Transfer Pricing Risk Management & Dispute Resolution Post BEPS era

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Uphold public interest

What is BEPS

Base Erosion and Profit Shifting (BEPS) refers to the erosion of national taxation bases and the artificial shifting of profits between jurisdictions resulting generally from the inability of industrial-age tax laws to respond to the digital economy, and specifically from the existence of unintended gaps and mismatches between different countries' tax systems

- Establishing coherence in the domestic rules that affect cross-border activities.
- Reinforcing substance requirements in the existing international standard.
- Improving transparency

What is BEPS

Coherence
Inappropriate use of international tax legislation to obtain unintended tax benefits

- Action 2 Hybrid mismatch arrangement
- Action 3 Controlled foreign corporation (CFC) rules
- Action 4 Interest deductions and other financial payments
- Action 5 Harmful tax practices

Substance
Mismatch of where profits are taxed vs where ppl responsible are located

- Action 6 Preventing tax treaty abuse
- Action 7 Artificial avoidance of PE
- Action 8 TP and Intangibles
- Action 9 Aspects of risk and capital
- Action 10 High risk transactions

Transparency
Equip tax authorities for better audits

- Action 11 Methodologies and data analysis
- Action 12 Disclosure rules
- Action 13 Documentation and CbCR
- Action 14 Dispute resolution

Action 15 Multilateral instrument

Action 1 Digital economy

Application of the Arm's-length Principle

Pre BEPS

amount charged by one related party to another for a given product must be the same as if the parties were not

Post BEPS

Fair share of profits
Focus on substance over form

Cost of getting it wrong

82. A person who, without reasonable cause, fails to keep, retain, or maintain a document as required under a tax

Penalty for failing to keep documents.

(2) A person who fails to submit a document, other than a tax return, as required under a tax law by the due date shall be liable to a penalty of one thousand shillings for each day or part day of default but the total penalty shall not exceed fifty thousand shillings.

(3) For the purposes of subsection (2), a person ceases to be in default at the time the document is received by the Commissioner.

84. (1) This section applies to a person—

Tax shortfall penalty.

subsection (1) relates, the penalty shall be one hundred thousand shillings.

Cost of getting it wrong

Under the TPA – Section 82 Failure to keep documents – 10% or KES100K

Under the ITA – Section 18(3) Gives power to the Commissioner to amend your cross border inter related party transactions to what is correct.

Under the TPA – Section 84 20% tax shortfall or 75% if omission is deliberate.

1% interest per month

Transfer Pricing Adjustments

Section 18(3) of the ITA

shall be deemed to be income accrued in or derived from Kenya.

Finance Act 2010
11.6.2010

Finance Act 2016

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

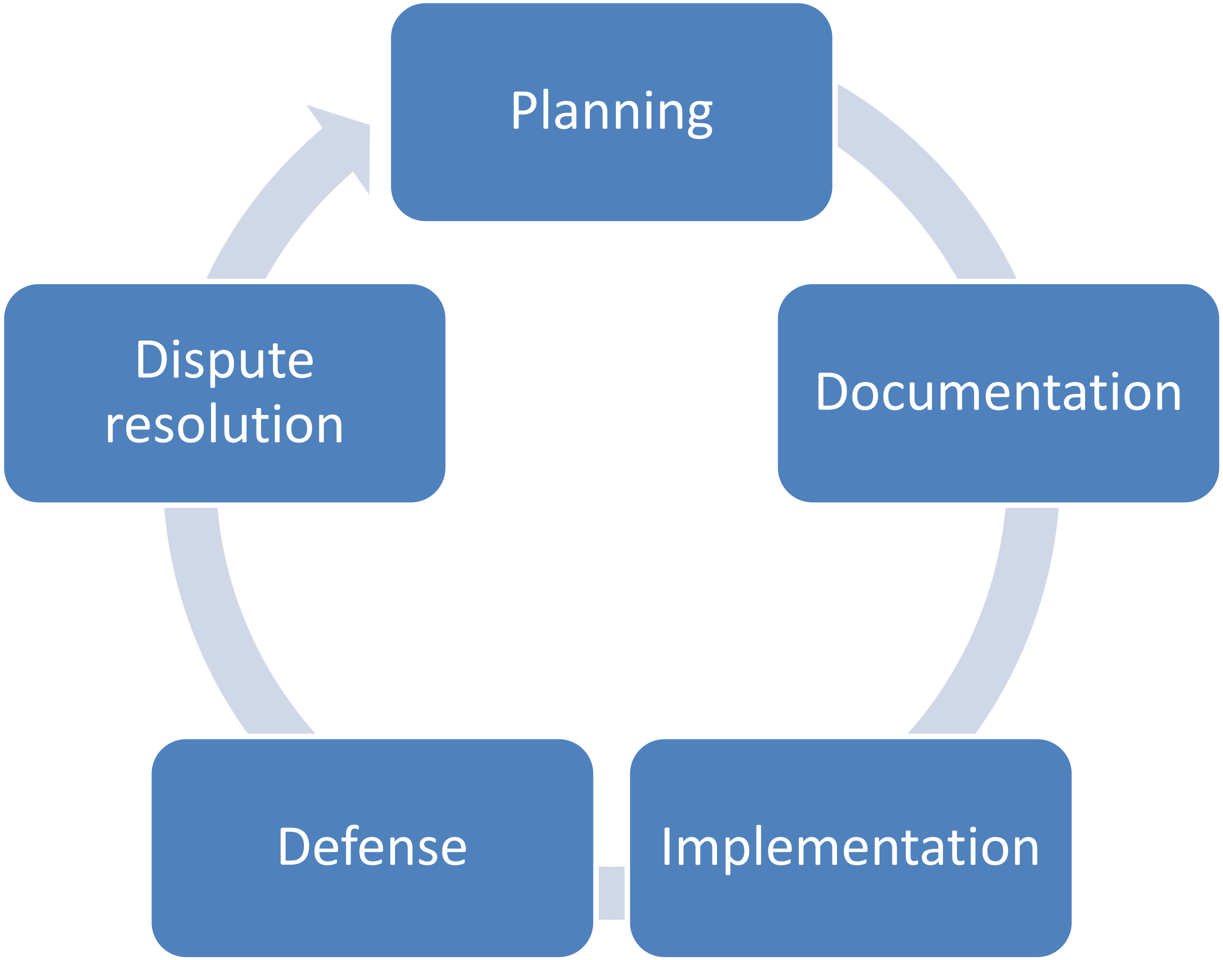
Key transfer pricing risks

Functional analysis	Alignment with the commercial reality of the operations
Legal Agreements	Alignment with the commercial reality and TP documentation
TP Method Applied	Ensure proper justification
Implementation of policy	Ensure TP Policy is properly implemented
Comparability	Availability of appropriate internal or external comparables

Evaluating Risk

- Consider how to reflect items from a compliance and reporting perspective
- Consider language (wording) used
- Considering using robust documentation
- Consider obtaining a ruling or an opinion

Dispute avoidance and resolution



TP Audit Triggers

- Setting up holding company in low tax jurisdiction
- Recurring losses
- Significant management and royalty payments
- Significant end year related party adjustments
- Restructuring
- Media publicity

TP Audit Procedures

- KRA gives a notice of intention to audit
  - *Tax payer should provide the information requested and attend to meetings requested by the KRA*
- KRA , after examining the documents and holding meetings may issue preliminary findings
  - *Tax payer should aim at discussing these findings with the aim of reducing the tax demand*
- KRA, may issue a formal assessment on issues not resolved
  - *Tax payer should object to the assessment within the stipulated time*

Dispute resolution tools

- Negotiation / Alternative Dispute Resolution / Settlement
- Litigation
- Competent authority / Mutual agreement procedure (MAP)
- Advance Pricing Agreement / Rulings /Safe harbour rules

Adjudication process

Procedure:

Objection to Commissioner
Within 30 days having paid tax not in dispute Commissioner to respond within 60 days

High Court

If still aggrieved by decision by TAT one may appeal to High Court

Tax Appeals Tribunal
If still aggrieved by Commissioner's decision may appeal to TAT

Court of Appeal

After High Court TPA provides this as highest court

Mutual Agreement Procedures

Provided under tax treaties Article 25 (Mutual Agreement Procedure) of the UN Model

Comes into play when one country incorrectly applies the treaty or differing views

Action 14 calls for effective dispute resolution mechanisms

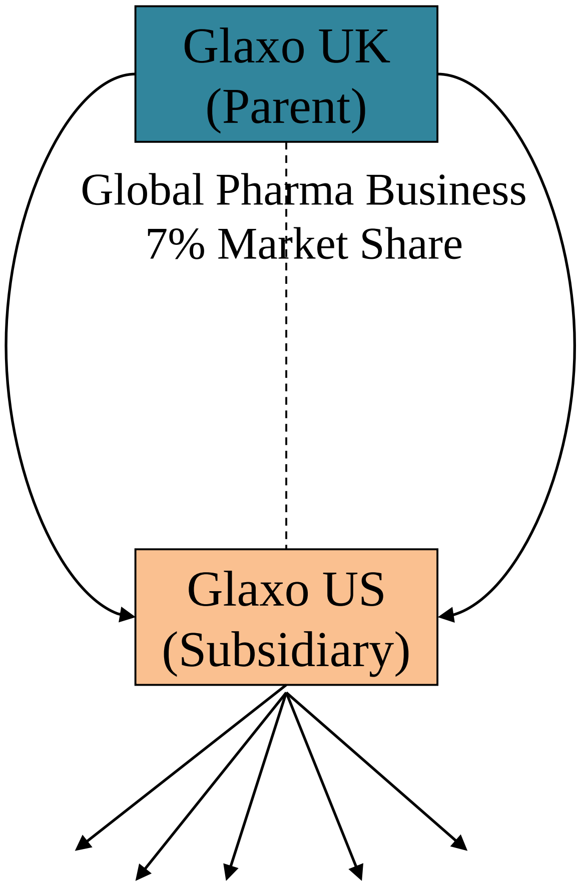
Outcomes: More than 80% of MAPs concluded in 2017 resolved the issue for transfer pricing cases and more than 75% for other cases.

Back to strategy

- Understand the TP Rules and Regulation
- Maintain up to date TP documentation
- Maintain signed related party contracts
- Have proper disclosure in the return
- Understand the transfer pricing audit process
- Understand the options available to resolve transfer pricing disputes

Glaxo Smithkline vs Commissioner of IRS

- Sales of tangible items such as raw materials, samples,drugs,etc. (i.e.,COGS)
- Transfer price based on resale minus methodology



- License of intellectual Property rights
- Royalty Periodically adjusted - Glaxo U.S. achieves target profitability

From 1980 to '94, Glaxo US grew from 65th to 2nd largest Pharma Company in US

Glaxo Smithkline vs Commissioner of IRS

- Long dispute dating back to early 1990s covering six products licensed by Glaxo (UK parent) to its US subsidiary.
  - **ZANTAC**, anti-ulcer compound
    - Largest product represented ~77% of dispute
- Glaxo attempted APA process
  - Glaxo acquired SmithKline Beecham and desired to use similar terms to SKB's APA for TAGAMET (an earlier anti-ulcer product) but IRS refused
- US and UK Competent Authorities could not resolve. UK Inland Revenue supported Glaxo
- Subsequent to Tax Court filings, case settled
- Facts were not fully disclosed figure given as USD 3.4B

Glaxo Smithkline vs Commissioner of IRS

Performed in U.K.	**Performed in U.S.**
• Discovered, developed, patented ZANTAC. Reimbursed US for development expenses.	• Some clinical trials
• Manufacturing process R&D	
• Developed regulatory approval package	• Assisted with US FDA approval process.
• Primary manufacturing (chemical)	• Secondary manufacturing (formulation/packaging)
• Owned trademarks	
• Designed marketing and co-promotion strategy	• Conducted promotion and direct selling activities.

Glaxo Smithkline vs Commissioner of IRS

Royalties paid to the UK

Success based on marketing and sales in US market

Not able to prove clear ownership of patent

Glaxo Smithkline vs Commissioner of IRS

IRS Deficiency notice - Royalty

- Deduction for royalty on know-how limited to what was decided in the agreement
- Increase in Royalty rate not warranted - no increase in value of intangibles
- Royalty on Trademark / Marketing intangibles – disallowed
- Glaxo US – developer of Trademark / Marketing intangibles
- Proposed adjustments confirmed with Residual Profit Split Method

Glaxo Smithkline vs Commissioner of IRS

IRS Deficiency notice - Constructive Dividend

Transfer prices in excess of arm's length amount constitute interest free loans on which interest should be accrued and taxed

Alternatively, excess payments to related parties constitute constructive dividends subject to 5% withholding tax (separate Notices of Deficiency).

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