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Welcome to Transfer Pricing

Mbiki Kamanjiri

Introduction- Transfer Pricing

Definition:

“the setting of the **price** for goods and services sold between controlled (or related) legal entities within an enterprise. For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent to the subsidiary is the **transfer price**.”

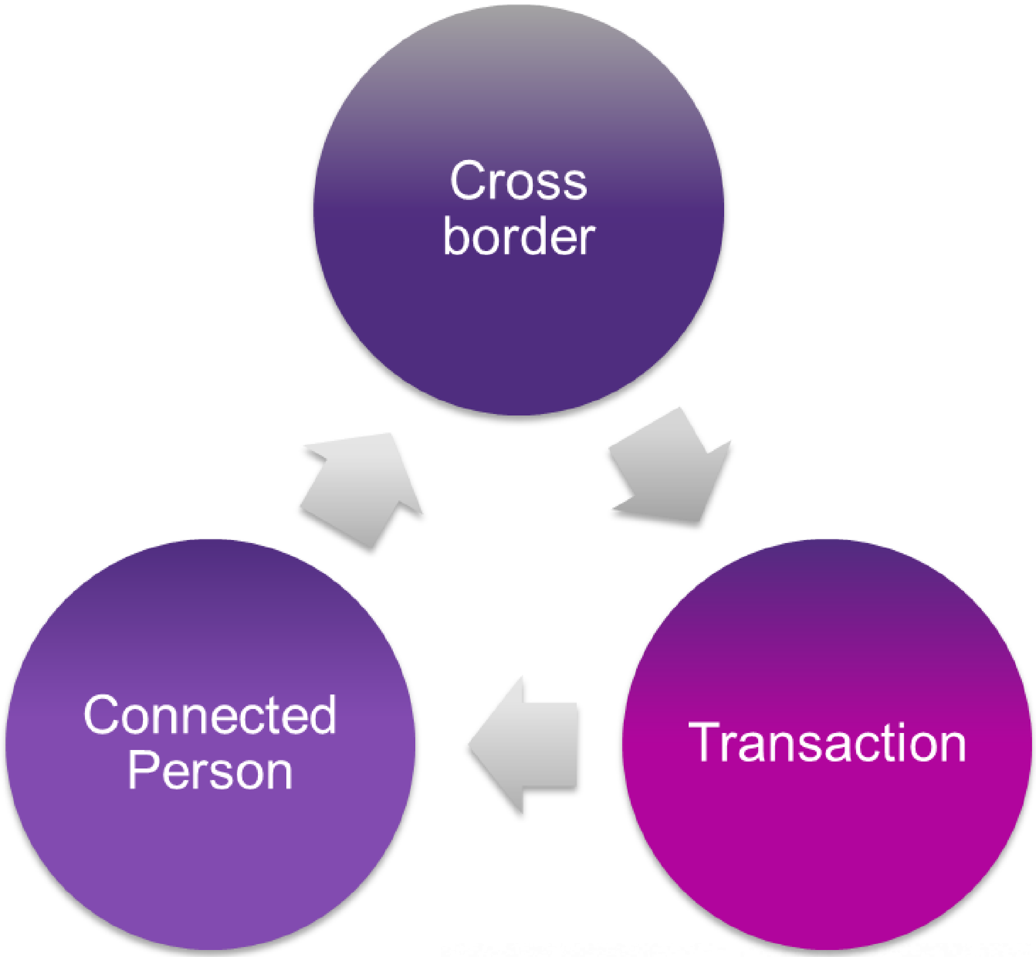
Introduction- Transfer Pricing

The arm's length price:

Purpose of a transfer pricing method is described in the **OECD Guidelines 2.1**:
" *to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle"*
OECD definition based on **Article 9 of the OECD Model Tax Convention**:

'[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be 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 occurred, may be

Introduction- Transfer Pricing



What is transfer pricing? In the news

Legislative provisions

Unilever Kenya
Limited
vs
CIT

Contract Manufacturing

1995 contract to distribute household goods to UG

Section 18(3)

Commissioner has power to adjust profits to reflect arm's length

Prices to UG lower

Kenya charged lower prices to UG than what it sold to local customers

Commissioner not issued guidelines

UKL relied on OECD guidelines to come up with "**transfer price**"

Section 18(3) of The Income Tax Act Cap 476 of Laws of Kenya

ICPAK
Uphold Public Interest

" Where a non-resident person carries on business with a related resident person or through its permanent establishment and the course of that business is ~~so arranged~~ such that it produces to the resident person or through its permanent establishment either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person or through its permanent establishment from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length."

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Legislative provisions

The Income Tax (Transfer Pricing) Rules, 2006

1 July 2006

To provide guidelines to related parties in determining “Arm’s Length”

Provides for 5 methods

CUP, RPM, CPM, PSM & TNMM
6th method

Shall apply to

Related parties; and
Transacting with each other crossborder

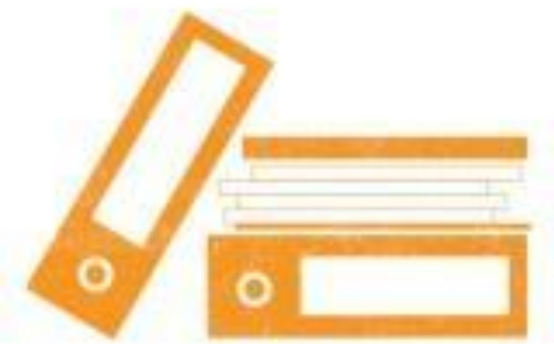
Guidelines on documentation

Guidance on what is to be contained in the TP doc

General contents of a TP policy document (Rule 9)

Section

1. Executive summary
2. Transfer Pricing Legal Framework in Kenya
3. Industry Overview
4. Company Overview
5. Competitors Analysis
6. Functional, Asset and Risk Analysis
7. Transactions Under Review
8. Selection of TP Method
9. Economic Analysis



Supporting the transfer prices

CUP

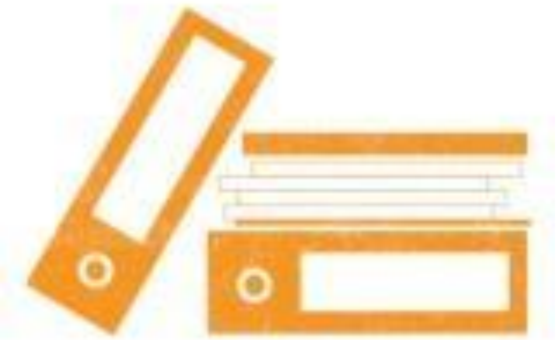
Comparable uncontrolled price

RPM

Resale Price Method

CPM

Cost Plus Method



PSM

Transactional Profit Split Method

TNMM

Transactional Net Margin Method

Comparable Uncontrolled Price Method

CUP

Compares the price charged for property or services transferred in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances.

It is used when:

a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or

b) reasonably accurate adjustments can be made to eliminate the material effects of such differences

CUP

Compares the price charged for property or services transferred in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances.

Application:

a) Royalties; or

b) Interest;

c) Sale of goods (raw and finished

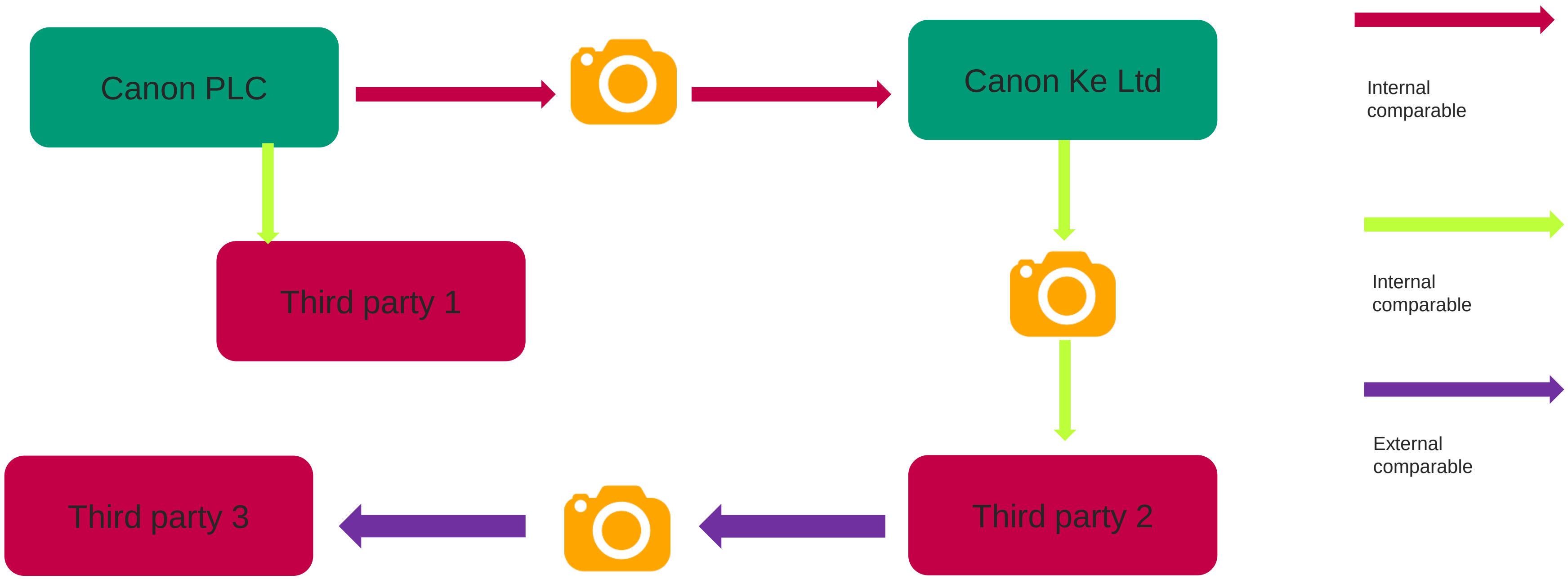
Example in application

A company A sells a product to associated company B in country X. For comparability purposes, company C has been identified in a different country but sells the same type of product, of the same quality and quantity. Factors to be considered would be;

- ✓ Time, stage in production/distribution, conditions of production and business strategies of the company.
- ✓ The terms of contract in the comparables. Are the two transactions in the same market level (e.g. retail or wholesale) and substantially same in volume? Are payment terms, product warranties and conditions for returns implicit in the contract?
- ✓ Differences that have material effect on pricing. Can the same be reasonable and accurately adjusted?

Example in application

CUP



Resale Price Method

RPM

Considers the price at which a product that 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 on this price representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed, make an appropriate profit.

RPM

Considers the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise.

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.

This method is probably most useful where it is applied to marketing operations

RPM

Considers the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise.

When searching for a comparable margin to be applied in the resale price method one would have to consider the following:

- ✓ Similarity in product properties, construction and function;
- ✓ Company type, volume of sales, market level and sales functions (e.g. advertising, packing and after-sales service such as warranties)
- ✓ Use of trademarks or other such properties in distribution

RPM – Application post BEPS

Traditionally, benchmarking of Canon Kenya Limited gross margin against that of comparable independent distributors would have been adequate.

•In accordance with BEPS Action on intangibles, further analysis on the application of the Resale Price Method would be necessary to establish:

- Legal obligations and rights;
- Functions, assets and risks;
- Intangible value to be created through activities; and
- Compensation provided for the functions performed

How do the intangibles related return impact on application of Resale Price Method i.e. discount on price , royalty, etc?

Cost Plus Method

CPM

Considers the costs incurred by the supplier of property or services in a controlled transaction supplying to an associated purchaser.

An appropriate cost plus mark up is then added to this cost.

This method is probably most useful :

- ✓ where semi-finished goods are sold between associated parties;
- ✓ where associated parties have concluded joint facility agreements long-term buy-and-supply arrangements; or
- ✓ where the controlled transaction is the provision of services.

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CPM – Application post BEPS

The Cost Plus works on the premise that costs are a driver of value and that profits are referenced or reflective of the costs incurred.

In the post BEPS world, need to further investigate where the value is created (BEPS Action 8 to 10) through a value chain analysis:

- In an industry where consumers are brand sensitive, a cost based method may not be appropriate.
- Where a highly valuable product is developed with minimal costs going into R & D, a cost based method may be inaccurate.
- Comparability of cost structure of tested party vis-a-vis the comparable very relevant as different cost structures maybe indicative of non-comparability.

Cost Plus method focuses more on the supplier to the transaction. In the post BEPS world, increased emphasis on a two sided analysis.

Transactional Net Margin Method

TNMM

Considers the net profit relative to an appropriate base (e.g. costs, sales, assets) realized from a controlled transaction.

- ✓ The net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, i.e. "internal comparables".
- ✓ Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise

TNMM – Application

- ✓ Company P is a manufacturer of product A using original technology and subsidiary S distributes A in country X.
- ✓ S sells A to a dozen third party agents in country X. S doesn't engage in any original advertising or sales promotion activities and hence RP is not applicable.
- ✓ As a result of use of original technology, it was not possible to find comparable transactions to apply CUP or CP method to company P.

TNMM – Application

- ✓ Have complete financial data for the last three years
- ✓ Be free from business disruptions e.g mergers & takeovers
- ✓ Have no outliers like consistent loss making comparables
- ✓ Be from the same economic region as the tested party
- ✓ Special consideration for intangibles

TNMM – Application

- ✓ Find an Inter-quartile range (IQR)
- ✓ Place the company in an IQR

Transactional Profit Split Method

PSM

Seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transactions

- ✓ First identify the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged
- ✓ Then split those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

PSM – Application

Seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transactions

Company P in the UK wins contracts for research work in Kenya. Subsidiary S conducts the research work. Company R in the US produces the research tools. Clients in Kenya pay directly to company P in the UK.

Post BEPS application

Profit splitting factors

Need to ensure that there is a strong correlation between profit allocation factors and value creation.

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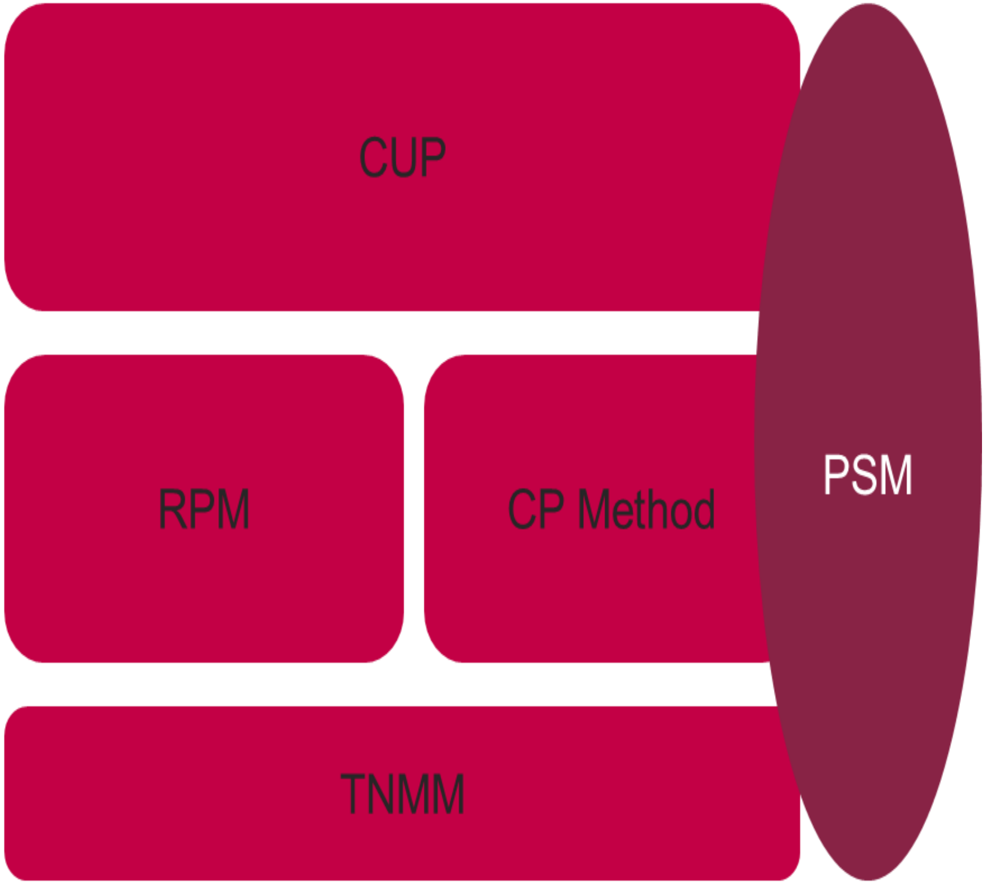
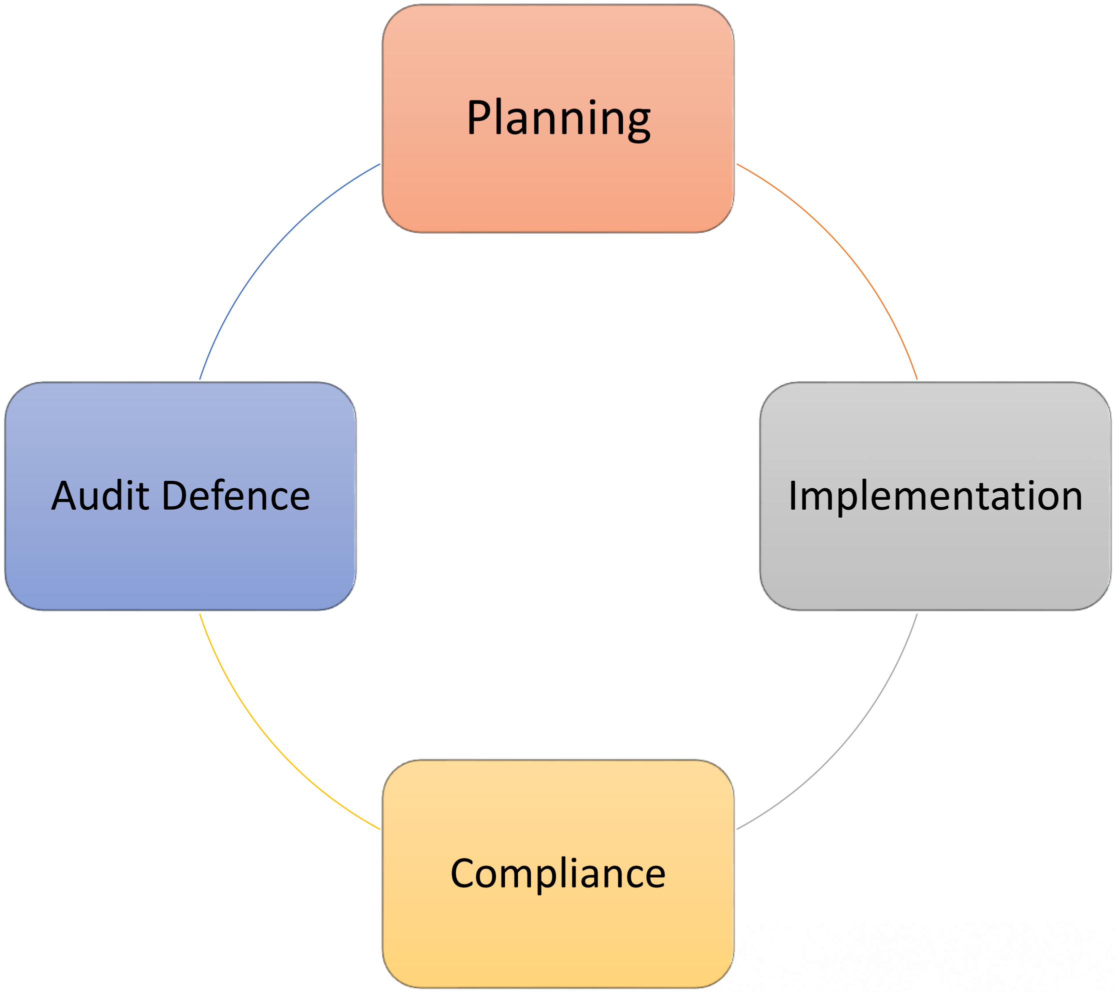
Relationship of methods to the P&L

Revenue
(Cost of sales)
GP
(Operating expenses)
Operating profit



Transfer Pricing Life Cycle



5th Floor,
Avocado Towers,
Muthithi Road, Westlands,
Nairobi
Kenya

T +254 20 3752830 | 3747681 | 2402975
F +254 20 3749839

www.grantthornton.co.ke

Mbiki Kamanjiri
Manager – Tax Consulting Services
Cell +254 721 449 468
E ; mbiki.kamanjiri@ke.gt.com

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