes, including a review process to ensure adjustment for material changes, and document the processes

Data collection/organisation

- Monitor international dealings and their economic context to identify any material changes as they occur.
- Collect data relevant to evaluating the impact of these changes on the arm's length consideration.

Action/evaluation

- If the data used to establish the outcome changes, you should review the process and your choice of methodology.
- Set up a system to support ongoing application of the chosen method in future years.
- Establish a review mechanism to ensure that if material changes occur, you adjust the comparability analysis or methodology as appropriate.

The fourth step involves monitoring your process for setting arm's length transfer pricing. We highly recommend that you document the steps you have taken to monitor the continuing relevance of the process.

Taxation Circular No 02 of 2011

Annexure C – Legislation and Treaty Extracts

The following extracts from PNG legislation and treaties are current as at the time of publication of this Circular.

Division 15. (Main Operating Provisions)

Agreements and Determination of Source of Certain Income.

197A. INTERPRETATION.

(1) In this Division, unless the contrary intention appears–

“acquire” includes–

- (a) acquire by way of purchase, exchange, lease, hire or hire-purchase; and
- (b) obtain, gain or receive;

“agreement” means 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;

“derive” includes gain or produce;

“expenditure” includes loss or outgoing;

“income” includes any amount that is, or may be, included in assessable income or taken into account in calculating an amount that is, or may be, included in assessable income;

“permanent establishment”, in relation to a taxpayer, means–

- (a) a place that is a permanent establishment of the taxpayer by virtue of the definition “permanent establishment” in Section 4; or
- (b) a place at which any property of the taxpayer is manufactured or processed for the taxpayer, whether by the taxpayer or another person;

“property” includes–

- (a) a chose in action; and
- (b) any estate, interest, right or power, whether at law or in equity, in or over property; and
- (c) any right to receive income; and
- (d) services;

“right to receive income” means a right of a person to have income that will or may be derived (whether from property or otherwise) paid to, applied or accumulated for the benefit of, the person;

“services” includes 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–

Taxation Circular No 02 of 2011

Annexure C – Legislation and Treaty Extracts

(i) the performance of work (including work of a professional nature);
or

(ii) the provision of, or the use or enjoyment of facilities for amusement, entertainment, recreation or instruction; or

(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; or
(c) an agreement between a banker and a customer of the bank entered into in the course of the carrying on by the banker of any business of banking; or
(d) an agreement for or in relation to the lending of moneys;

“supply” includes—

- (a) supply by way of sale, exchange, lease, hire or hire-purchase; and
(b) provide, grant or confer;

“taxpayer” includes a partnership and a taxpayer in the capacity of a trustee.

(2) The definition of “taxpayer” in Subsection (1) shall not be taken to affect in any way the interpretation of that expression where it is used in this Act other than this Division.

(3) In this Division, unless the contrary intention appears—

- (a) a reference to the supply or acquisition of property includes a reference to agreeing to supply or acquire property; and
(b) a reference to consideration includes a reference to property supplied or acquired as consideration and a reference to the amount of any such consideration is a reference to the value of the property; and
(c) a reference to the arm’s length consideration in respect of the supply of property is a reference to the consideration in respect of the supply if the property had been supplied under an agreement between independent parties dealing at arm’s length with each other in relation to the supply; and
(d) a reference to the arm’s length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm’s length with each other in relation to the acquisition; and
(e) a reference to the supply or acquisition of property under an agreement includes a reference to the supply or acquisition of property in connection with an agreement.

197B. OPERATION OF DIVISION.

(1) Nothing in the provisions of this Act other than this Division shall be taken to limit the operation of this Division.

Taxation Circular No 02 of 2011

Annexure C – Legislation and Treaty Extracts

(2) In the application of this Division, the operation of Section 53A shall be disregarded.

197C. INTERNATIONAL AGREEMENTS.

For the purposes of this Division, an agreement is 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 Papua New Guinea by the non-resident at or through a permanent establishment of the non-resident in Papua New Guinea; or

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

197D. ARM'S LENGTH CONSIDERATION DEEMED TO BE RECEIVED OR GIVEN.

(1) Where–

(a) a taxpayer has supplied property under an international agreement; and

(b) the Commissioner General, having regard to any connection between any two or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any two or more of those parties, were not dealing at arm's length with each other in relation to the supply; and

(c) consideration was received or receivable by the taxpayer in respect of the supply but the amount of that consideration was less than arm's length consideration in respect of the supply; and

(d) the Commissioner General determines that this subsection should apply in relation to the taxpayer in relation to the supply,

then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm's length consideration in respect of the supply shall be deemed to be the consideration received or receivable by the taxpayer in respect of the supply.

(2) Where–

(a) a taxpayer has supplied property under an international agreement; and

(b) the Commissioner General, having regard to any connection between any two or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any two or more of those parties, were not dealing at arm's length with each other in relation to supply; and

(c) no consideration was received or receivable by the taxpayer in respect of the supply; and

Taxation Circular No 02 of 2011

Annexure C – Legislation and Treaty Extracts

(d) the Commissioner General determines that this subsection should apply in relation to the taxpayer in relation to the supply,

then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm's length consideration in respect of the supply shall be deemed to have been received and receivable by the taxpayer in respect of the supply at the time when the property was supplied or, as the case requires, any of the property was first supplied, or at such later time or times as the Commissioner General considers appropriate.

(3) Where–

(a) a taxpayer has acquired property under an international agreement; and

(b) the Commissioner General, having regard to any connection between any two or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any two or more of those parties, were not dealing at arm's length with each other in relation to the acquisition; and

(c) the taxpayer gave or agreed to give consideration in respect of the acquisition and the amount of that consideration exceeded the arm's length consideration in respect of the acquisition; and

(d) the Commissioner General determines that this subsection should apply in relation to the taxpayer in relation to the acquisition.

then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm's length consideration in respect of the acquisition shall be deemed to be the consideration given or agreed to be given by the taxpayer in respect of the acquisition.

(4) For the purposes of this section, where, for any reason (including an insufficiency of information available to the Commissioner General), it is not possible or not practicable for the Commissioner General to ascertain the arm's length consideration in respect of the supply or acquisition of property, the arm's length consideration in respect of the supply or acquisition shall be deemed to be such amount as the Commissioner General determines.

Taxation Circular No 02 of 2011

Annexure C – Legislation and Treaty Extracts

Extract from Agreement between Australia and The Independent State of Papua New Guinea For The Avoidance of Double Taxation and the Prevention of fiscal Evasion with respect to Taxes on Income.

ARTICLE 9

Associated Enterprises

1. Where:

- (a) an enterprise of one of the [Contracting States](#) participates directly or indirectly in the management, control or capital of an enterprise of the other [Contracting State](#); or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the [Contracting States](#) and an enterprise of the other [Contracting State](#),

and in either case conditions operate between the two enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another, 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 and taxed accordingly.

2. Nothing in this Article shall affect the application of any law of a [Contracting State](#) relating to the determination of the tax liability of a person, including determinations in cases where the information available to the competent authority of that State is inadequate to determine the [income](#) to be attributed to an enterprise, provided that that law shall be applied, so far as it is practicable to do so, consistently with the principles of this Article.

3. Where profits on which an enterprise of one of the [Contracting States](#) has been charged to tax in that State are also included, by virtue of paragraph 1 or 2, in the profits of an enterprise of the other [Contracting State](#) and charged to tax in that other State, and the profits so included are profits which might have been expected to have accrued to that enterprise of the other State if the conditions operative between the enterprises had been those which might have been expected to have operated between independent enterprises dealing wholly independently with one another, then the first-mentioned State shall make an appropriate adjustment to the amount of tax charged on those profits in the first-mentioned State. In determining such an adjustment, due regard shall be had to the other provisions of this [Agreement](#) and for this purpose the competent authorities of the [Contracting States](#) shall if necessary consult each other.