Institute of Certified Public Accountants workshop on Taxation in a dynamic Economy

Principles of Transfer Pricing

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Outline

- Why transfer pricing
- Arm’s length principle
- Legal framework in Kenya
- Comparability analysis
- Transfer pricing methods
- Intra-group services
- Intangible assets

Why Transfer pricing

- Global publicity about activities of multinational is on the rise as many countries seek to protect and increase their tax base.
- Many Multinational Enterprises (MNEs) are on spot due to transfer pricing issues.
- Examples of media reports/cases
  - Apple case (USA)
  - Microsoft case (USA)
  - Caterpillar case (USA)
  - Google case (UK)
  - Suzuki-Maruti Case (India)
  - Unilever Kenya Ltd (Kenya)
  - Karuturi (Kenya)

Why Transfer pricing

- Globalization
  - Integration of national economies and markets
  - Free movement of capital and labour
  - Removal of trade barriers.
  - Relaxation of forex controls – repatriation of cash
  - Technological and communication developments (Google case European sales done from Ireland)

Why Transfer pricing

- Existence of different tax rules in different countries- creates gaps and frictions
  - Gap – double non taxation (Apple case)
    - U.S – residence by registration; Ireland – Residence by place of effective management
  - Friction – double taxation
  - Consequence: room for arbitrage by taxpayers
  - Need to develop clear & predictable international rules

Why Transfer pricing

- Upsurge in multinational enterprises
  - Mergers and take- over's - economies of scale
  - A 2016 report shows some of the worlds biggest MNes as follows (Kenyan GDP was USD 70.53 billion):-
    - WalMart Stores turnover - $ 482 billion
    - China National Petroleum - $ 299 billion
    - Sinopec Group - $ 294 billion
    - Toyota - $ 237 billion
    - Apple - $ 234 billion

Why Transfer pricing

- **Other issues**

- About 30% of international transactions take place between related parties *(U.N Practical Manual on Transfer Pricing*. *P11 Para 1.1.3)*.
- 2002-2006, TP contribution to illicit financial flow out of developing countries was between $ 858.6 million and $ 1,060 million (*Global Financial Integrity*).
- High Level panel on Illicit financial flows from Africa highlight transfer pricing is a major contributor (*United nations, Economic Commission for Africa*).
- **Kenya:** (Global Financial Integrity report : DN, 12th May 2014, p. 1,8 & 9): A U.S-based International financial watchdog indicates that Kenya lost KES 1.1 trillion (USD 13 billion) between 2002 to 2011 through mis-invoicing.

Why Transfer pricing

- **Transfer pricing (TP)?**
- Transfer pricing refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of a Multinational group. (United Nations Transfer Pricing Manual).
- Transactions between related parties are referred to as “Controlled transaction”.
- Typical transactions:-
  - Sale or purchase of goods
  - Sale, transfer or purchase tangible assets
  - Sale, purchase or licensing of intangible assets
  - Provisions of services
  - Borrowing or lending of money

Arm's Length Principle

- International transfer pricing standard.
- Independent enterprises transact with each other, under conditions determined by market forces.
- Transaction between related parties may not be directly affected by external market forces in the same way as those of independent parties.
- Transaction between related parties do not automatically signify price manipulation.
- **Arms length principle requires that test** be done to ensure that the pricing of controlled transactions reflect conditions and terms of independent enterprises operating under similar circumstances.

TP Legal framework in Kenya

1. Section 18(3) of Income Tax Act (Arm’s length principle)

- *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 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 or 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.*

TP Legal framework in Kenya

2) Income Tax (Transfer Pricing) Rules, 2006

- Scope of the rules
- Transactions subject to TP review
- Transfer pricing methods
- Requirement to maintain a transfer pricing policy document and avail it upon request by the Commissioner.
- Requirement to determine the arms' length price and avail documents to evidence the calculation.
- Power of the Commissioner to request for transfer pricing documents

TP Legal framework in Kenya

- Scope of transfer pricing in Kenya
- Transactions between one party in Kenya and another member of an MNE group outside Kenya.
- Transactions between a permanent establishment in Kenya and its Head Office or other branches located outside Kenya.
- Transactions between a resident associated person and another resident associated person where one of the party is located in a preferential tax regime in Kenya e.g. EPZ or SEZ (Finance Act, 2017).

TP Legal framework in Kenya

3) International guidelines on transfer pricing

In Unilever Kenya Limited v The Commissioner of Income Tax (Income Tax Appeal No. 753 of 2003 it was held that in the absence of local rules/guidelines on determination of the arms length price, international best practice was applicable.

- Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
- United Nations Practical Manual on Transfer Pricing for Developing Countries

TP Legal framework in Kenya

4) Tax treaties and the Model Tax Conventions

- Tax treaties in Article 9 (*Associated Enterprises*) require application of the Arm's length Principle.
- Article 9 of the OECD Model Tax Convention provides that:-
- *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 accrued, may be included in the profits of that enterprise and taxed accordingly.*

Comparability analysis

- Comparability analysis is at the core of application of arm’s length principle.
- Objective: - To identify a comparable uncontrolled transaction for the purpose of benchmarking the pricing in the controlled transaction.
- A transaction is deemed to be comparable uncontrolled transaction (independent party comparable transaction) when:-
  - no differences exist that materially affect the profit level indicator being analysed; or
  - where such differences exist, reasonable accurate adjustments can be made to eliminate their effect.

Comparability analysis

- Comparable uncontrolled transactions could be:-
  - Internal comparables; or
  - External comparables.

Internal comparable Transaction – One part of an MNE group transaction is entered into with an independent party.

Identification of internal comparable transaction (Internal CUP/T) requires thorough analysis and evidence on the transactions of the group with third parties.

Once identified, it's the most direct and reliable comparable.

External comparable Transaction(s) – Transactions between independent parties under comparable circumstances.

These comparables are sourced from commercial databases e.g. Amadeus, Orbis

Comparability analysis

- **Key principles for searching comparables:-**
- The process should be documented in a systematic manner.
- The process should be transparent and verifiable.
- Sufficient analysis of the controlled transaction having regard to the functions undertaken, assets used and risks assumed by the parties to the transaction is necessary for selecting:-
  - the tested party
  - most appropriate TP method
  - profit level indicator
- Test existence of internal comparable uncontrolled transaction(s) prior to searching for external comparables.

Comparability analysis

- **Key principles for searching comparables…ctd:-**
- Determination of the available source of information for external comparables.
- Determining the key characteristics to be met by potentially comparables transactions (Search Criteria).
- Determination of and making of comparability adjustments, where appropriate.
- Interpretation and use of the search results to determine the arm’s length remuneration.

Comparability analysis

- **Comparability factors**

The economically relevant factors for accurate delineation of the transaction are:-

- The **contractual terms** of the transaction.
- The **functions performed** by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
- The **characteristics of property** transferred or services provided.
- The **economic circumstances** of the parties and of the market in which the parties operate.
- The **business strategies** pursued by the parties.

Transfer pricing methods

- Income Tax (Transfer Pricing) Rule 7 highlights the following TP methods:-

1) Comparable Uncontrolled Price (CUP)
2) Resale price Margin (RPM)
3) Cost Plus Method (CPM)
4) Transactional Net Margin Method (TNMM)
5) Profit Split Method
6) Such other method as may be prescribed by the Commissioner from time to time.

Transfer pricing methods

- The most appropriate transfer pricing method has to be selected on a case by case basis, having regard to the following factors:-
  - Nature of the transactions or class of the transactions being tested.
  - The functions performed by each party to the controlled transaction, taking into functions undertaken, assets used and risks assumed.
  - Availability of reliable information to apply the method.
  - Degree of comparability between the controlled and uncontrolled transaction.

Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Comparable Uncontrolled Price	▪ High level of product comparability. ▪ Often not appropriate where the transaction is influenced by existence of intangible assets. ▪ Comparability adjustments are often necessary to enhance its reliability.	Any controlled transactions as long as it can reliably be established.
Cost Plus Method	▪ A reasonable degree of product comparability is required. ▪ Sufficient information on functions undertaken is relevant. ▪ Accurate determination of cost of activities.	▪ Service transactions ▪ Manufacturing transactions

Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Resale price method (RPM)	▪ A reasonable degree of product comparability is required. ▪ Sufficient information on functions undertaken is relevant. ▪ Accurate determination of sales to end customer.	Sales and distribution activities.
Transactional Net Margin Method (TNMM)	▪ Emphasis on comparability in processes and functional analysis. ▪ Segmentation of results is vital.	Applicable to different transactions depending on the selected profit level indicator e.g. Cost, sales, Capital Employed.

Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Profit Split Method	▪ Existence of highly integrated/ intertwined processes between the associated persons. ▪ Each party to the controlled transactions make unique and valuable contribution (functions, assets) to the transaction. ▪ Determination of the overall/combine profit to be shared in vital. ▪ Determination of splitting factor.	Applicable where one-sided methods are not appropriate and where factors for its use can reliably be determined.

Intra-group Services

- Intra-group services are very common transfer pricing issues.
- Income Tax (Transfer Pricing) rule number 6(d), 2006
- OECD TP Guidelines address intra-group services under Chapter 7 of the guidelines
- Financial services are also covered in Chapter 7 of the guidelines.

Intra-group Services

- Main issues for determination are:-
  - Whether intra-group services were rendered/provided.
  - Whether the intra-group charge for the services was in accordance with the arm's length principle.

Intra-group Services

- **Whether intra-group services were rendered/provided**.
- Overriding principles:-
  - Could an independent party operating under similar circumstances accept the charge or would it consider performing the services in-house?
  - Do the services rendered transfer commercial benefits to the recipient?
- Documentation to support existence of commercially beneficial services is at the core of the analysis.

Intra-group Services

- **Whether intra-group services were rendered/provided…ctd**
- Common risks

1. Duplicated services
   - Local entity performing the service itself and in deed has capacity to do so.
   - Some charge is included in another controlled transaction e.g. Procurement service fee yet the purchase price of the product includes a mark-up for the service.
   - Exception allowed on a case by case where duplication is undertaken to reduce risk e.g. Getting a second opinion on a legal matter.

Intra-group Services

- **Whether intra-group services were rendered/provided…ctd**
- Common risks

2. Inclusion of shareholder activities.
   - Costs relating corporate governance of the MNEs as a whole,
   - Costs relating to compliance of the parent company with relevant tax laws,
   - Costs relating to financial reporting and consolidation.

Intra-group Services

- **Whether intra-group services were rendered/provided…ctd**
- Common risks

3. Incidental benefits
   - Benefits enjoyed as a result of being part of large group without any specific action being taken.
   - Acquiring higher credit rating than the stand alone credit rating without any form of guarantee.
   - Enjoying preferential terms from suppliers due higher purchasing power of the group or the group economies of scale.

Intra-group Services

- **Determination of the arm's length price of the service rendered.**

- Once, satisfied that intra-group services were rendered, evaluation of arm's length price follows.
- The appropriate TP method for intra-group service is CUP or Cost plus or cost based TNMM.
- Determination of cost base is vital. Cost base can established using:-
  - Direct method; or
  - Indirect method.

Intra-group Services

- **Determination of the arm's length price…ctd**
- **Common risks**

➢ Laying more emphasize on benchmarking the intra-group charge.

➢ Failure to avail details of cost base especially where provider is outside Kenya.

➢ Failure to disclose details of the allocation basis especially where the provider is outside Kenya.

➢ Use the wrong allocation basis.

➢ Selection of wrong TP method.

➢ Use of inappropriate comparables.

Intangible assets

- The term “intangible” refers to something which is:-
  - not a physical asset or a financial asset;
  - capable of being owned or controlled for use in commercial activities; and
  - whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.
- Intangibles that are important for transfer pricing are not necessarily recognized for accounting purposes. For instance costs associated with developing intangibles from R&D: The costs are expensed and the intangible may not be reflected in the balance sheet.

Intangible assets

- Intangibles specifically relevant for transfer pricing:-
  - Patents;
  - Know-how and trade secrets;
  - Trademarks;
  - Trade names;
  - Brands;
  - Rights under contract and Government licenses;
  - License and limited rights in intangibles;
  - Goodwill (Reputational value)

Intangible assets

- Intangible are very easy to move across an MNE group; hence they easily cause TP risk.
- Functional analysis will seek to identify parties to the transaction who perform functions, assume risks and use assets in relation to on **Development**, **Enhancement**, **Maintenance**, **Protection** and **Exploitation** of the intangible.
- Generally, parties that perform the above functions are entitled to an arm's length reward in order to ensure that transfer pricing outcomes are aligned to value creation within an MNE group.

Intangible assets

- **Identification of intangibles:-**
- **Example 1**
- A Co, a Kenyan company had over 30 years produced bread using its plant, human resource and know-how. A Co. had marketed and sold the bread under its brand name, MegBread. However on 31/12/2012 it signed a Contract Manufacturing agreement with its related party (B Co.) in British Virgin Island granting A Co. license to manufacture MegBread on behalf of B Co.
- **Questions**

1. ***Identify the intangibles in this case?***
2. ***Do you expect functional differences in this case? Has the know-how moved? Has the brand loyalty and success changed?***

Intangible assets

- **Identification of intangibles:-**
- **Example 2**
- A Co is a Kenyan resident company engaged in distribution of Product Z under trademark “Zipp”. The distribution is executed under a license from B Co, a sister company of A Co, resident and domiciled in Luxemburg. Under the agreement A Co is conduct sales promotions and advertising activities in Kenya and the region under the strategic guidance of B Co. Industry information indicates that the sales promotion and advertisement expenditure of A Co is way above that of its peers.
- ***Questions***

1. ***Which intangibles are involved?***
2. ***What contribution does B Co make? How should it be rewarded?***

Intangible assets

- **Identification of intangibles:-**
- **Example 3**
- Company A and Company B are members of an MNE group that sells electronic appliances. Company A is responsible for product design, development and manufacturing whereas Company B undertakes marketing functions and the global distribution of the goods. For the manufacturing of the products, Company A decides on the levels of production and performs the quality controls. In doing so, Company A uses its valuable know-how and expertise regarding the manufacturing of electronic appliances. Company B is fully responsible for developing marketing strategy and expenditure level. The marketing activities performed by Company B result in a valuable trademark and associated goodwill by which their products are favourably differentiated from competitors' alternatives in the market.
- ***Identify the intangibles***
- ***Which transfer pricing method would be considered in this case?***

Intangible assets

- **Other Issues on intangibles (Not covered)**
- Determination of the arm's length price.
- Comparability analysis for intangibles
- Valuation of intangibles
- Hard to value intangibles

END

- Q&A