



ICPAK Seminar Transfer Pricing Workshop

Advance Pricing Arrangements

Presenter: Wilfred Alambo

5 July 2016



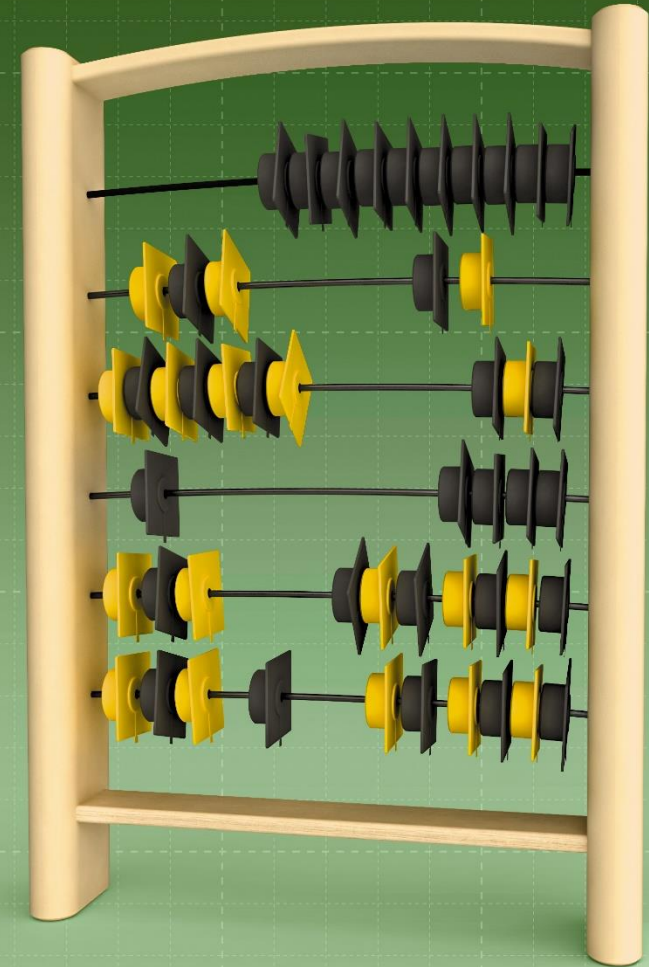
Table of contents

1. Introduction

2. Advance Pricing Arrangements (APAs)

3. Why APAs?

4. Q & A



Introduction



Scope of TP Rules - Kenya

- Transfer Pricing Rules, 2006 - Scope:
 - Transactions:-
 - Between **associated enterprises** where one enterprise is subjected to **tax in Kenya** and the other enterprise is **located outside Kenya**
 - Between a **Permanent Enterprise (Branch)** and its **head office** or other **related branches**;

Transactions Covered

- Transactions subject to TP Rules include transactions in relation to:
 - Tangible Goods;
 - Intangible Goods – trademarks, trade-names, patents; and
 - Services – management, engineering, after-sales services
- The TP mechanism provides the conceptual framework for pricing intercompany transactions in relation to the above
- Ensuring an appropriate allocation of income between the various tax jurisdictions in which a multinational company operates

Contextualising APAs - Jurisdiction

- Transfer pricing for tax purposes is governed by local jurisdictional authorities
- More than 50 countries have issued formal rules regulating transfer pricing practices
- Accompanied by documentation requirements and penalty provisions for non-compliance

A close-up photograph of two hands shaking in a firm grip, symbolizing a business agreement or partnership. The hands are wearing white dress shirts with dark pinstriped sleeves. The background is a clear, bright blue sky. A teal-colored rectangular box is overlaid on the left side of the image, containing the text 'Advance Pricing Arrangements' in white.

Advance Pricing Arrangements

Advance Pricing Arrangements - Introduction

- An APA is “an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria e.g:
 - Transfer Pricing (TP) method;
 - comparable and appropriate adjustments thereto; and
 - critical assumptions as to future events
- for the determination of the TP for those transactions over a fixed period of time.
- It is an advance agreement between a **taxpayer** and a **tax authority** in relation to the determination of the appropriate TP method to be used for pricing intercompany transactions

Advance Pricing Arrangements - Types

- **Deliver certainty** both to the taxpayer and tax authority on the tax outcome
- **Unilateral APAs** - agreed upon by a tax authority and a taxpayer within its tax jurisdiction
- **Bilateral APAs** - entered into through a mutual agreement between two tax authorities
- **Multilateral APAs** – agreed upon by a taxpayer and more than two tax authorities

Advance Pricing Arrangements - Development

- Japan and the United States championed the TP scene in the 1990s through establishing APA programs
- Different countries all around the world have adopted these to create an alternative to litigation on matters TP.
- If the TP process is left unbridled, the Multi-national enterprise (MNE) may attempt to use the uncertainty of the TP rules to their favour.
- On the other hand, the tax revenue authority may disregard the set prices and present a higher value of the transactions, leading to a dispute.

Advance Pricing Arrangements - Current

- APAs in some countries are binding contracts between the taxpayer and the tax revenue authority, while in others they are simply mutual understandings of administrative nature.
- The US has the most advanced APA system
- The KRA has indicated possibility of entering into APAs but without defining the kind of APAs that it intends to enter into
- APAs have been adopted by India, China, Mexico, Germany and the United Kingdom
- India and Mexico have adopted the OECD guidelines in the formulation of their APA

Why APAs?



Salient Features of an APA

- APAs may cover a variety of transactions but it is advisable to enter an APA for only the complex transactions owing to the high cost of negotiation and concluding the agreements
- However, since this is at the discretion of the taxpayer who submits the application for the APA, the resultant APA covers different areas from one taxpayer to another
- The transactions involved in APAs include dealings in goods and services, financing arrangements, and transfer and use of tangible/intangible assets
- Due to the cross border nature of TP, the APAs normally cover intercompany transactions across borders. However, in more developed jurisdictions, the APAs include certain domestic transactions between associated companies

Salient Features of an APA

- When the taxpayer makes the application and lists the transactions to form part of the APA, the tax revenue authority may amend this list to either include more transactions or limit the scope
- The application would normally have a description of all the intercompany transactions the taxpayer has in its operations. Out of all of them, the taxpayer notes the transactions it proposes to be covered in the APA
- It also notes the transactions it proposes to be excluded from the APA. The reasons for exclusion include the simplicity of the transactions
- Where the tax revenue authority views that any of the transactions the taxpayer proposes to be excluded are actually important and should be covered in the APA, it could review the list through discussion with the MNE

Salient Features of an APA

- The general period for APAs in a number of countries is 3 – 5 years
- The period takes into consideration both the tax revenue authority and the taxpayer. It takes a considerable length of time for the application process to be concluded
- It involves all stakeholders putting in effort to secure favourable terms for all parties
- Therefore, after the hard work put in, it would be illogical to subject the parties to a similar exercise again within less than 3 years
- This minimum period also guarantees the MNE certainty in the operations because they can plan for the minimum 3 years into the future, on how to conduct operations

Salient Features of an APA

- On the other hand, the agreements should not last too long. After 5 years the situations under which the taxpayer operates could have changed considerably
- Changes in the business environment and development of the law on TP may warrant a re-evaluation of the terms agreed
- With a maximum of 5 years the balance can be met, in securing the taxpayer an agreeable period and the certainty that attaches, while at the same time giving the tax revenue authority the opportunity to tweak the parties' standing after a maximum of 5 years

APAs vs TP Methods - Certainty

Methods	Comparability	Approach	Remarks
CUP	Very High	Prices are benchmarked	Very difficult to apply as very high degree of comparability required
RPM	High	GPM (on sales) benchmarked	Difficult to apply as high degree of comparability required
CPM	High	GPM (on costs) benchmarked	Difficult to apply as high degree of comparability required
PSM	Medium	Profit Margins	Complex Method, sparingly used
TNMM	Medium	Net Profit Margins	Most commonly used Method

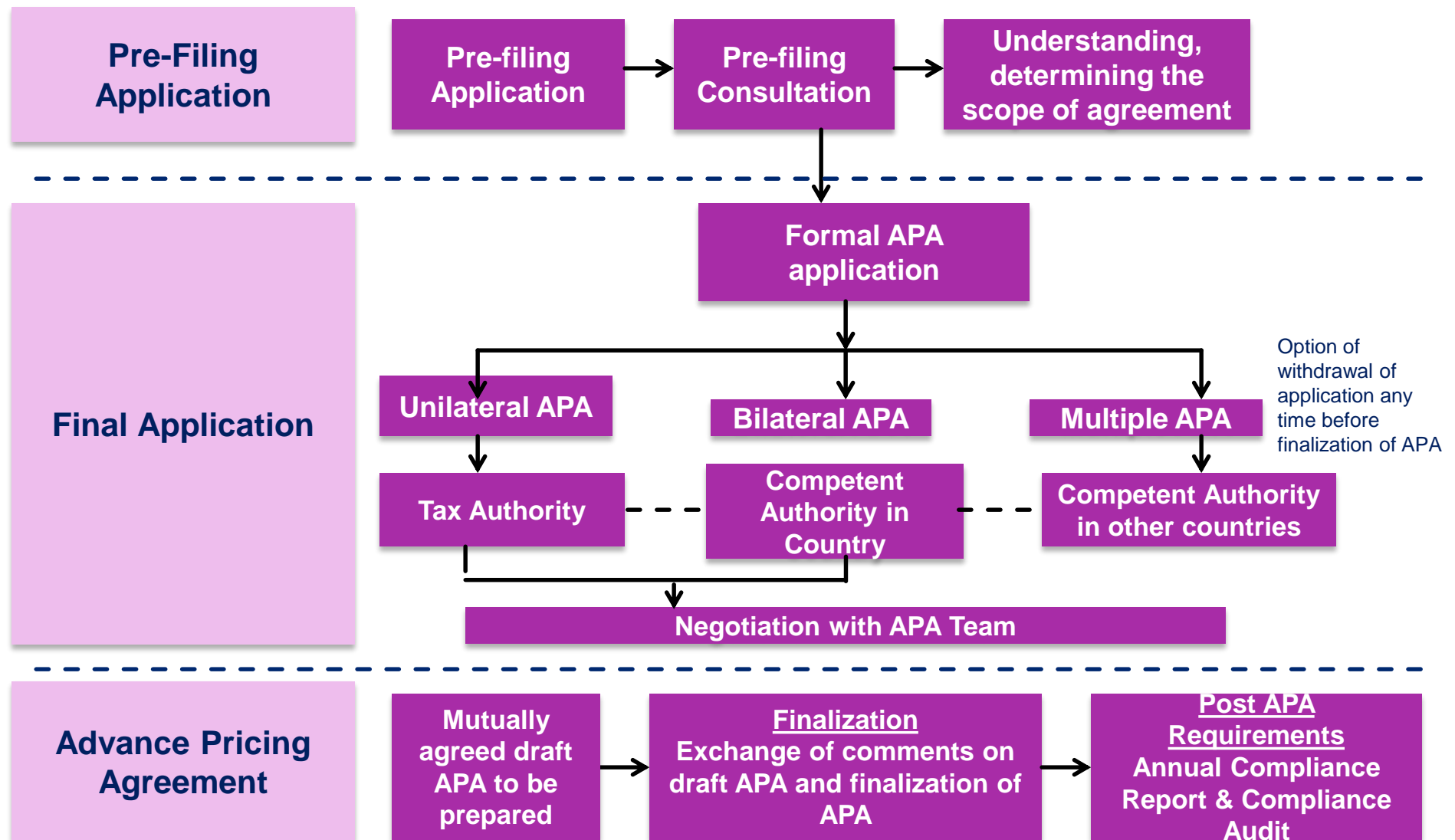
APA vs Documentation - Benchmarking / Economic Analysis

- Challenges of documenting a Search Strategy:
 - Selections - Method, Tested Party, profit level indicator;
 - Analysis of comparables;
 - Databases used;
 - Search methodology; and
 - Process of determining arm's length price
- Broad similarity in functions
- Appropriate documentation for reasonably accurate adjustments
- Documentation to capture commercial realities e.g. sufficient back-up documentation / justification

APA vs Documentation - Comparability Factors

- Challenges of determining the comparability factors:
 - The specific characteristics of the property transferred or services;
 - The functions performed, taking into account assets employed and the risks assumed
 - The contractual terms
 - Conditions prevailing in the markets

APA Process - OECD Illustration



- Strictly speaking, and going by the name attributed to them, APAs are agreements where the tax revenue authority and the MNE agree on the Arm's Length Price (ALP) in advance
- However, the parties may use the APA to determine the ALP for transactions in the past, through a 'rollback'
- The APA may be rolled back to cover transactions which were conducted in previous years
- A rollback offers certainty in the tax liability for historical activities, and are an effective way of resolving outstanding TP issues
- Towards the end of the APA term, the taxpayer may apply for renewal of the APA, which may be a simple process if there is no momentous alteration in the terms, or if the TP legal regime has not undergone substantive changes

Conclusion

- Taxpayers, corporate and individuals must pay sufficient attention to their tax affairs
- Need to temper the appetite for aggressive tax planning with a pinch of morality
- Whilst it is generally agreed that governments should avoid excessive or double taxation, taxpayers should also not seek to achieve double non-taxation
- A mutual agreement between the taxpayer and the tax authority would serve both very well

Q&A



Thank you



Presenter Details



Wilfred Alambo

Senior Advisor – Tax and Regulatory Services
KPMG Advisory Services Ltd
Telephone: **+254 020 2806000**
Email: walambo@kpmg.com.ke