

# ***Institute of Certified Public Accountants Transfer Pricing Workshop***

## ***Transfer Pricing Post BEPS***

***by***

***Antony Munanda  
Ag. Manager,  
International Tax Office, KRA.***

***6<sup>th</sup> June 2018***

# Outline

- Transfer pricing methods selection
- Intra-group services
- Intangible assets

# Transfer pricing methods

## Transfer Pricing 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) Commodity pricing – CUP applicable for commodity transactions.

# 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	<ul style="list-style-type: none"> <li>▪ High level of product comparability.</li> <li>▪ Often not appropriate where the transaction is influenced by existence of intangible assets.</li> <li>▪ Comparability adjustments are often necessary to enhance its reliability.</li> </ul>	Any controlled transactions as long as it can reliably be established.
Cost Plus Method	<ul style="list-style-type: none"> <li>▪ A reasonable degree of product comparability is required.</li> <li>▪ Sufficient information on functions undertaken is relevant.</li> <li>▪ Accurate determination of cost of activities.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Service transactions</li> <li>▪ Manufacturing transactions</li> </ul>

# Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Resale price method (RPM)	<ul style="list-style-type: none"> <li>▪ A reasonable degree of product comparability is required.</li> <li>▪ Sufficient information on functions undertaken is relevant.</li> <li>▪ Accurate determination of sales to end customer.</li> </ul>	Sales and distribution activities.
Transactional Net Margin Method (TNMM)	<ul style="list-style-type: none"> <li>▪ Emphasis is on comparability in processes and functional analysis.</li> <li>▪ Segmentation of results is vital.</li> </ul>	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
Commodity pricing - CUP	<ul style="list-style-type: none"> <li>▪ Existence of quoted price for commodities.</li> <li>▪ Date of transaction based on shipping documents.</li> <li>▪ Transparent source of quoted prices.</li> </ul>	Commodities

# Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Profit Split Method	<ul style="list-style-type: none"> <li>▪ Existence of highly integrated/ intertwined processes between the associated persons.</li> <li>▪ Each party to the controlled transactions make unique and valuable contribution (functions, assets) to the transaction.</li> <li>▪ Determination of the overall/combine profit to be shared in vital.</li> <li>▪ Determination of splitting factor.</li> </ul>	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 transactions are also covered in Chapter 7 of the OECD TP Guidelines. However, there is on-going work of developing more robust guidelines on Financial Transactions by the OECD.

# 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 principle – Benefit Test:-
  - Would an independent party operating under similar circumstances accept the charge if the service was rendered by an independent party; 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...ctnd

### • 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...ctnd

### • Common risks

#### 2. Inclusion of shareholder activities.

- Cost relating to juridical structure of the parent company itself (cost of parent company shareholders' meetings, cost of issuing parent company shares, costs of the parent company board).
- Costs relating to financial reporting and consolidation.
- Costs relating to raising of funds for the parent acquisitions and costs relating parent company investor relations
- Costs which are ancillary to corporate governance of the MNEs as a whole,
- Costs relating to compliance of the parent company with relevant tax laws,

## 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.
- Group Synergies
  - Enjoying preferential terms from suppliers due higher purchasing power of the group or the group economies of scale.
  - Increased borrowing capacity – Cash pooling

## Intra-group Services

**Whether intra-group services were rendered/provided...ctd**

### **Common risks**

4. On-call services and “retainer fees”
  - What is the potential need for the services involved?
  - Are the services involved readily available from other sources?
  - To what extent has the entity used the services over a period?

All these issues have to be evaluated on case by case basis. Evidence of previous use of such services is critical.

## 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. Details of the pool must be provided.
- Cost base can be recharged using:-
  - Direct method; or
  - Indirect method.



# Intra-group Services

## Other Intra-group Issues

1. Pass through costs
  - Costs involving use of third parties (external costs)
  - Where internal resources of the service provider are not used, such costs should not be marked up.
  - Often, taxpayers mis-allocate in this cost pool to reduce the taxable profits.

# Intra-group Services

## Other Intra-group Issues

2. Low-value-adding services:-
  - Are of supportive nature;
  - Are not part of the core business of the MNE group;
  - Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
  - Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

Adoption of simplified approach is a country decision.

# Intra-group Services

## Determination of the arm's length price...ctnd

### 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.

# Why Intangible Assets?

- Importance of intellectual property rights ( e.g. trademarks, patents and copyrights) to business has increased.
- ‘Key value drivers’ within an MNE group.
- Intangible assets account for 50%-70% of the market value of public companies.
- Value of intangible assets may exceed the combined value of all tangible assets held by a company.
- World’s most valuable brands (2017): <https://www.forbes.com/powerful-brands/list/#tab:rank>

# • Why Intangible Assets?

Inbox x Thomson Reuters - ONE x F The World's Most Valuable Brands x

Secure | <https://www.forbes.com/powerful-brands/list/#tab:rank>

## Forbes The World's Most Valuable Brands

2017 RANKING

Spreadsheet Reprints Logo Licensing

Filter list by: **Rank** Company All industries ▼ Search by brand name

Rank	Brand	Brand Value	1-Yr Value Change	Brand Revenue	Company Advertising	Industry
#1	Apple	\$170 B	10%	\$214.2 B	\$1.8 B	Technology
#2	Google	\$101.8 B	23%	\$80.5 B	\$3.9 B	Technology
#3	Microsoft	\$87 B	16%	\$85.3 B	\$1.6 B	Technology
#4	Facebook	\$73.5 B	40%	\$25.6 B	\$310 M	Technology

WON NOMINEES....xlsm Thomson Reuters ....pdf Thomson Reuters ....pdf Thomson Reuters ....pdf Show all x

3:35 PM 2/16/2018







# • Why Intangible Assets?

Inbox x F The World's Most Valuable Brands x

Secure | <https://www.forbes.com/powerful-brands/list/#tab:rank>

## Forbes The World's Most Valuable Brands 2017 RANKING

[f Share](#)  
[t Tweet](#)  
[in Share](#)  
[reddit](#)  
[+1](#)  
[Submit](#)

	#5	Coca-Cola	\$56.4 B	-4%	\$23 B	\$4 B	Beverages
	#6	Amazon	\$54.1 B	54%	\$133 B	\$5 B	Technology
	#7	Disney	\$43.9 B	11%	\$30.7 B	\$2.9 B	Leisure
	#8	Toyota	\$41.1 B	-2%	\$168.8 B	\$4.3 B	Automotive
	#9	McDonald's	\$40.3 B	3%	\$85 B	\$646 M	Restaurants
	#10	Samsung	\$38.2 B	6%	\$166.7 B	\$3.7 B	Technology

Windows taskbar: Internet Explorer, VLC, Chrome, Firefox, Word, PDF Reader, File Explorer, PowerPoint, System tray: 3:39 PM 2/16/2018



# Identification of 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)



# Identification of Intangible Assets

The following are not TP relevant intangibles:-

- 1) **Market specific characteristics** - may affect the prices paid for specific goods and services in a particular market. These may include:-
  - the high purchasing power of households in a particular market;
  - low prevailing labour costs,
  - proximity to markets,
  - favourable weather conditions.

# Identification of Intangible Assets

The following are not TP relevant intangibles---ctnd

- 2) **Group synergies-** may include:
  - streamlined management,
  - elimination of costly duplication of effort,
  - integrated systems,
  - purchasing or borrowing power,
- 3) **Assembled workforce-** Team of well-skilled and experienced staff. However, such employees may **transfer of know-how** or their work may lead to enhancement of existing intangibles.
- 4) **Location savings**

# Ownership of intangibles and value creating transactions

- Transfer pricing analysis requires identification of the parties within the MNE group who share in the exploitation of the intangible involved.
- Also, its important to identify which party or parties within the MNE that bear the cost associated with **development, maintenance, enhancement, protection and exploitation** (DEMPE) of the intangible.
- Members of the MNE group performing DEMPE functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle.
- The compensation is established in line with arms' length using appropriate TP method and having due regard to comparability analysis.
- Alignment of TP outcomes with value creation.

# Ownership of intangibles and value creating DEMPE transactions

- Generally, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible, as well as the right to prevent others from using or otherwise infringing the intangible.
- The legal owner will be considered to be the owner of the intangible for transfer pricing purposes.
- Identification of legal owner is simply a reference point when determining the arm's length compensation for the transactions relating to development, maintenance, enhancement, protection and exploitation of intangibles. **All members of the MNE group are entitled to return** based on their functions, assets and risks in relation to DEMPE transactions.

# Functional Analysis in DEMPE Transaction of Intangibles

## Examples of functions:-

- Design and control of research and development programmes;
- Control over strategic decisions regarding intangible development programmes,
- Management and control of budgets;
- Decisions regarding defence and protection of intangibles;
- Decisions regarding ongoing quality control.

## Examples of risks

- Risk of R&D failure;
- risk of product obsolescence;
- Risk of infringement;
- Product liability risk.

# Functional Analysis in DEMPE Transaction of Intangibles

## Examples of asset used:-

- Funding;
- Physical assets;
- Intangibles (know-how, patents, customer relationship)

## Arm's Length Compensation – DEMPE Transactions

- There are **two types of returns** from exploitation of intangibles :
  - 1) *Ex ante* - Anticipated/expected future income/cash flows;
  - 2) *Ex post* – Income actually earned from the intangibles.

Generally, intangible returns are determined based on *ex ante* approach. However adjustment are made by comparing the actual and anticipated returns. The difference is share depending on functional analysis.

# Arm's Length Compensation – DEMPE Transactions

## Transfer pricing Methods

- 1) Profit Split
- 2) CUP – Licensing of Intangibles
- 3) Intangible valuation methods



# Arm's Length Compensation – DEMPE Transactions

## Other Arm's Length considerations

### 1) *Enhancement of marketing intangibles*

- Is a distributor/marketer entitled to extra compensation above the distributor's margin?
- What are the terms of the contract/distribution license?
- Has the distributor incurred significant costs on advertisement, marketing and promotion (AMP) activities?
- Benchmarkings study is necessary to establish the level of AMP expenditure by comparable distributors.

# Arm's Length Compensation – DEMPE Transactions

## Other Arm's Length considerations

### 2) *Use of group name*

- Do you pay for use of group name?
- Generally no: Passive benefit. However, if there are expected commercial benefits there would be a charge.
- Test whether the user of the name is creating or enhancing the value of the name in its jurisdiction.
- Acquisition of existing successful business by another, say a foreign company may lead to questions as to who should be paying the other. Examples:-
  - Suzuki-Maruti Case
  - A local case; in court.

# Examples

- **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?*

# Examples

## 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?*

# Examples

## Example 3

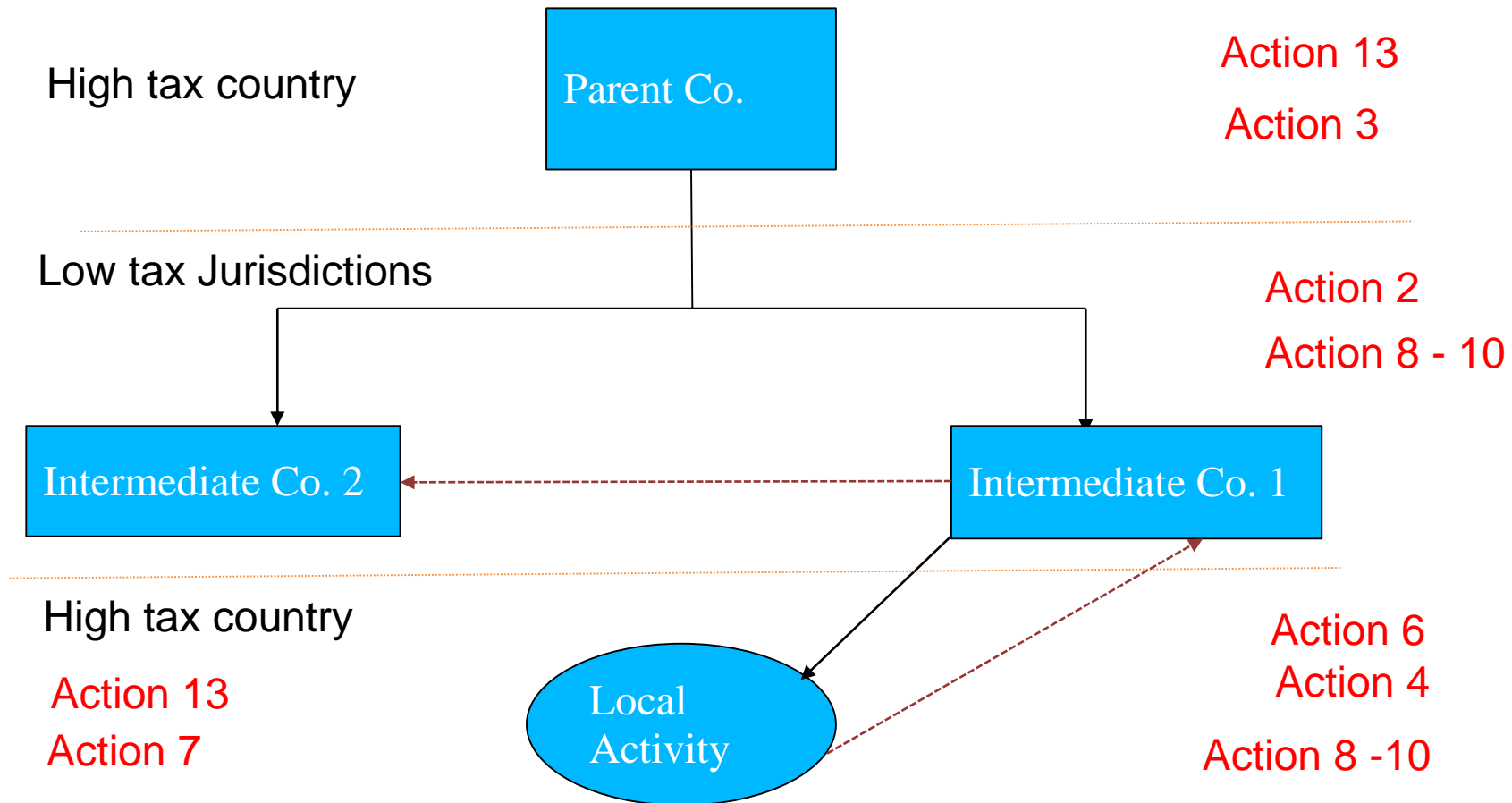
- Company A and Company B are members of an MNE group that sells electronic appliances. Company A is responsible for product design, development and manufacturing whereas Company B undertakes marketing functions and the global distribution of the goods. For the manufacturing of the products, Company 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)**
- Comparability analysis for intangibles licensing transactions
- Valuation of intangibles
- Hard to value intangibles

# TP Relevant BEPS Actions

- Some Key Action Plans



# END

- Q&A