TRANSFER PRICING

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Friday,12th April 2019

Uphold public interest

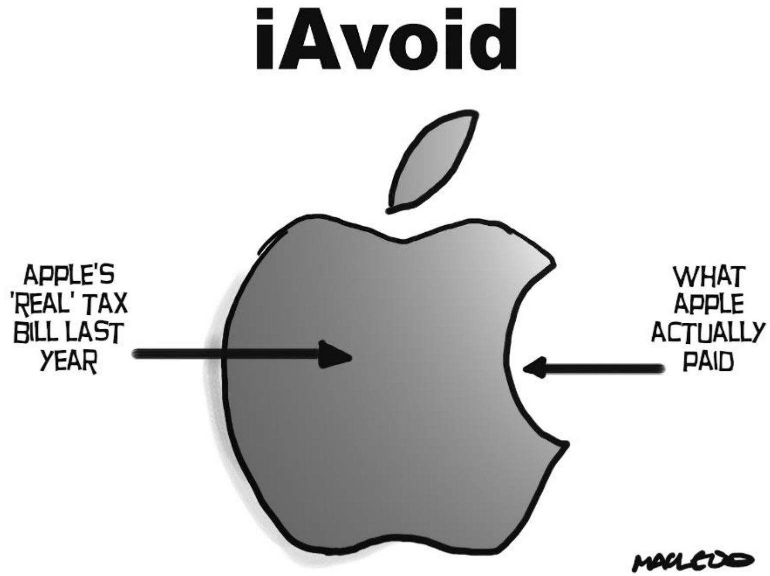
Presentation agenda

- Transfer Pricing – Key Highlights
- Transfer Pricing Methods
- Recent Cases in Kenya
- Case Studies
- Recent Changes and Emerging Issues

Transfer? (Mis)Pricing?

TRANSFER FEES?

TRANSFER PRICE?



What is Transfer Pricing?

Horngren, Foster and Datar (1996) ;Define transfer pricing as a price that a unit, segment, department, division, etc. charge for a product or service provided to another subunit of the same organization.
In Taxation realms, transfer pricing is predominantly an international matter.

Treaties incorporating Provisions based on Article 9(1) and 7(2) of The OECD and UN Model tax Conventions set the arms length principle as the boundary for applying each of the contracting states domestic legislation in relation to transactions that fall within their scope.

What is Transfer Pricing?

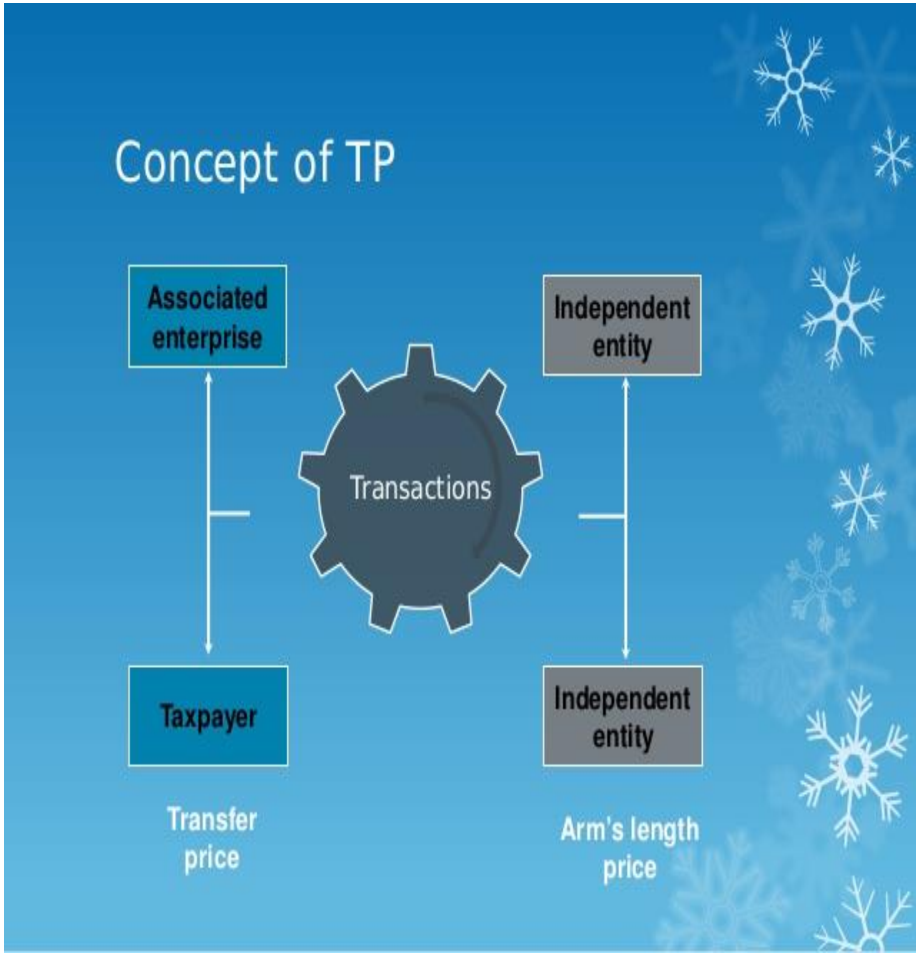
Article 9(1) of the OECD MTC Provides that

Where,

a) an enterprise of a Contracting State participates directly or indirectly in the **management, control or capital** of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case **conditions** are made or imposed between the two 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.

What is Transfer pricing?



Key Elements of Transfer Pricing.

- Association-Cross border or even local (SEZs and EPZs)
- Conditions
- Commercial or financial relations
- Independent
- Re-writing of books

Legislation

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

*18(3) Where a **non-resident person** carries on **business** with **a related resident person** and the course of such business is such that it produces to the resident person 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 such resident person or through its **permanent establishment** from such business shall be deemed to be of such an amount as might have been expected to accrue if the course of that business had been conducted by independent persons dealing at **arm's length*** **(Emphasis is mine)**

The term" non-resident" is now expanded to include SEZs and EPZs- Sec 18A L.N 15 of 2017.

Legislation...

Unilever Kenya Ltd v Commissioner of Income Tax

Contract to manufacture and distribute household goods to Unilever in the region.

KRA averred that the prices that were charged by UKL for the goods produced under the contract were not at arm's length (lower than what it sold to local customers) i.e. (Some) Cost plus 5% resulting into a loss for the Kenyan company.

KRA relied on Sec 18(3) as it were, to adjust profits to reflect arm's length by comparing price between related and unrelated customers in Uganda. UKL relied on OECD guidelines to come up with "transfer price based on cost plus".

It was held that the section 18(3) could not be relied upon without guidelines including the OECD Guidelines.

The case set the stage for TP Guidelines of 2006.

Legislation....

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

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
- administrative regulations, including the types of records and

Legislation....

- 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

Provides for 5 methods-Rule 7

CUP, RPM, CPM, PSM ,TNMM and the 6thmethod.

Legislation….

Transactions subject to TP Rules-Rule 6

- 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

Comparability and Arm's Length Principle.

OECD Guidelines (2017) 1.33-1.36; Chapter I

- Central to the application of the arm's length principle is comparability analysis which is a comparison of the economically relevant characteristics of a controlled transaction with the economically relevant characteristics of transactions between independent enterprises.
- To establish the degree of actual comparability it is necessary to compare the controlled and uncontrolled transactions based on 5 comparability factors:

Comparability ....

- Characteristic of property or services
- Functional Analysis
- Contractual Terms
- Economic Circumstances
- Business strategies

The importance of each factor will vary from case to case and depending on the Transfer Pricing method used.

TP Methods

Transfer pricing methods

Traditional transaction methods

- Comparable uncontrolled price method
- Resale price method
- Cost-plus method

Transactional profit methods

- Transactional net margin method
- Profit split method
  - Contribution analysis
  - Residual analyses

Other methods

(provided the transfer prices satisfy the arm's-length principle)

Transfer Pricing Methods

Selection of the most appropriate method OECD Guidelines 2.2 -2.8; Chapter II

The appropriateness of the method is based on a consideration of:

- the respective strengths and weaknesses of each method;
- the nature of the controlled transaction;
- the degree of comparability between controlled and uncontrolled transactions; and
- the availability of reliable information needed to apply the selected method

TP Methods …

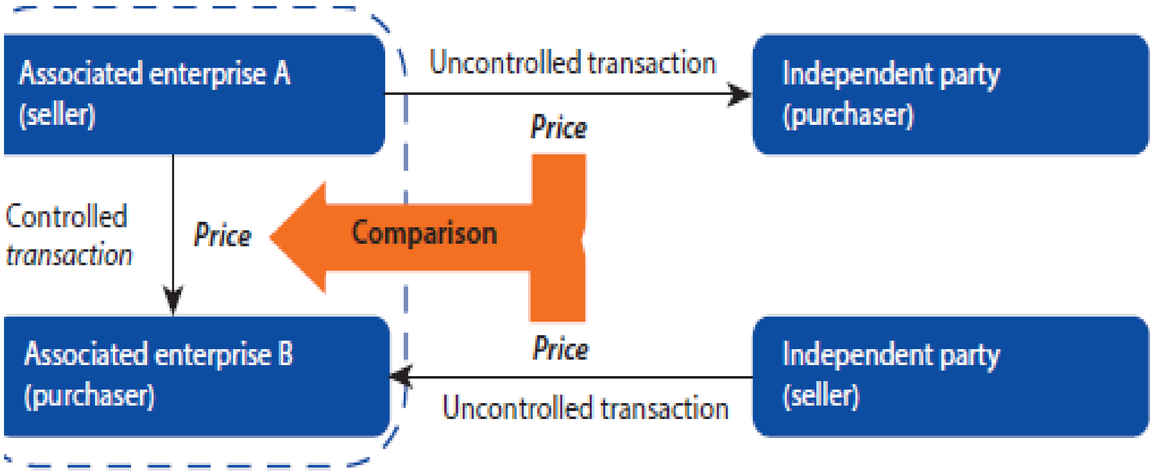
There is no hierarchy of methods, however:

- Where, after taking account of the above, the CUP and another method can be applied in an equally reliable manner, the CUP method is preferred (OECD Guidelines 2.3).
- This is because it provides a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction.

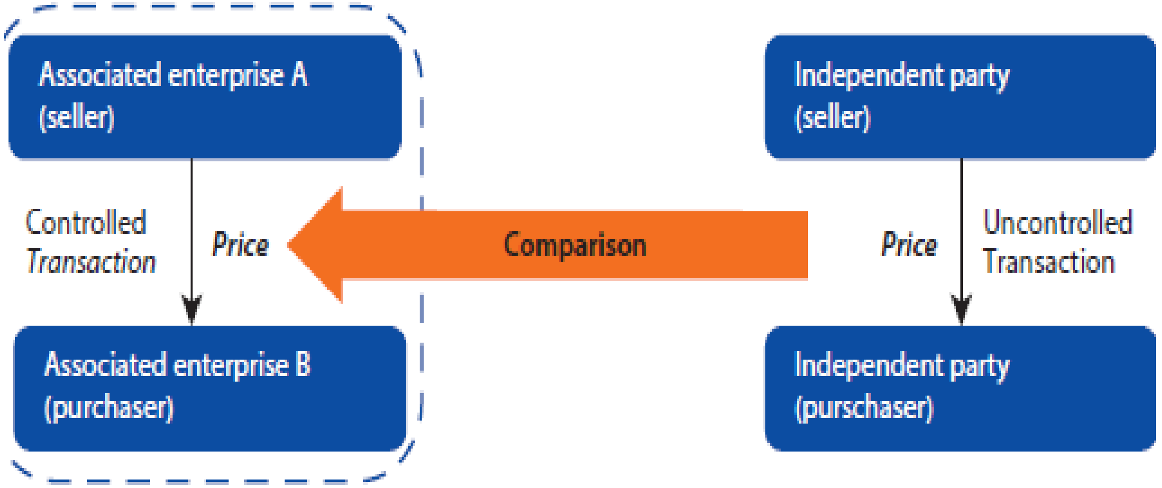
Comparable Uncontrolled Price (CUP) Method

- The CUP method involves a comparison of the prices charged in the controlled transactions with the prices charged for comparable goods or services(including financial and intangible property) in uncontrolled transactions.
- Prices that differ may indicate that the conditions of the controlled transaction are not consistent with the arm’s-length principle.
- Minor price differences may have a material impact on the condition being examined hence it requires high standard of comparability relative to the other transfer pricing methods.

Types of CUP



Internal Cup



External Cup

CUP Method…

The main strengths of the CUP method are

(a) it requires a detailed transaction analysis,

(b) because the price in the transaction is the subject of the analysis, it is not a one-sided analysis (no sided). There is, therefore, no requirement to select a tested party, and

(c) The method is not affected by accounting principles as to say costs.

CUP Methods….

Difficulties in application include;

- High Degree of comparability of the products and the transaction.
- Detailed information about transactions is often not publicly available.
- Where available, such transactions often are not comparable for the purposes of applying the CUP method. For example, similar transactions with independent parties may have been entered into at a different level in the market or in different geographic markets.

Adjustments to CUP….

Where potentially comparable transactions are identified, but there are one or more differences that materially affect the price, comparability adjustments may be possible to neutralize this effect. Examples may include the effect of

- Quantity discounts, delivery terms, contractual terms, and minor product differences.

Some differences may be impossible to account for by making adjustments, such as

- differences in geographical market, branding (trademarks) or valuable intangibles, functional differences, and significant contractual differences.

Applicability of CUP ....

The most common examples of the CUP method being successfully applied in practice include;

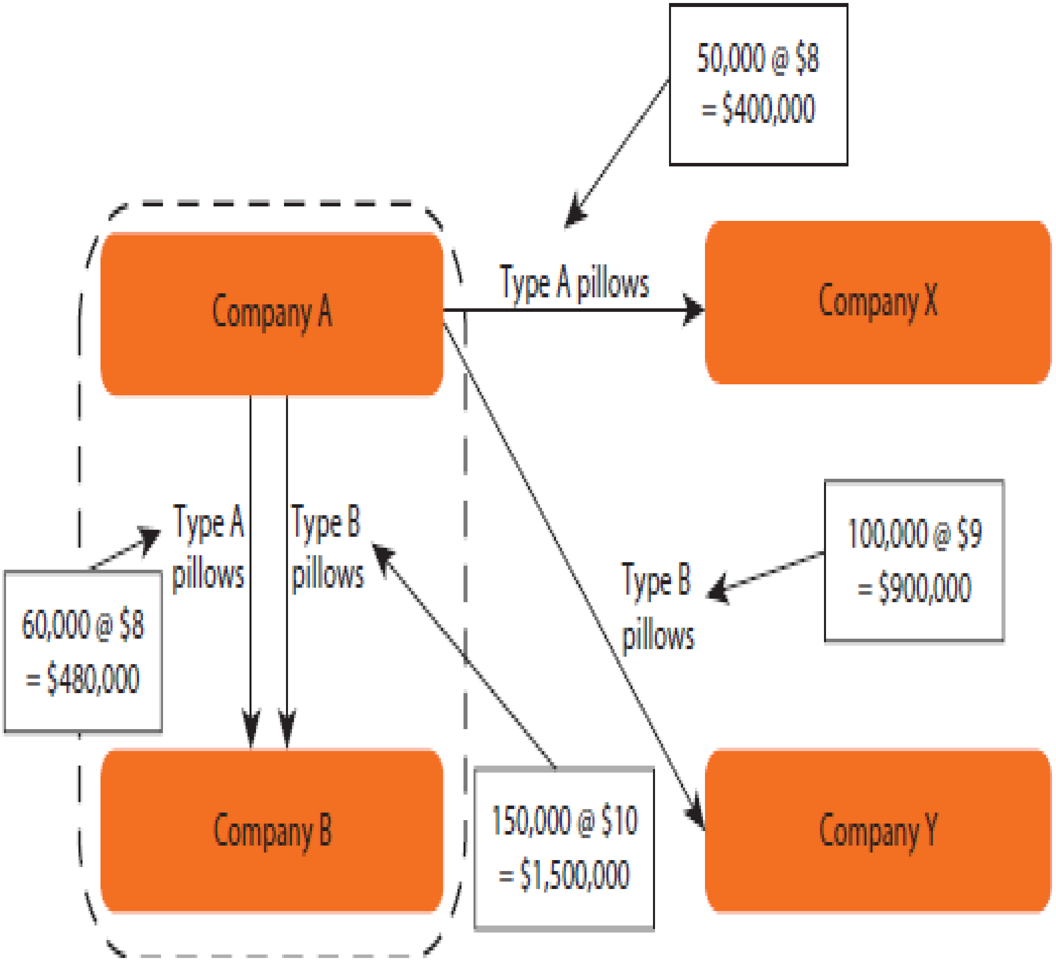
- Cases where internal comparable exist (tangible goods, services, royalty rates, etc.)
- Certain commodities transactions
- Financial transactions (interest rates on loans, guarantee fees etc.)

CUP Case Study….

Company A and Company B are associated parties. Company A manufactures pillows (Type A and Type B), which it sells to Company B, which distributes the pillows in its local market.

Company A also sells Type A pillows to Company X and Type B pillows to Company Y, both of which are independent distributors in the same local markets (quantities and prices as specified).

Case Study



Assume

- The sales of Type A pillows to Company X are comparable to the sales of Type A pillows to Company B.
- The sales of Type B pillows to Company Y are comparable to the sales of Type B pillows to Company B, except for a 10 percent quantity discount that was provided to Company Y.
- Further research reveals that this discount is provided to all independent customers purchasing over 100,000 units per annum.annum.

Case Study

- The price charged for the sales of Type A pillows to Company B appears to satisfy the arm's length principle– *no adjustment required.*
- The price charged for the sales of Type B pillows to Company B does not appear to satisfy the arm's-length principle– *adjustment may be required.*

Possible adjustment: Reduction in price charged by 10 percent (resulting in the arm's length price being US$9) to afford Company B the same quantity discount that independent parties are afforded, i.e., decrease total price charged by US$150,000, increasing Company B's profit by US$150,000 and decreasing Company A's profit by US$150,000.

RESALE PRICE METHOD….

- This method starts with the price at which the product under controlled transaction is resold to an independent enterprise (The “Resale Price”) which is the reduced by an appropriate gross profit margin (“Resale price margin”) to determine the arm’s length price.
- It is a one sided method as the resellers margin is examined hence the tested party has to be selected.
- The appropriate resale price margin may be determined by reference to the gross profit margins earned in internal by external comparable.

RESALE PRICE METHOD….

Functional analysis is key since parties with comparable profiles are compensated similarly.

The method is applicable in;

- A reseller purchases products for resale from associated parties and independent parties, but due to product differences the CUP method cannot be applied e.g. toasters and blenders;
- Typically used for testing a reseller/distributor who has not added substantial value to the products for example, making physical modifications, contribution of valuable intangible property, or significant marketing activities.
- Commissionaires and agents not undertaking significant marketing activities.

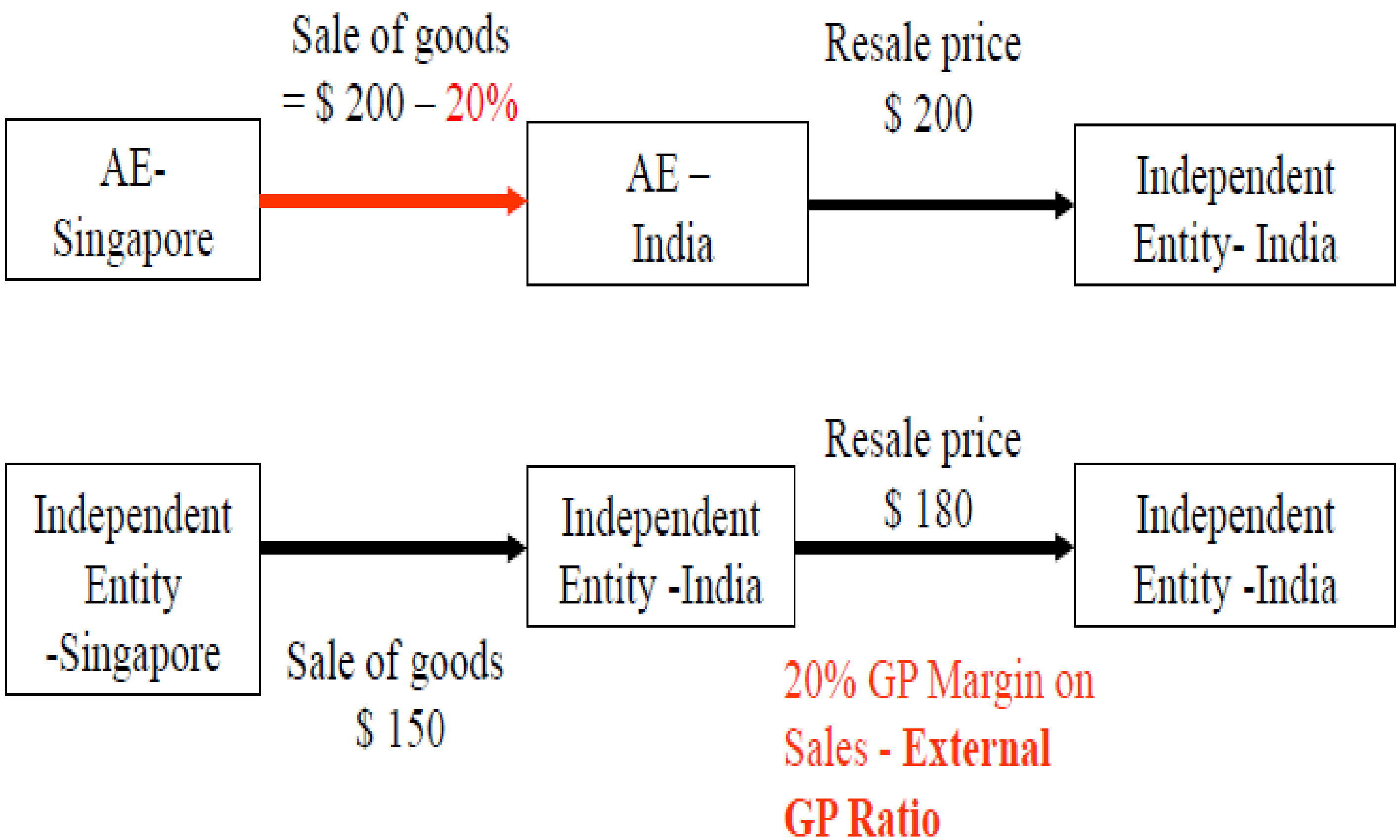
RPM Application….

- Differences such as Inventory Levels, Contractual Terms, Accounting practices need to be adjusted for:
- The practical application of this method may pose various difficulties due to Differential accounting policies followed by the enterprises;

– E.g.: Some companies include exchange loss or gain in purchase / sale whereas some companies show it as part of administrative and other expenses.

– E.g.: Some companies include excise duty on purchase in Purchase A/c whereas some companies show it as part of rent, rates and taxes.

RPM Case Study



COST PLUS METHOD (CPM)….

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- The method Considers the costs incurred by the supplier of property or services in a controlled transaction supplying to an associated purchaser. An appropriate "cost plus mark up" is then added to this cost.
- Accounting consistency—particularly the composition of the relevant cost base is paramount to the reliable application of the cost-plus method.
- The cost-plus markup represents the margin that a supplier of the relevant goods or services would seek to make to cover costs, taking into account the functions performed, assets employed, and risks assumed.

CPM....

- As with the resale price method, close similarity of products is less important as compared to CUP method while functional comparability is more important.

This method is applied in;

- Sales of products where the manufacturer, such as a contract manufacturer, does not contribute valuable intangible property or incur substantial risks
- Intragroup services (e.g., contract R&D, toll manufacturing, etc.)

CPM….

Material difference in FAR or other factors affecting gross profit margin need to be adjusted to the Cost Plus method. Includes;

- ***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

Transactional Net Margin Method (TNMM)

- The TNMM examines an appropriate financial indicator (based on net profit) that the tested party realizes in controlled transactions and compares it with that realized in uncontrolled 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 take into account the effects on profits of product life cycles and short term economic conditions.

TNMM....

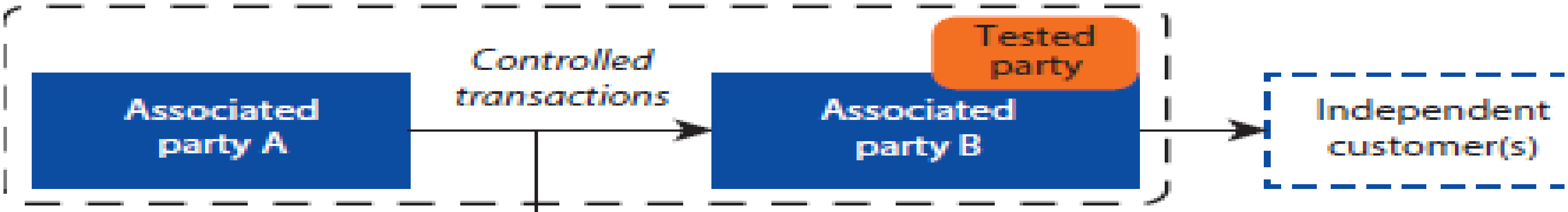
- TNMM becomes inevitable where the assessee has interlinked transactions of purchase and sale from / to related parties where they cannot be benchmarked isolated
- Procedure for application Selection of the tested party

1. Period of Comparison
2. Aggregation of Transactions
3. Identification of Comparable entities
4. Profit Level Indicators
5. Adjustment Calculations

Profit Level Indicators

Financial indicators		Tested party	Examples of use
Operating profit margin (also "EBIT/sales ratio") ROS	Operating profit[a]/sales	Party earning sales income	Distribution enterprises
Return on total costs (also "full cost-plus markup") FCM	Operating profit/total costs	Party incurring costs	Service providers and manufacturers
Berry ratio	Gross profit/operating expenses	Party incurring operating expenses	Distribution enterprises
ROA	Operating profit/assets[b]	Party holding and employing assets	Asset-intense activities
ROCE	Operating profit/capital employed[c]	Party with capital employed	Asset/capital-intense activities

TNMM Case Study



Revenues:	25,000,000
Cost of goods sold:	20,000,000
Operating costs:	5,312,500
Operating profit:	687,500
Return on sales (%):	2.75

Comparison

	Return on total costs (%)
Comparable A	2.00
Comparable B	2.37
Comparable C	2.89
Comparable D	3.5
Comparable E	3.11

Arm's-length range: 2.0–3.5%

Profit Split Method (PSM)

PSM evaluates whether the allocation of the combined profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined profit or loss

PSM Continued

PSM is usually appropriate when:

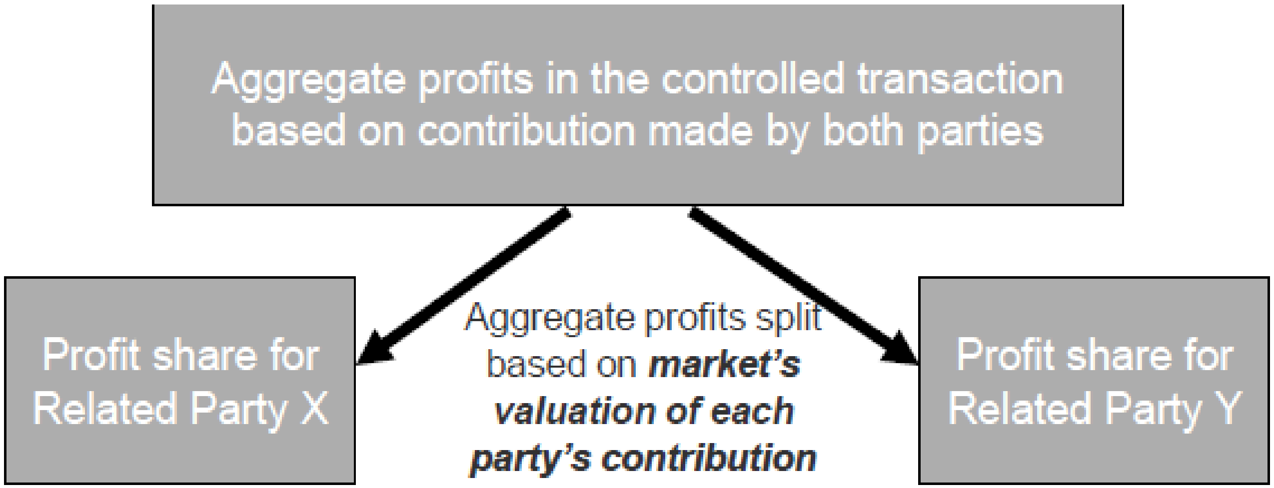
– Operations are highly integrated for which a one-sided method would not be appropriate

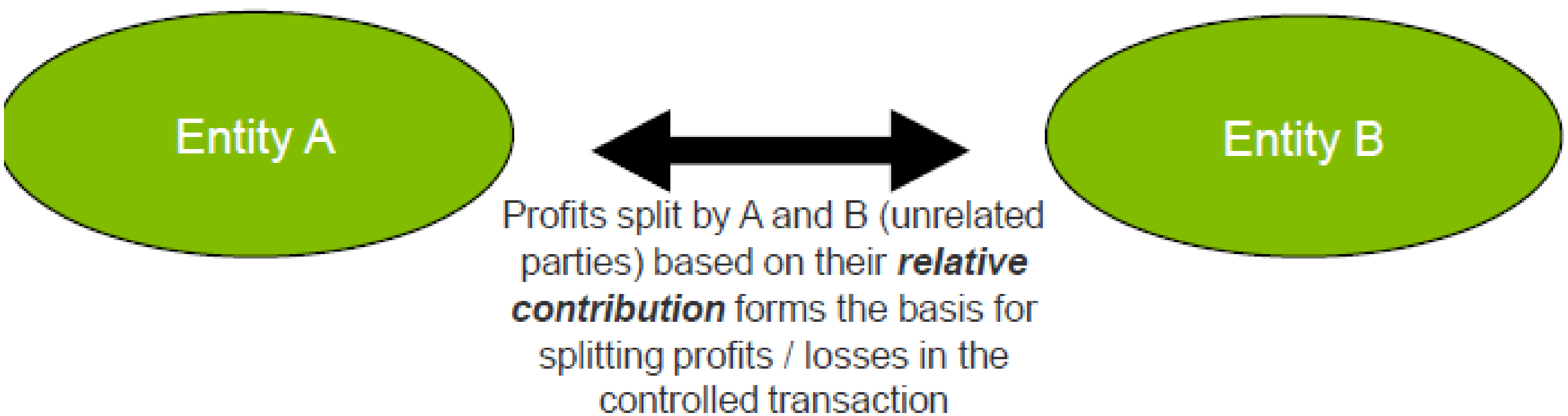
– Parties to the transaction make unique and valuable contributions and profit arising to the group cannot be assigned to one of the entities of the group

– Adequate comparable are unavailable to set margins for all the entities

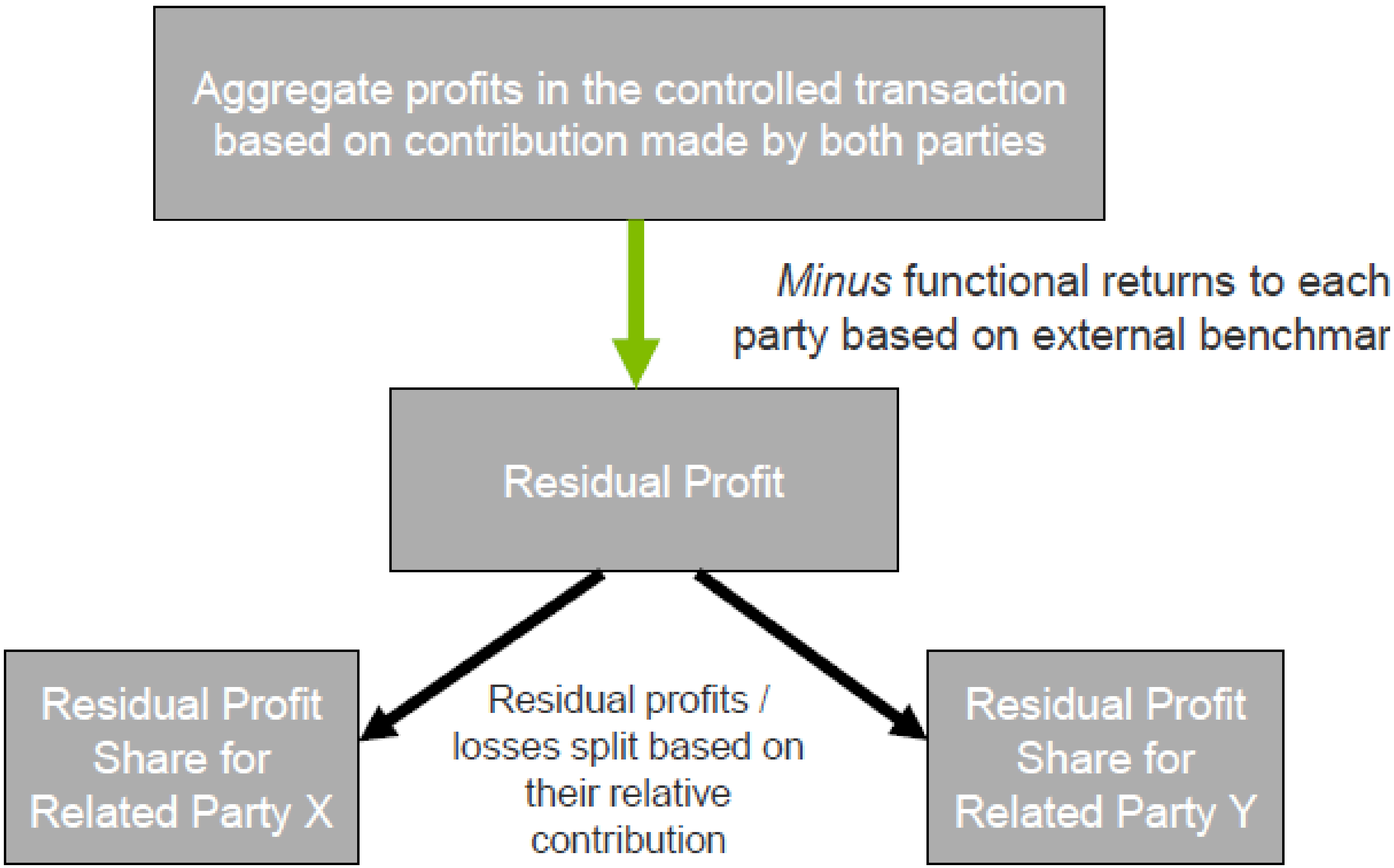
- **Two methods under PSM,** Contribution method and Residual methods.

Comparable Profit Split Method / Contribution Method





Residual Profit Split Method



PSM Continued

Typical example of Industries, where PSM can be applied:

– Telecommunications, Pharmaceuticals ,Courier/ logistic

In practice, division of combined profits at the second stage 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.

Cases in Kenya

C*ommissioner* of Income *Tax vs Karuturi Limited*

The Kenyan company in the business of growing and exporting rose flowers entered into an agreement with Flower Express (FE), a related party, tax resident in Dubai, under which Karuturi would sell to FE roses on a free-on-board (Kenya) terms. However, before the roses could leave Kenya, they would be resold by FE to third parties at substantially higher prices. The third parties would then export the flowers to markets controlled by FE, especially in Europe (Flash Title).

Kenya was doing all the functions and contributing highly (Public data) to the overall Flower Express Business while packing losses in Kenya (KRA).

In making the TP assessment of Karuturi KRA applied the comparable uncontrolled price (CUP) method.

The case has had further developments; Receivership even as the taxes are still owing.

Case Law

India vs Amphenol Interconnect India (Private) Ltd., March 2018, Bombay High Court, case no. 53

- . **Activity:** Manufacturing of electric connectors, accessories, cable assemblies and system integrations for application in various industries such as military, aerospace and telecom etc. The same are specialized and customized in nature i.e. manufactured against only specific orders.
- **Contentions**:-

1. Whether the resale of goods and sales assistance services for a commission could be aggregated for transfer pricing purposes

2. whether the CUP or the TNM was the most appropriate transfer pricing method

- Decision; The court found that that the CUP Method could not be used for the buy/sell transaction because of differences in location, volumes and customization and further, the transactions could be aggregated and benchmarked together using the TNM Method.

Recent Development

Recent Developments…

1. Base Erosion and Profit Shifting (BEPS) Project.

The **OECD/G20 BEPS** Project creates a single set of consensus-based international tax rules to protect tax bases while offering increased certainty and predictability to taxpayers. There are 15 action plans.

Actions 8-10 also christened *Aligning Transfer Pricing Outcomes with Value creation.*

Action 8: Assuring that TP outcomes are in line with value creation Intangibles	**Action 9:** Assuring that TP outcomes are in line with value creation (Risks & Capital)	**Action 10:** Assuring that TP outcomes are in line with value creation (Other high-risk transactions)

Recent Developments...

2. BEPS Action 13; Country-by-Country Reporting

It is a three-tiered standardised approach to transfer pricing documentation. This standard consists of

(i) a master file containing standardised information relevant for all MNE group members;

(ii) a local file referring specifically to material transactions of the local taxpayer; and

(iii) a Country-by-Country Report containing certain information relating to the global allocation of the MNE group's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

Q&A