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Tax Seminar:

Transfer Pricing – A Customs Perspective

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Presentation Outline

- Background
- TP and Customs Valuation – Worldwide Developments
- Customs vs TP
- OECD framework & customs valuation
- Dealing with customs Valuation and TP
- Managing Customs – TP Challenges
- Emerging issues in TP
- Q & A

Background

Background – What is TP

- Transfer Pricing is a mechanism for the pricing of goods and services between related entities:
  - Tangible Goods;
  - Intangible Goods – trademarks, trade-names, patents; and
  - Services – management, engineering, after-sales services

Background – The TP Mechanism

- Mechanism to provide the conceptual framework for *pricing intercompany transactions*

- Ensuring an appropriate allocation of income between the various tax jurisdictions in which a multinational company operates

Background – TP is Jurisdictional

- Transfer pricing for tax purposes is **governed by local jurisdictional authorities**
- More than 80 countries have issued **formal rules** regulating transfer pricing practices
- Accompanied by **documentation requirements** and **penalty provisions** for non-compliance.

Background – What is Customs

- Article VII of GATT- Rules on Customs Valuation

- Customs value of imported goods shall be the transaction value (provided the buyer and seller are not related)

- Customs duty is determined by; product classification, rules of origin and customs value

Background – Similarities

- Multinational enterprises need to comply with both:
  - Transfer pricing rules; and
  - Customs valuation rules

- Similarities
  - Both customs and TP rules are designed to reach arm's-length values

Background – Differences

- **Differences:**
  - **Rules are set by two organizations with different objectives:**
    - ✓ **Customs: the World Trade Organization (WTO) and World Customs Organization (WCO)**
    - ✓ **Transfer pricing: Organization for Economic Co-operation and Development (OECD)**

Background – The Challenge

- For cross border related-party transactions, taxpayers must:
  - Efficiently determine intercompany prices; and
  - Consider different and distinct guidelines, principles, and objectives of customs and income tax

Customs vs. TP

Differences	Customs	Income Tax (TP)
Different Objectives	Maximize COGS/Import value	Minimize COGS/Import value
Different Law	WTO/WCO or EACCMA	OECD or Section 18(3) ITA
Different Focus	Per unit price of imported goods	Aggregate income of importer
Different Time Periods	Entry-by-entry declarations	Annual period

Customs vs. TP…cont'd

Differences	Customs	Income Tax (TP)
Different Comparable Sets	Product/Industry Comparability	Functional Comparability
Different Methods	Circumstances of sale Test/Test Values	TP Methods as per TP Rules
Different Measures if not Arm's Length	Rejection of transaction value/invoice price	Adjustment of transfer price/invoice price

TP and Customs Valuation – Worldwide Developments

Canada – Duty Refund

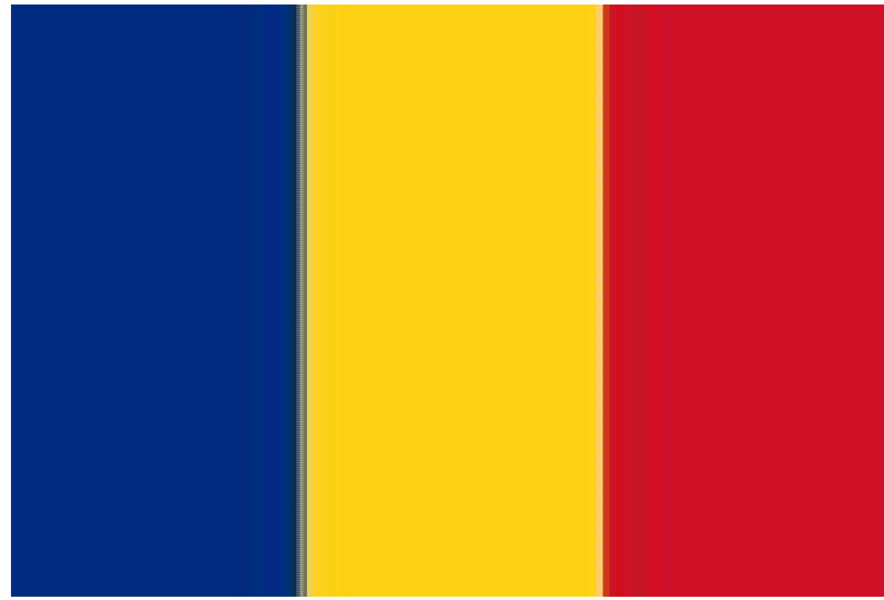
- **Canada** - new case law the potential for a duty refund where the transfer pricing adjustment results in a decreased customs value

Chile – Agreement on Prices

- **Chile** - recently enacted legislation that would allow the customs and income tax authorities to agree on the same price for corporate tax and customs purposes

Romania – Penalties

- **Romania** - implemented new legislation restructuring penalties applicable to transfer pricing adjustments that result in increased customs values



Vietnam – Penalties on Custom Values

- **Vietnam** - revised its penalty structure related to customs value adjustments when transfer pricing adjustments are made

Europe – Guidelines on TP & Customs

- France, Italy, and the Eurasian Economic Commission (the regulatory body of the customs union of Belarus, Kazakhstan, and Russia) have either newly issued or are expected to issue publicly available guidance on the treatment of related party transfer (customs) prices and transfer pricing adjustments

The OECD Framework and Customs

Establishment of TP

- Several institutions particularly focused on getting transfer pricing regimes established in Africa:
  - The United Nations (UN);
  - The Organisation for Economic Cooperation and Development (OECD);
  - The European Commission (EC); and
  - African Governments

Implementation of the ALP

- **Most appropriate transfer pricing regime for implementation of the arm's length principle (ALP):**
  - **OECD Guidelines – resource-intensive and costly for developing countries**
  - **UN Practical Manual on Transfer Pricing for Developing Countries (UN Practical Manual)**
  - **Local legislation and regulations**

Income Tax Act - ITA

- **Section 18(3) of the ITA - ALP**
  - **Commissioner empowered to adjust the profits for related party transactions**
- **Section 18(6) of the ITA – Related party**
  - **Company's direct or indirect participation in the management, control or capital**
  - **Third party's direct or indirect participation in both companies**

Customs and Related Party Transactions

- Where **buyer and seller are related** - transaction value is accepted provided that the **relationship does not influence the price**

- Importer demonstrates that transaction value closely approximates the following:

  - Transaction value in sales to unrelated buyers of identical goods for export to the same country of importation

Customs and Related Party Transactions

- Customs Authority examine the **circumstances surrounding the sale** and the transaction value shall be accepted provided that the relationship does not influence the price

- **Examination** only occurs where there are **doubts** about the acceptability of the price

Dealing with Customs Valuation & TP

Case Study 1 (Comparable Companies)

❖ Basic Facts

- Import of tangible goods
- Transfer pricing uses TNMM using the manufacturer as the tested party based on functional comparable
- Upon audit for customs, customs authority rejects comparable used by the taxpayer as they are in the wrong industry

Case Study 1 (Comparable Companies)

❖ Approach

- No true conceptual issues
- Revisit criteria used to select comparable to reflect customs as well as transfer pricing considerations

Case Study 2 (Transactional Approach)

- **Basic Facts**

- **Manufacturer has more than enough profits overall to satisfy custom's expectations**

- **Cannot show that the pricing of individual transactions complies with customs rules**

Case Study 2 (Transactional Approach)

❖ Approach

- Need to show that each transaction is arm's length

- Focus on how prices are set

- If after-the-fact adjustments, need to determine how they apply to each transaction

Case Study 3 (Changes in Prices)

❖ Basic Facts

- The overall profits earned by the manufacturer are sufficient for both customs and transfer pricing purposes

- The prices for some products fail to cover all of the seller's costs while the prices on other products generate high profits

Case Study 3 (Changes in Prices)

- **Approach**
  - **Floor price**
  - **Offsetting reductions in the price of higher profit products**

Case Study 4 (True-up)

❖ Basic Facts

- ➢ Taxpayer makes an adjustment on the tax return
- ➢ Customs officials:
  - ✓ Typically insist that an upward adjustment must be reflected in higher import prices
  - ✓ Typically refuse to give credit for lower prices for a downward adjustment to dutiable value
  - ✓ May assert penalties even if this change has no impact upon duties

Case Study 4 (True-up)

❖ Approach

- Consider focusing on how prices are set and monitored
- Link adjustments to formulas dependent upon uncontrollable external factors
- Ensure that proper procedures are followed

Case Study 5 (Benchmark Manufacturer)

Basic Facts

- The transfer pricing study benchmarks intercompany buyer
- The manufacturer/seller earns an adequate profit
- Customs rejects the transfer pricing study because it tests the profits of the distributor

Case Study 5 (Benchmark Manufacturer)

- **Approach**
  - Consider a supplemental analysis of manufacturer's profits

Case Study 6 (Dealing with Overall Losses)

Basic Facts

- Manufacturer and the distributor or even an overall system loss in the transactions
- Transfer pricing places distributor at a profit
- Customs insists that the manufacturer must earn a minimum profit

Case Study 6 (Dealing with Overall Losses)

- **Approach**
  - Decide which is more important/more flexible: customs or transfer pricing
  - Prepare for a difficult audit
  - Consider dispute resolution options

Managing Customs – TP Challenges

TP Issues with Customs Concerns

- **Distribution profits** above the inter-quartile ranges in the country of importation
- **Comparables** not in the same product line or operating in the same country of exportation
- **Retro-active pricing adjustments** and other related compensating adjustments
- **Off Invoice/off-transfer price** payments to the foreign seller (i.e., licensing, royalty, marketing, research and development, and other services related payments)

Managing the Customs – TP Challenge

- **Planning**
  - Proactively combine customs and tax planning & analysis from the beginning of a study
  - Take advantage of customs advance ruling processes where available
  - Utilize customs reconciliation and value adjustment programs for ongoing price adjustments where available
  - Exploit customs appraisement hierarchy in arm's-length test scenarios

Managing TP and Customs Valuation

Customs	Income Tax (TP)
Customs ruling	Advance Pricing Arrangement (APA)
Customs valuation review	Transfer pricing risk assessment review
Customs reconciliation process	Transfer pricing adjustment process
Internal controls and risk management	Transfer pricing documentation
Product/Industry Comparability	Functional Comparability

Proactive TP and Customs Process

- Combine tax and customs planning from the earliest possible opportunity
- Utilize pre-approval processes
- Centralize procurement policies and internal controls
- Implement robust document tracking and customs entry reconciliation processes
- Introduce ongoing policies, procedures and internal controls
- Monitor inter-company transaction flow and profitability

Conclusion

- In many jurisdictions, taxpayers are required to maintain documented evidence that their inter-company prices meet both the customs and tax arm's-length standards
- Taxpayers without an integrated proactive approach may be challenged to consistently demonstrate that they meet both standards
- KPMG has developed an integrated approach and methodologies to assist clients to address both sets of valuation requirements

Emerging TP issues

The Changing Landscape - Background

Transfer pricing is at the heart of the debate.

Context

- Governments under extreme fiscal pressure as a consequence of the global economic crisis
- As a consequence, there has been increased political focus on perceived tax avoidance by multinationals
- The G20 was concerned that current international tax rules and frameworks were/remain inadequate

The Changing Landscape - Background

Transfer pricing is at the heart of the debate.

Context

The OECD response to growing pressure was to release the Base Erosion and Profit Shifting report

The G20 was applying political support/pressure to push for change

There is a drive to develop a tax system that is fit for purpose for today's multinationals and digital age

Back ground for BEPS

- MNEs minimize tax burden leading to:
  - Government being harmed due to less revenue and higher cost to ensure compliance
  - Individual tax payers being harmed when others shift revenues outside their jurisdiction
  - Business being harmed through reputational risk where they do not comply; where local companies cannot compete; and where MNEs shift profits to low tax jurisdiction areas

These are the challenges paving way to BEPS

BEPS Broken Down

- BEPS relates to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation
- BEPS refers to the negative effect of multinational companies' tax avoidance strategies on national tax bases
- BEPS can be achieved through the use of transfer pricing, or, more correctly, "transfer mis-pricing"

BEPS – Where Are We Now?

1	Digital Economy	*Report on challenges complete Sept 2014; VAT discussion draft Dec 2014, final report Dec 2015*
2	Hybrid Mismatches	*Recommendations complete Sep 2014; guidance implementation Sep 2015*
3	CFCs	*Discussion draft April 2015; recommendations Sep 2015*
4	Interest deductions	*Discussion draft Dec 2014; recommendations Sep 2015, changes OECD guidelines Dec 2015*
5	Harmful tax practices	*Initial report complete Sept 2014; strategy for non-OECD members Sep 15 final criteria Dec 2015*
6	Treaty abuse	*First report complete Sep 2014; discussion draft Collective Investment Vehicles Nov 2014, final late 2015*
7	Definition of PE	*Discussion draft Oct 2014; changes OECD Model tax convention Dec 2015*
8	TP - Intangibles	*First report Transfer Pricing Guidelines intangibles complete Sep 2014; Final report Sep 2015*
9	TP - Risk & Capital	**Consolidated** *Low value-adding intra group services, commodity transactions and use of profit splits - discussion drafts Nov and Dec 2014; Discussion draft Cost Contribution agreements April 2015; all final Sep 2015*
10	TP - High Risk	
11	BEPS data	*Request for input Aug 2014, discussion draft April 2015, recommendations Sep 2015*
12	Mandatory Disclosure	*Discussion draft March 2015; public consultation May 2015, recommendations Sep 2015*
13	TP - Documentation	*Final template Sep 2014;Implementation guidance February 2015; implementation mechanism final April 2015*
14	Dispute Resolution	*Discussion draft Dec 2014, changes OECD Model Tax Convention Sep 2015*
15	Multilateral Instrument	*Feasibility report complete Sep 2014; draft mandate Jan 2015 with reports late 2015, with conference to follow*

2014 | 2015

We are here

New TP documentation requirements

- MNEs will be required to prepare and provide a three-tiered transfer pricing documentation:

Master file
- Objective: Risk assessment
- Approach: Provides an overall picture of business, the multinational group and its economic activity
- Major differences with current core documentation

Local file
- Objective: Focus on significant transactions
- Approach: Provides additional detail on the operations and transactions relevant to that jurisdiction
- Some differences with current local documentation

Country-by-Country Reports
- Objective: Prioritize audit issues
- Approach: Provides summary data by jurisdiction. A snapshot of the group tax structure
- New requirement altogether

- This information should make it easier for tax authorities to identify whether companies have engaged in practices that have the effect of artificially shifting substantial amount of income into tax-advantaged environments.

Country-by-country reporting

It is NEW	■ Separate from transfer pricing documentation and not previously required ■ Tax authorities will have right to obtain profit data in all countries where MNE operates ■ Recommended to be required for years starting on or after January 1, 2016, filing due one year after the end of the fiscal year
Beyond Transfer Pricing information	■ A lot of this information is not typically presented in existing transfer pricing reports ■ Will require concerted effort by MNEs to determine process, ownership, and technology to obtain information
Risk assessment tool	■ Intended to be used by OECD as a risk-assessment /audit planning tool ■ Used by tax administrations in evaluating other BEPS related risks and potentially economic and statistical analysis
Will affect many MNEs	■ U.S. and U.K. to adopt CbyC reporting. CbyC is expected to have early adoption in other countries - requiring any MNE with annual revenues of more than EUR 750 million and entities located where adopted to prepare regardless of headquarter location

Country-by-country reporting

Final template – Table 1

Table 1: Overview of allocation of income, taxes and business activities by tax jurisdiction										
Tax Jurisdiction	**Unrelated Party Revenue**	**Related Party Revenue**	**Total Revenue**	**Profit (loss) before income tax**	**Income tax paid (on a cash basis)**	**Income tax accrued – current year**	**Stated Capital**	**Accumulated Earnings**	**Number of employees**	**Tangible Assets other than Cash and Cash Equivalents**
Country A	✘	✘	✘	✘	✘	✘	✘	✘	✘	✘
Country B	✘	✘	✘	✘	✘	✘	✘	✘	✘	✘
Not resident in any tax jurisdiction	✘	✘	✘	✘	✘	✘	✘	✘	✘	✘

Note: (a) Translate to the functional currency of the Reporting MNE at average rate.

General guidelines

- Use same data source consistently year on year (e.g., consolidated reporting packages, separate entity statutory financial statements(a), etc.)
- Group GAAP versus Local GAAP – differences, practicalities
- No formal requirement for reconciliation, useful for internal audits
- Aggregated on a country basis
- Revenue includes sales, royalties, interest and any other income
- Employee numbers as FTEs, may include contractors
- No definition of income tax, include WHT
- Local currency converted into parent company's currency

Tax jurisdiction

- Reporting on a tax jurisdiction basis.
- **Self assess** tax residence – Tax treaty tie breakers, or principles of place of effective management.
- **Dual resident** entities – apply the tax treaty tie breaker, or if no treaty, report in the place of effective management.
- **Not resident anywhere** – report all such vehicles in a single line

Country-by-country reporting

Final template – Table 2

Table 2: List of all Constituent Entities of the MNE group included in each aggregation per tax jurisdiction															
			Activities												
Tax Jurisdiction	**Constituent entities resident in the tax jurisdiction**	**Tax jurisdiction of organisation or incorporation if different from tax jurisdiction of residence**	**Research and development**	**Holding or Managing intellectual property**	**Purchasing or procurement**	**Manufacturing or production**	**Sales, marketing or distribution**	**Administrative, management or support services**	**Provision of services to unrelated parties**	**Internal group finance**	**Regulated financial services**	**Insurance**	**Holding shares or other equity instruments**	**Dormant**	**Other**
Country A	Entity A	Country B		✓											
	Entity B				✓	✓			✓						✓
Country B	Entity C		✓							✓	✓	✓			
	PE 1						✓								

Scope

Reporting – ultimate parent of an MNE group.

Constituent Entity – any separate business unit of the MNE group:

i) Company; ii) Corporation; iii) Trust; iv) Partnership; etc.

Included in the consolidated group for financial reporting purposes.

Entities excluded from accounts due to **size/materiality** – include for CbyC report.

Permanent Establishments/Branches

Report separately if separate income statement prepared for:

- Regulatory;
- Financial reporting;
- Internal management; or
- Tax purposes.

Include in the country where they are situated

Exclude from the 'parent' country

Exceptions are accumulated earnings and stated capital. Report the former in the parent and the latter in the parent unless there is a defined capital requirement in the PE jurisdiction for regulatory purposes

Kenya and BEPS compliance

- ***Is Kenya compliant with BEPS guidelines issued by OECD?***
- **Kenya showing strong indication towards implementation of BEPS action plans**

- **In 2014, KRA officials attended OECD workshop on BEPS action plan implementation**
- **KRA have requested some taxpayers to provide CbC data as part of an audit even though *no change has been made to TP Rules – yet!***
- **BEPS action plan implementation may become a reality in Kenya in 2015.**

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Thank you

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Burning Questions

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