

Transfer pricing

The Interaction between TP, Customs and VAT

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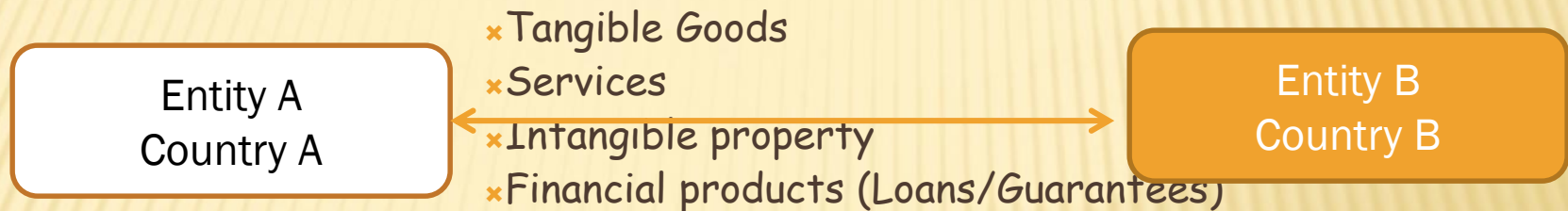
Agenda

- ✦ Introduction
- ✦ Common features and Natural conflicts between TP, Customs and VAT
- ✦ Transfer Pricing Adjustments
- ✦ Global / regional considerations

Introduction

Underlying principles of transfer pricing

✗ Intercompany transactions



✗ Article 9 of the MTC defines the arm's length principle as:

"If conditions are made or imposed between the two (associated) enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then profits that, but for those conditions, would have accrued to one of the enterprises may be included in the profits of that enterprise and taxed"

Based on functions performed, risks assumed and assets used

Direct impact on profitability of an enterprise and with that, on income tax

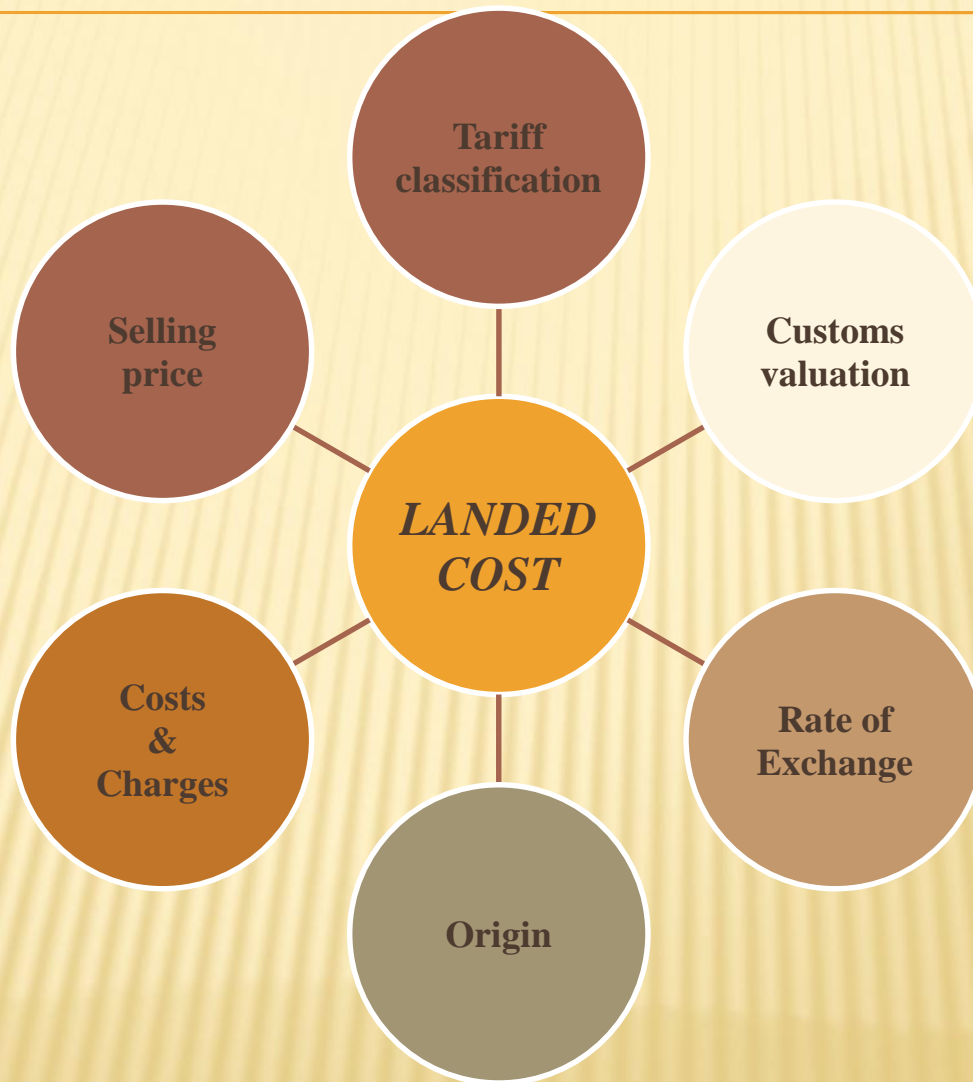
Underlying principles of VAT

- ✗ VAT - a multi-point destination based system of taxation: tax levied on value addition at each stage of transaction in the production / distribution chain
- ✗ Transaction-based
- ✗ Goods or services
- ✗ The value is determined by agreement (exceptions exist)
 - ✗ Upon import value: linked to customs
- ✗ Documents / Invoices / reports

Underlying principles of Customs

- ✗ Based on the “physical” movement of goods into a country (not necessarily a sale)
- ✗ Seven ways to define value (global framework)
- ✗ Documents, value must be known upon import, immediate reporting
- ✗ Handled by related or third parties – but you are always liable

Commercial relevance for customs / VAT



Transfer pricing, Customs & VAT:

Conceptual framework

Transfer Pricing / Direct Tax	Customs and VAT
OECD Guidelines	WTO/GATT rules
Focused on profit/margin	Focused on transaction value
Local legislation on the rise	Legislation in existence
TP documentation	Invoicing and customs documents
Functions and profits	Customs valuation rules
Possible aggregation of transactions	No off set of transactions allowed
High prices result in lower tax amounts (inbound)	High prices result in higher tax amounts (duties/VAT)
Some say it has been around almost 100 years	It is the oldest tax in the world

Transfer pricing, Customs & VAT: Methods

Methods	Transfer pricing	Customs
Transaction based methods	Comparable uncontrolled Price (CUP)	Transaction value of the Merchandised product
		Transaction value of identical Goods method
		Transaction value of Similar Goods Methods
	Resale Price Method (RPM)	Deductive method
Profit-based methods	Cost Plus method (CPM)	Compute Method Derivative Method
		Fall-back method
	Profit split method (PSM)	
	Transactional Net Margin Method (TNMM)	

Common features and natural conflicts between TP, Customs and VAT

Potential conflict?

- ✗ Can there be a mismatch between TP and Customs/VAT
 - ✗ If so, which will prevail
 - ✗ Impact on both sides of the border
 - ✗ Statute of limitation
 - ✗ Timing
 - ✗ Which transactions
 - ✗ Statistical obligations
 - ✗ Document requirements
 - ✗ How do tax offices deal with this
 - ✗ How do you deal with this

Interplay between transfer pricing, customs and VAT

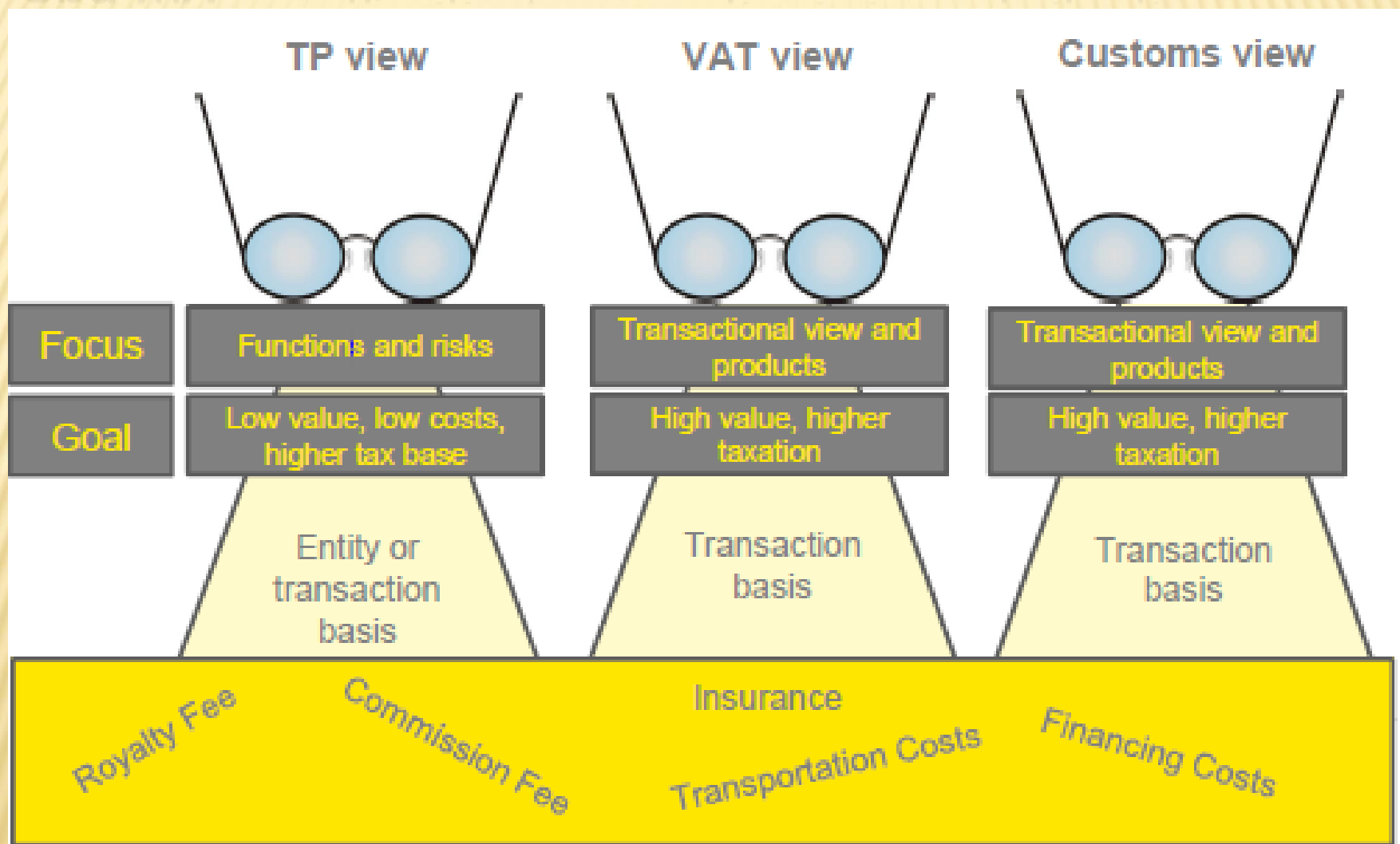


✗ Questions to consider:

- ✗ Is the price arm's length?
- ✗ Can the royalty be separated from the product price for customs and VAT purposes
- ✗ Is documentation necessary?
- ✗ What if the price changes retrospectively?



Potential conflict between transfer pricing, customs and VAT – authorities' perspective in import situations



Conflicts arising from the authorities' perspective

Viewpoint from a pure
revenue collection
perspective

Lower transfer price

Results in:

Less deductible expenses

More taxable profit

Customs duty

Income Tax

Viewpoint from a pure
revenue collection
perspective

Higher transfer price

Results in:

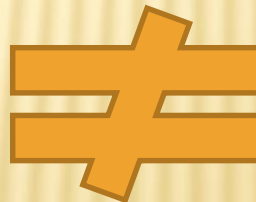
More deductible expenses

Higher customs value

Higher authority income

Customs Duty

Income Tax






Transfer Pricing Adjustments

Transfer pricing adjustments

- ✗ Increased prevalence of transfer pricing adjustments
- ✗ Markets and business fluctuates
- ✗ Even with the best models and predictions, reality may be different
- ✗ Practical implications:
 - ✗ Transfer pricing: documentation, guidelines, agreements
 - ✗ VAT: Reporting and document requirements, refunds, payments
 - ✗ Customs: Reporting and documentation requirements, refunds, payments, rebates
 - ✗ Exchange control

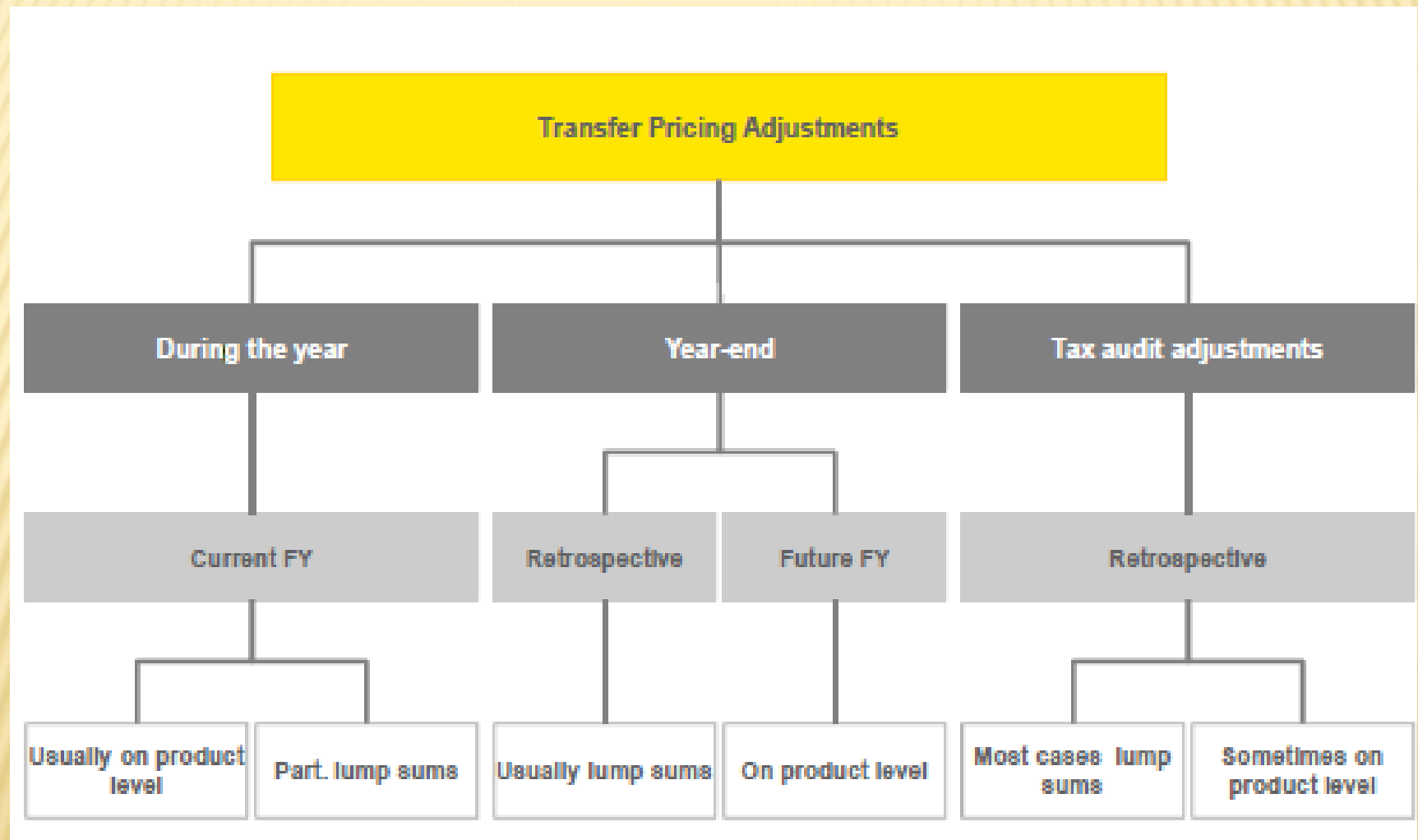
Transfer pricing adjustments: types

Transfer pricing adjustments		
During the year	Year-end	Tax audit adjustments
<ul style="list-style-type: none"> ✗ Predictable that budgeted values won't be reached (e.g. due to sales slump) ✗ Adjustments of transfer prices according to the modified budgeted values 	<ul style="list-style-type: none"> ✗ Target / actual comparison shows differences between target and actual ✗ Retroactive transfer pricing adjustments in order to reach target (usually OM) 	<ul style="list-style-type: none"> ✗ During the tax audit transfer prices get adjusted between related entities ✗ May increase taxable profits in KE (i.e. inbound case: decrease, outbound case: increase)
		
Upstream and downstream adjustment	Upstream and downstream adjustment	Single-sided adjustment

✗ Requirements for TP adjustments

- ✗ Agreed upon before adjustments period takes place (agreement)
- ✗ All pricing factors are named in detail in the agreement
- ✗ Reasons for adjustments are outside of the control of transaction parties

Transfer pricing adjustments: types



Retroactive adjustment

- ✦ A retroactive transfer price adjustment is one of the following three
 1. Allocation of profit from one entity to another entity
 2. A service
 3. An amendment to previously agreed transaction prices

Retroactive adjustment

1. Allocation of profit from one entity to another entity
 - + Could be capital, could be dividends (what if there is no direct shareholding)
 - + No VAT consequences, there is no consideration for a supply
 - + Impact on customs value

Retroactive adjustment

2 A service

- + What is the nature of the service
- + Contractual arrangements
- + What if the consideration is negative
- + Exchange control

Retroactive adjustment

- 3 An amendment to previously agreed transaction prices, amounting to real revaluation
- ✗ Probably VAT consequences depending on:
 - + Does this affect the prior consideration for VAT
 - + Is the prior supply of goods corrected: discount or additional payments?
 - + Are all products and periods equal - in what period must it be reported?
 - + Must invoices be re-issued
 - + Has too much or too little customs duties / VAT been paid - refunds?
 - + What is the legal basis for the adjustment
 - + What does it mean for the original import
 - + Documentary / Invoice requirements

Transfer pricing adjustments - conclusion

- ✗ Retroactive transfer price increase = potential customs value increase
- ✗ Retroactive transfer price decrease = potential customs value decrease
- ✗ The key questions to ask when a transfer pricing adjustment is made to the value of the goods (either up or down):
 - ✗ Do local customs authorities require reporting of the adjustment?
 - ✗ What is the implication of the adjustment on foreign exchange controls?
 - ✗ What is required to implement the adjustment?
 - ✗ Is the importer liable to pay additional customs duties?
 - ✗ Can the importer obtain refunds of customs duty?
 - ✗ Will there be interest and/or penalties?
 - ✗ Is there any risk of penalties for underpayment of provisional taxes?

Global considerations

International debate

- ✗ WCO GUIDE TO CUSTOMS VALUATION AND TRANSFER PRICING - June 2015
 - ✗ A few quotes:
 - ✗ *..This methodology, based on the 'arm's length principle, is generally accepted as the international standard used by businesses and tax authorities...*
 - ✗ *..Many countries have confirmed that the transaction value is used in 90-95% of all importations...*
 - ✗ *..It has been recognised that at this stage any alignment or merger of tax and Customs methodologies is **not a realistic proposition** given the particulars of the existing legal frameworks upon which they are based...*

International debate

- ✖ WCO GUIDE TO CUSTOMS VALUATION AND TRANSFER PRICING - June 2015
- ✖ International Chamber of Commerce express 2 main concerns:
 - ✖ *..Tax and Customs administrations, even within one country ...have **different approaches**... while both administrations seek to achieve the same goal, which is arm's length pricing, revenue interest in the transaction still remain at odds with each other....*
 - ✖ *..Tax and Customs administrations often set rules independently for the same transaction/good...*
 - ✖ *..Given that intercompany transactions account for more than 60% of global trade in terms of value, the divergence of customs and transfer pricing valuation presents an obstacle to the liberalization of trade and inhibits international development for companies of all sizes...*

So what does this mean for you?

- ✗ Will authorities listen to this?
- ✗ Can you use it today/tomorrow?
- ✗ Are there solutions or only problems?
- ✗ What should you do?

Questions/ Comments

