Transfer Pricing Principles

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Introduction, African overview and TP methods

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Background

Background

- Transfer Pricing is a mechanism for the pricing of goods and services between related entities:
  - Tangible Goods;
  - Intangible Goods – trademarks, trade-names, patents; and
  - Services – management, engineering, after-sales services

Background…cnt'd

- Mechanism to provide the conceptual framework for *pricing intercompany transactions*
- Ensuring an appropriate allocation of income between the various tax jurisdictions in which a multinational company operates

Background…cnt'd

A Simple Example

Kenya Co

Sales	100
Cost of Goods	(70)
Gross Profit	30
Operating Expenses	(25)
Operating Profit	5

This is the profit and loss statement of a Kenya distribution company

Does it have any transfer pricing issues?

Does it have any transfer pricing risk exposure?

In isolation, it is impossible to assess anything!

Background…cnt'd

Simple Intra - Group Transaction

Kenya Co → *Product transfer* → **Uganda Co**

Uganda Co → *Transfer price = 70 KShs 7 per unit* → **Kenya Co**

Sales	70
Total Costs	(60)
Operating Profit	10

Sales	100
Cost of Goods	(70)
Gross Profit	30
Operating Expenses	(25)
Operating Profit	5

Consolidated Operating Profit = 15

Background…cnt'd

Effect of Higher Transfer Price

Product transfer

Kenya Co → **Uganda Co**

Uganda Co → **Kenya Co**

Transfer price = 80
At KShs 8 per unit

Kenya Co

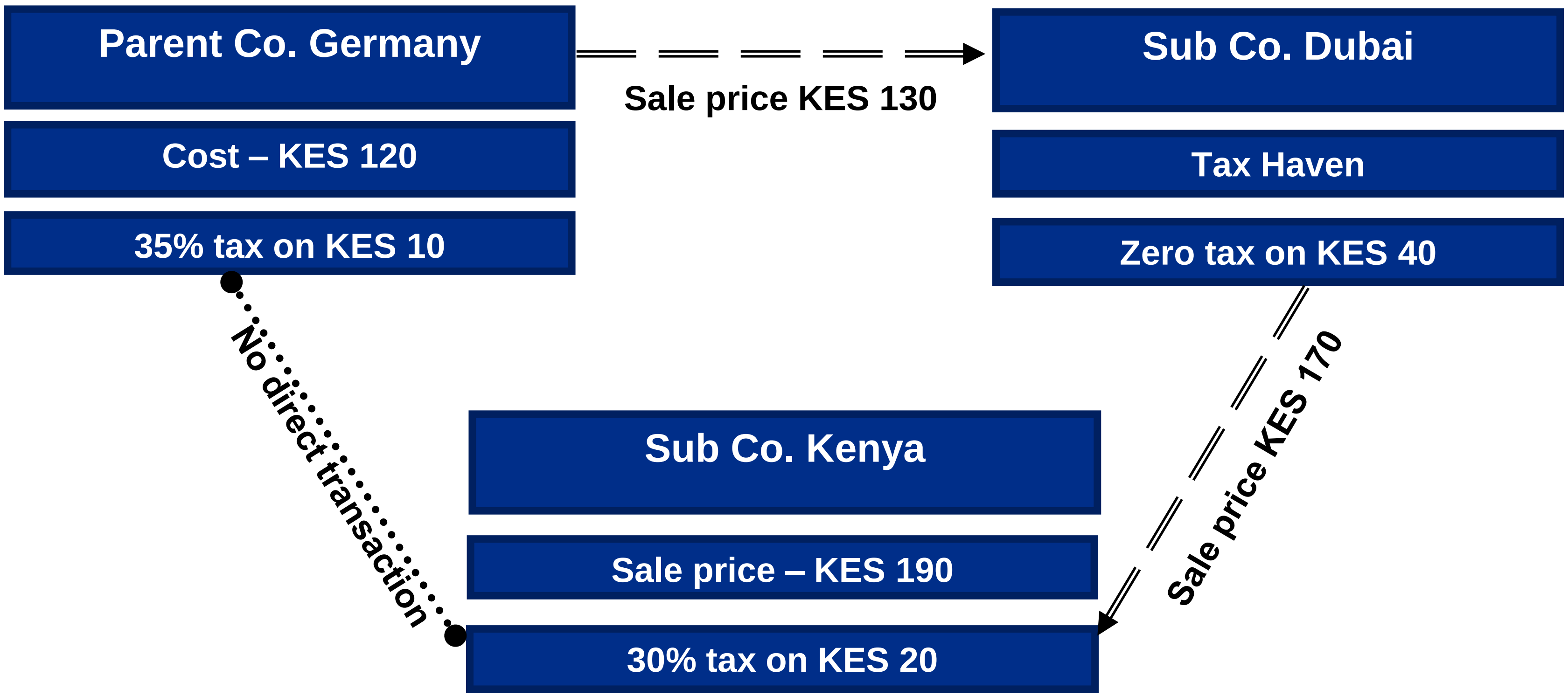
Sales	80
Total Costs	(60)
Operating Profit	20

Uganda Co

Sales	100
Cost of Goods	(80)
Gross Profit	20
Operating expenses	25
Operating loss	-5

Consolidated Operating Profit = 15

Background...cnt'd



To prevent shifting out of profits by manipulating prices

TP is jurisdictional

- Transfer pricing for tax purposes is governed by local jurisdictional authorities

- More and more countries have issued formal rules regulating transfer pricing practices

- Accompanied by documentation requirements and penalty provisions for non-compliance.

TP in Africa

Crux of the matter

Governments under extreme fiscal pressure

Focus on perceived tax avoidance by MNEs

Develop a tax system that is fit for purpose

Establishment of TP

- The negotiations by OECD members, the G20 and non-OECD members (including African countries) on an equal-footing basis

- Aim - to fix a global tax system believed by some to allow MNEs to reduce their effective tax rate in a jurisdiction without corresponding reduction in value-creating economic activities

Establishment of TP

- **Concern - international tax rules designed more than a century ago and may no longer be adequate to address the current business environment, especially in Africa**

Establishment of TP

- Several institutions particularly focused on getting transfer pricing regimes established in Africa:
  - The United Nations (UN);
  - The Organisation for Economic Cooperation and Development (OECD);
  - The European Commission (EC); and
  - African Governments

Establishment of TP

- The 2017 edition of the OECD TP Guidelines incorporates substantial revisions made in 2016 2016 to reflect the clarifications revisions agreed in the 2015 BEPS Reports

- TP regulations based on the Guidelines have been implemented in several African Countries

Establishment of TP

- **The 2017 edition of the UN Practical Manual is a response to the need for clearer guidance on the policy and administrative aspects of applying TP analysis to MNEs' transactions in developing countries**

KPMG

Arm's length principle

ICPAK
Uphold Public Interest

- **Most appropriate transfer pricing regime for implementation of the arm's length principle (ALP):**
  - **OECD Guidelines – resource-intensive and costly for developing countries**
  - **UN Practical Manual on Transfer Pricing for Developing Countries (UN Practical Manual)**
  - **Local legislation and regulations**

General provisions

- **Revenue Authorities - ALP**
  - **E.g in Kenya Commissioner empowered to adjust the profits for related party transactions**
- **Related party**
  - **Company's direct or indirect participation in the management, control or capital**
  - **Third party's direct or indirect participation in both companies**

TP Rules/Regulations

TP Rules/Regulation - Purpose

- Some countries

- To provide guidelines in determining the arm's length prices

- To provide administrative regulations, including the types of records and documentation to be submitted

TP Rules/Regulatiosn

❖ TP Rules/Regulations - Scope:

- Between associated enterprises
- Mostly one enterprise is **subjected to tax in that jurisdiction** and the other enterprise is **outside** the tax jurisdiction/in preferential tax regime
- Transactions **between PE** and **its head office** or other related branches

Transactions

❖Transactions:

- the purchase or sale of goods and services;
- the sale, purchase or lease of tangible assets;
- the transfer, sale, 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 the enterprise involved

TP Methods

Summary of TP Methods

- The price if the parties to the transaction were unrelated

- Different TP methodologies for assessing the arm’s length nature of intra-group trading

Summary of TP Methods

- Consideration - TP Rules/Regulations and the 2017 OECD Guidelines

- The onus is on the taxpayer

Summary of TP Methods

❖ Factors to be taken into account

- **The degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables**

- **The quality of the data and assumptions used in the analysis**

Most appropriate method

- **"Prescribed" methods (Rule 7 - Kenya):**
  - **Best suited to the facts and circumstances of each transaction; and**
  - **Provides the most reliable measure of an arm's length price - "Most Appropriate Method"**

Prescribed methods

Prescribed Methods

- **Cost (Traditional) Methods**
  - CUP Method
  - RP Method
  - CP Method
- **Transactional/Profit Methods**
  - PS Method
  - TNM Method

No hierarchy or preference of methods prescribed under the Guidelines

"Any other method that may be prescribed by the Commissioner where it may not be possible to apply the above methods"

Validity of method

- **Validity of these methods depends on:**
  - **The circumstances of the tested party**
  - **The availability of comparable data**
  - **OECD Guidelines on the most appropriate method (the one that gives the most reliable results)**

CUP

- **Comparable Uncontrolled Price (CUP)**
  - **The transfer price in a controlled transaction is compared with that in an uncontrolled transaction**
  - **Accurate adjustments may be made to eliminate material price differences**

CUP

- Comparable Uncontrolled Price (CUP)
  - Internal CUP
  - External CUP

RPM

❖ Resale Price Method (RPM)

- Price of the product is compared with the resale price at which the product is sold to an independent enterprise
- The resale price is reduced by the resale price margin

CPM

❖ Cost Plus Method (CPM)

- Costs incurred by the supplier of a product in a controlled transaction are assessed

- A mark-up is then added to make an appropriate profit in light of the functions performed, and the assets used and risks assumed

PSM

❖ Profit Split Method (PSM)

- Profits earned in very closely interrelated controlled transactions is split among the related enterprises

- Split dependent on the functions performed in relation to the transaction, and compared with a profit split among independent enterprises in a joint venture

TNMM

- **Transactional Net Margin Method (TNMM)**
  - **The net profit margin attained by a multinational enterprise in a controlled transaction is compared to the net profit margin that would have been earned in comparable transactions by an independent enterprise**

Summary

Methods	Comparability	Approach	Remarks
CUP	Very High	Prices are benchmarked	Very high degree of comparability required
RPM	High	Benchmark on sales	Higher degree of comparability required
CPM	High	Benchmark on costs	High degree of comparability required
PSM	Medium	Profit Margins	Sparingly used - complexities of attributing profit
TNMM	Medium	Benchmark on net profit margins	Most commonly – focus on bottom line

Q&A