TRAINING ON TRANSFER PRICING

Income Tax Workshop

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VENUE: Grand Regency Hotel Nairobi

INTRODUCTION TO TRANSFER PRICING

What is Transfer Pricing?

- Prices at which an enterprise transfers physical goods and intangibles or provide services to their related party/ies. Controlled Vs Uncontrolled transaction.

Statutory Provisions

- Section 18 (3) of the Income Tax Act ("ITA")

- The Income Tax (Transfer Pricing) Rules, 2006 ('TP Rules').

OECD

- The general application of the arm's length principle is articulated in the Associated Enterprises Article - Article 9 of the OECD Model Convention.

- OECD TP Guidelines for Multinational Enterprises and Tax Administrations.

Section 18 of the Income Tax Act

Persons covered –relationship [S. 18(6)]

a) either person participates directly or indirectly in the **management, control** or **capital** of the business of the other; or

b) a third person **participates directly or indirectly** in the management, control or capital of the business or both.

c) an individual, who participates in the management, control or capital of the business of one, is **associated** by marriage, consanguinity or affinity to an individual who participates in the management, control or capital of the business of the other

Transfer Pricing Guidelines

Purpose of TP Rules 2006

- to provide guidelines to be applied by related enterprises, in determining the arm's length prices of goods and service in transactions involving them, and

- to provide administrative regulations, including the types of records and documentation to be submitted to the Commissioner by a person involved in transfer pricing arrangements.

Scope of guidelines

- Transactions between related companies in a MNE

- Transactions between a permanent establishment and its head office or other related branches

R. 6 − Transactions subject to TP Rules

- the sale or purchase of goods;
- the sale, purchase or lease of tangible assets;
- the transfer, purchase or use of intangible assets;
- the provision of services;
- the lending or borrowing of money; and
- any other transactions which may affect the profit or loss of involved entity

R. 7 − Methods

- the comparable uncontrolled price (CUP) method
- the resale price method
- cost plus method
- profit split method
- transactional net margin method
- Any other method − Commissioner's approval

- R. 8 – Application of Most Appropriate Method (MAM)

- R. 9 – Power of Commissioner to request for information

- R 10– Application of arm's length pricing (Transfer pricing Policy and supporting documentation)

ARM'S LENGTH PRINCIPLE

- Related parties - charge the same price, royalty and other fee in relation to a controlled transaction as that which would be charged by independent enterprises in an uncontrolled transaction in **comparable** circumstances.

- Reference to the profits that would have arisen if the same transactions had been executed by independent enterprises.

Functional analysis

- Analysis of the functions performed, assets used and risks assumed by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions.

Comparability analysis

- Central to the application of the arm's length principle.

- The comparison of a controlled transaction with an uncontrolled transaction or transactions

- The search for comparables

Determining Comparability

- In determining comparability and making adjustments, the OECD has identified a number of factors that must be considered:

a) *Characteristics of property or services*

- Differences in the specific characteristics of property or services can often explain the differences in their open market value. Comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions or activities. Focus should be put on the attributes or characteristics that are valued by customers, including the intangible benefits of design, trademark, and perceived quality.

b) *Functions, Assets and Risks (FAR Analysis)*

- 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 transactions.

- The economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transaction is important.

c) *Contractual terms*

- Define explicitly or implicitly the way the responsibilities, risks and benefits are divided between independent enterprises. Examples of the terms and conditions that may influence the agreed price/margin include:

  - Credit and payment terms;

  - Volume, duration, product and service liabilities of the parties; and Warranties and exchange risk

d) *Economic and marketing circumstances*

- Arm's length prices or margins vary across different markets even for transactions involving the same property or services. Achieving comparability requires that:

- the markets in which the independent and associated enterprises operate are comparable; and

- Differences either do not have a material effect on price or can be appropriately adjusted if they do have a material effect.

e) Business Strategies

– E.g. in Market penetration strategies - forgo some profits or incur losses to position for more l profits in the future.

– Costs incurred or profits forgone - which enterprise obtains benefit from these decisions?

TP Methods
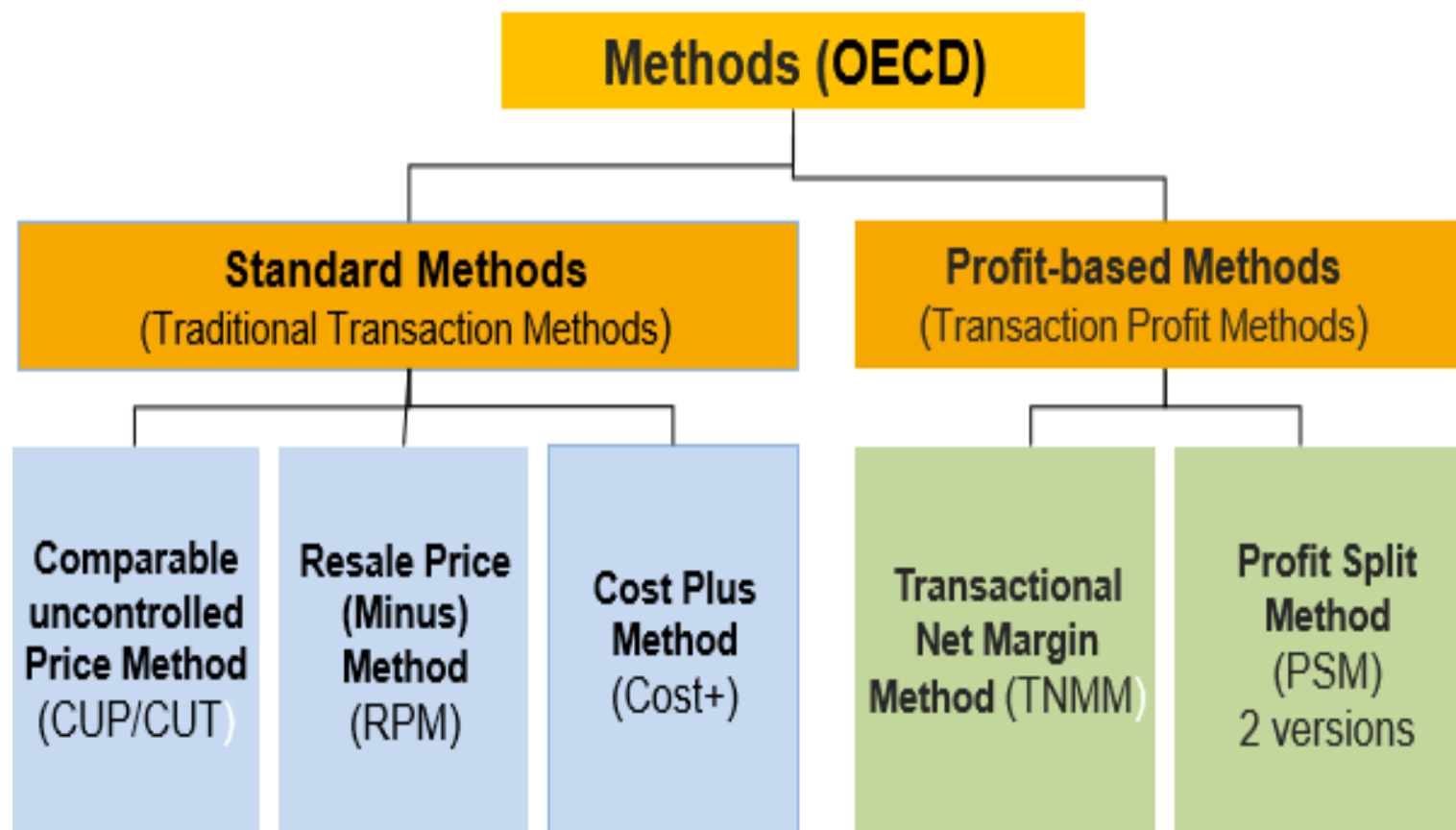
Selection Of Transfer Pricing Method

Most Appropriate Method

- ITA insists on applying the 'Most Appropriate Method' (MAM)
- MAM means a Method Which is best suited to facts and circumstances of transaction – the most reliable measure of an arm's length price
- MAM is to be determined considering – Nature and class of transaction
- Functions, assets and risks undertaken by assessee and other party
- Degree of comparability between underlying transaction and uncontrolled transactions
- Extent to which reliable and accurate adjustments can be made to account for differences, if any
- Availability, coverage and reliability of data necessary for application of method
- Nature, extend and reliability of assumptions required to be made in application of method

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MAM is to be determined considering

Selection of Tested Party	– Nature and class of transaction – Functions, assets and risks undertaken assessee and other party
Comparability Analysis	– Degree of comparability between underlying transaction and uncontrolled transactions – Extent to which reliable and accurate adjustments can be made to account for differences, if any
Selection of Tested Party & Comparability Analysis	– Availability, coverage and reliability of data necessary for application of method – Nature, extend and reliability of assumptions required to be made in application of method

A) Comparable Uncontrolled Price Method (CUP)

- Compares the price 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.

- An uncontrolled price is the price agreed between independent parties for the transfer of goods or services.

- Types

- a) internal CUP - Comparison of tested transaction with the transaction where the taxpayer or the other party sells or buys a particular product or service to or from an unrelated enterprise under similar terms and circumstances in comparable quantities and market

- b) external CUP- price to the controlled transaction is compared to the price of a comparable transaction between third party enterprises.

  - Sources of External CUP :Metal / Commodity / Stock Exchanges, Customs Data, Yields earned by Bonds listed on Stock Exchanges, Loan transactions database, Royalty transactions database

- ***CUP….Cont***

- It requires close similarity in products, property or services that are involved

- Where the prices of the product fluctuate regularly, timing of the transaction also relevant

    – Where the prices remain constant over period, such transactions can be aggregated and be benchmarked together

Most appropriate situations;

- Interest rate charged on an inter-company borrowing between associated enterprises;

- Royalties charged on licensed intangible properties (e.g. Trademark, design, copyright, etc.);

- Price charged for the sale of listed securities.

- Guarantee Fee Benchmarking

Example A1

- Company Ke resident in Kenya manufactures a machine which it sells at a price of Kshs 1 Million to a Mauritius subsidiary but at a price of Kshs 1.2 Million million to an independent Mauritius company.

- **Add Kshs 200,000 to Ke's turnover.

Example A2

- Company Ke resident in Kenya is trading in the NSE and holds stock which would raise Kshs 1.5 million on the over the counter market. It sells to an overseas associated enterprise the stock for Kshs1 million.

- *** A sum of Kshs 500,000 should be adjusted in Ke's tax computations.

- Most reliable comparability factors -similarity of products, contract terms and economic/ market conditions.

Example 3

Particulars	Related party	Unrelated party	Adjustments
Price paid (inclusive of taxes)	25,000	23,500	
Delivery terms	CIF	FOB	
Quantity	100 pcs	110 pcs	
Freight		200	200
Insurance		150	150
Credit Period	90 days	Upon dispatch	
Int Rate on Wkg Capital	12% p.a		705
ALP	adjust independent party by 1,055		24,855

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Cost plus method C+

- C+ uses costs incurred by the supplier of property or services in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed taking into account assets used and risks assumed and the market conditions.

- Uses margins computed after direct and indirect costs of production

- Adjustments are required to account for product differences.

- Useful in the following transactions:

    (a) Sale of semi-finished goods between members of a group;

    (b) Joint facility agreements or long term buy and supply arrangements concluded between associated enterprises; and

    (c) Provision of service.

Application of CPM – Adjustment for differences

- Adjustments may be required in the GP of comparable transaction(s) / companies for material difference in FAR or other factors affecting gross profit margin

- Following types of adjustments may be particularly relevant

    - *Working Capital.* Inventory, debtors and creditors (collection cycle)
    - *Contractual Terms:* Warranties provided, Sales or purchase volume, Credit terms, Transport terms
    - The *complexity* of the manufacturing process or of the assembly operations
    - Manufacturing, production, and process engineering
    - The extent of the procurement, purchasing, and inventory control activities
    - *Cost structures.* The age of plant and equipment
    - *Business experience*. Whether the business is in a start-up phase or is mature
    - *Management efficiency*. As indicated by expanding or contracting sales, or by executive compensation over time

Example B1

- Company Ke resident in Kenya is an enterprise specializing in the production of Integrated Circuits for an overseas associated enterprise. Under the arrangement, Company Ke would be provided with all the technical know-how used in the manufacturing of the Integrated Circuits.

- Company C is an independent contract manufacturer of printed Integrated Circuits in Kenya. It sells the products to an independent German distributor. Company C, identified as an external comparable enterprise, charges an average mark-up of 10 per cent.

- Assume Company KE incurred direct and indirect costs of Kes 400,000 in producing one Integrated Circuits; the arm's length cost plus mark-up would be Kes 40,000

Steps in applying C+

1 Compute the direct and indirect cost incurred in controlled transaction

2 Determine the normal gross profit margin earned in similar uncontrolled transaction

3 Apply the margin in step 2 on amount arrived at in step 1 after making the necessary adjustments, if any to arrive at the ALP

Example B2

- Company Ke resident in Kenya is a manufacturer of men trousers. It sells the trousers to its related party subsidiary F in the US. Company Ke earns a 5 per cent gross profit mark-up with respect to its manufacturing operation. Companies X, Y, and Z are unrelated domestic manufacturers in Kenya of men trousers. Companies X, Y, and Z sell to unrelated foreign purchasers and earn gross profit mark-ups with respect to their manufacturing operations that range from 3 to 5 percent.

- Company KE accounts for supervisory, general, and administrative costs as operating expenses, and thus these costs are not reflected in cost of goods sold. The gross profit mark-ups of Companies X, Y, and Z, however, reflect supervisory, general, and administrative costs as part of costs of goods sold.

- If the cost plus method is used, the gross profit mark-ups of Companies X, Y, and Z must be adjusted to provide accounting consistency.

C. Resale Price Method (RPM)

- RPM - price at which a product that has been purchased from related party is resold to an independent party.

- Most useful where the reseller contributes little to the value of the product ultimately on-sold on an arm's length basis. More reliable if the reseller on-sells within a short time – the more time that lapses, the greater the risks assumed in relation to changes in the market, in rates of exchanges, etc. in which such factors need to be taken into account in any comparison.

- RPM focuses more on functional comparability –

  – Underlying principle:

    Distributor is remunerated for its functions as it does not carry out any value adding activities

Steps

1 Determine the gross profit margin earned in comparable uncontrolled transactions

2 Subtract the appropriate gross margin and expenses from the applicable resale price

3 The remainder will be the arm's length price with the controlled entity

Example C1

- Company Ke resident in Kenya purchased fashion and apparel from its UK parent company and sells them through various retail outlets in Kenya.

- Company C, an independent distributor, purchases similar products from various suppliers in the Far East, sells the same to end customers and earns an average gross margin of 40 per cent.

- Assume Company Ke sold a particular line of women's apparel it purchased from the UK parent company and derived sale proceeds of $200 million. The arm's length price for this line of apparel it purchased from the UK parent company should be $120 million (i.e. $200 ÷ 100 × (1 - 40).

D. *Profit Split Method (PSM)*

- PSM evaluates whether the allocation of the combined profit attributable to the related parties to a controlled transaction (s) is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined profit.

- Identifies the profits to be split for the associated enterprises to the controlled transactions in which the related parties are engaged.

- Split the combined profits between the parties 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.

There are two main approaches to profit splits depending on the information available;

- Contribution profit splits method

- Residual profit splits method (RPSM)

The type used is likely to depend on what is feasible in the light of the information available.

a) Contribution Analysis

Under this approach, the <u>combined profits</u> (total profits) from the controlled transactions are divided between the associated parties based upon a reasonable approximation of each party's respective contribution to earning the overall profit (often referred to as the system, or channel profit).

Where the division cannot be supported by comparables data, it is based on the relative value of the functions performed, assets used and risks assumed by each party with <u>appropriate allocation keys</u>.

b) Residual Analysis

Divides the combined profits from the controlled transaction in <u>two stages</u>.

First a share of profit is allocated to each of the parties as the arms length reward for the non-unique contributions they make. This has to be done using appropriate comparables.

The <u>profit not allocated at the first stage is computed</u>. It is referred to as the <u>residual profit</u>. It follows that it is attributable to the non-routine functions undertaken by the parties (such as the production of key intellectual property).

Allocation Keys

- In practice, division of combined profits is generally achieved using one or more allocation keys e.g. a percentage or a variable

- Allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and /or R&D, engineering, marketing) are often used.

- Other include headcount, incremental sales, number of servers, data storage, floor area of retail points etc.

E. Transactional Net Margin Method (TNMM)

- TNMM examines the net profit margin relative to an appropriate base such as sales, costs or assets that a party realizes from a controlled transaction or transactions that it is appropriate to aggregate. This is compared with the result achieved by independent parties on a similar transaction or transactions.

- Margins are calculated after operating expenses. As a result, differences in transactions that would not have an effect on a gross margin need to be accounted for under this method.

- Multiple year data should be considered for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions.

Application of TNMM

Functions, Asset and Risk Analysis

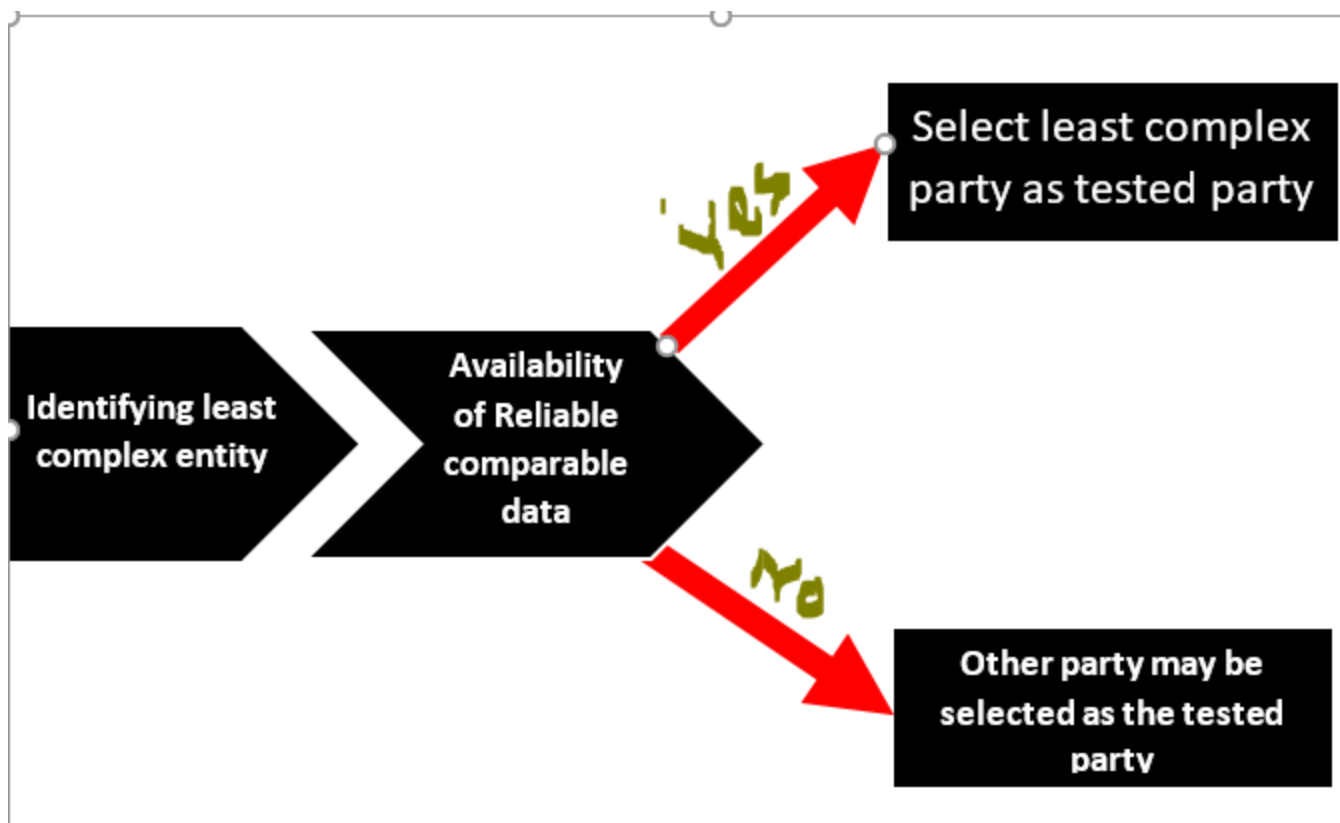Characterization of the entity

Evaluation of TP Method

Selection of TNMM as Most Appropriate Method

Selection of Tested Party

Selection of Profit Level Indicator

Comparability Analysis

Selection of Tested Party

Identifying least complex entity

Availability of Reliable comparable data

Yes → Select least complex party as tested party

No → Other party may be selected as the tested party

Generally a least complex entity without its own intangibles or unique assets and which only performs the routine functions For e.g., a distributor, sales agent, contract manufacture

Period of Comparison

- As per the IT Rules, multiple year data can also be used for comparability, in order to eliminate the accounting differences, product life cycles, varying businesses and discrepancies in shorttem economic conditions

   – The averages for the multiple year data can be simple average or weighted average depending upon the facts of each case.

Aggregation of Transactions

- Multiple transactions entered into by the enterprise which are so interlinked that they cannot be evaluated separately.

- TNMM is applied by aggregating the such transactions with respect to closely linked products, similarity of functions, longterm arrangements, and intangible rights.

- If aggregation using this criteria is not possible then on company wide basis. However, it is preferred to aggregate the transactions at the most micro level to the extent it can reliably be analyzed

Identification of Comparable

- Internal or External comparison

- External Comparison involves selection of comparable independent enterprise having similar FAR.

- For external comparison the information which are available in public domain can only be used

- Selection of Profit Level Indicator

Profit Level Indicators

PLI	Formula	TPM	Applicable
Operating Margin	Operating Profit/Net sales	TNMM	Distributors
Net Cost Plus Mark Up	Operating Profit/ Total costs	TNMM	Manufacturers, service providers
Return on Capital Employed	Operating Profit/Capital Employed	TNMM	Asset Intensive Mfg entities
Berry Ratio	Gross Profit/ SGA	TNMM	Routine service providers, Pure distributors
Gross Margin	Gross Profit/Net Sales	RPM	Distributors
Gross Cost Plus Mark Up	Gross Profit/COGS	C+	Manufacturing entities

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Case Study

Facts of the Case

Company A is a distributor of products in Kenya. Company A purchases Product X (accounting for 50 percent of its sales) from an unrelated party in UAE and Product Y (accounting for 50 percent of its sales) from A's foreign parent in British Virgin Islands. Products X and Y are similar in nature such that no adjustment is required for quality, design, or any other material item. Assume that the income statement for Company A is as follows:

	Product X	Product Y	Combined
Sales	10	10	20
Cost of sales	4	2	6
Gross profit	6	8	14
Selling, general, and administrative expenses	4	4	8
Operating income	2	4	6

- Product X is purchased from an unrelated manufacturer. The transfer prices for Product Y are based on a transaction-based method that produced arm's-length prices.

- KRA uses examines the tax return and finds out that ratio of operating income to sales on a combined basis is 6 divided by 20, or 30 percent. This ratio focuses on the total profit of the enterprise, irrespective of whether the purchases are from a related party. Suppose KRA has determined from its database search that comparable distributors should earn operating income/sales of 35 percent (7/20). In this case, the income statement, after adjustment by KRA, would appear as follows:

	Product X	Product Y	Combined
Sales	10	10	20
Cost of sales	4	1	5
Gross profit	6	9	15
SG&A	4	4	8
Operating income[a]	2	5	7

[a]Operating income is 35% of sales of $20.

Q & A