

# TRANSFER PRICING IN SUBSTANCE

**Presenter:** Jemimah Mugo ([jemimah.mugo@gmail.com](mailto:jemimah.mugo@gmail.com))  
Tax Director, Eastern Africa  
Deutsche Post DHL  
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# Disclaimer



- ❑ This material has been prepared for general informational and educational purposes only and is not intended, and should not be relied upon, as accounting, tax or other professional advice. Please refer to your advisors for specific advice.
- ❑ The views expressed by the presenter are not necessarily those of Deutsche Post DHL.

# Presentation agenda



- ❑ Transfer Pricing documentation Process
- ❑ Transfer pricing methods
- ❑ Comparability analysis and challenges

# Transfer pricing documentation process



# Defining the TP basis



## Step 1

- Determine the year(s) to be covered
- Financial performance analysis

## Step 2

- Perform broad-based analysis of your circumstances
- Industry and company analysis

## Step 3

- Understand and document the controlled transaction(s)
- Functional analysis guidance on the choice of the tested party; TP method; profit level indicator

# Review of comparability



## Step 4

- Review of existing internal comparables, if any
  - Identify the internal CUP

## Step 5

- Determine availability of external comparables
  - Comparability circumstances to be considered (functions, assets, risks, economic conditions)

## Step 6

- Select the most appropriate TP method & the PLI
  - Based on the functional analysis

# Comparability analysis



## Step 7

- Identify the potential comparables for benchmarking
  - Choose based on the functional analysis and document the search strategy

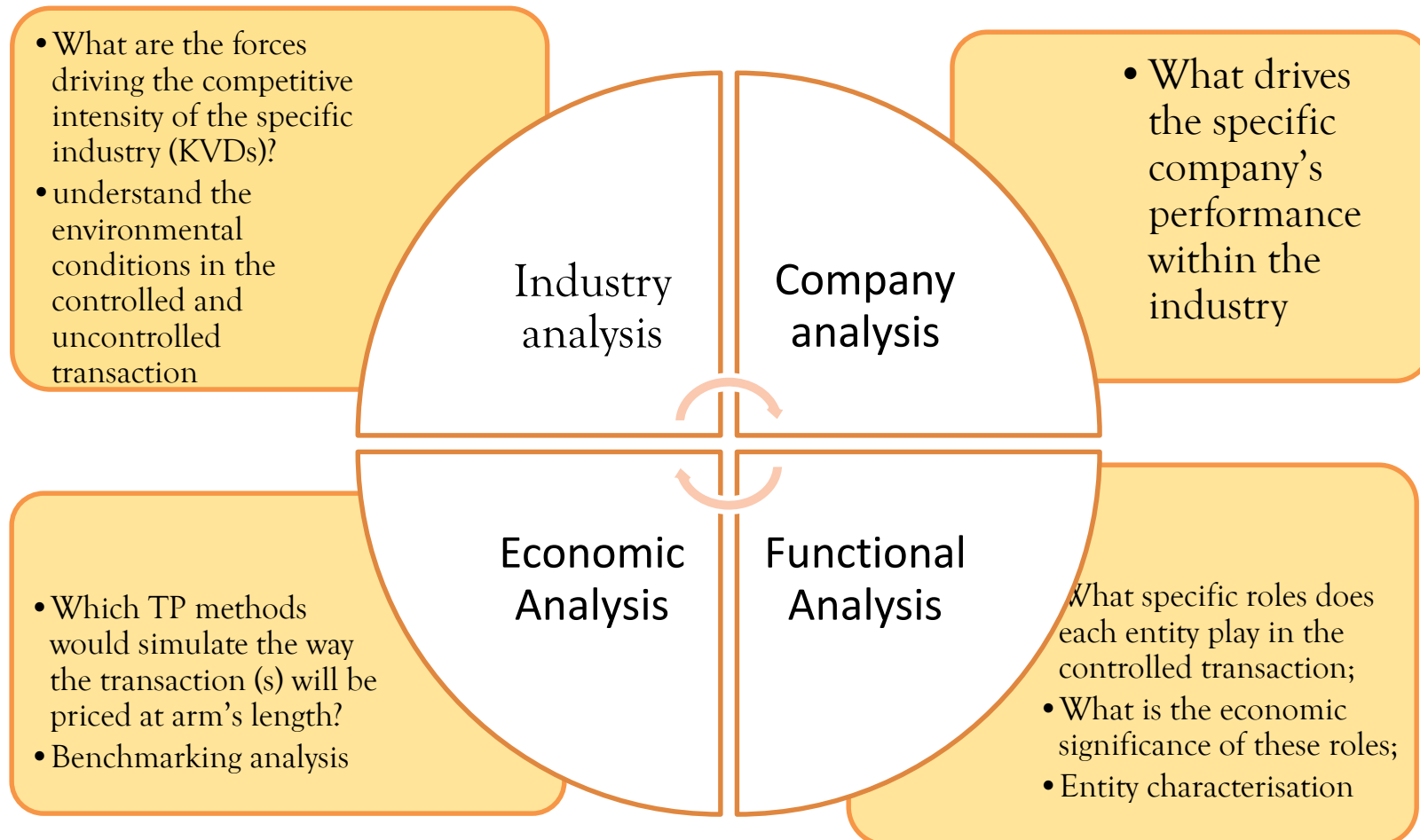
## Step 8

- Determine and make comparability adjustments, if any.
  - Consider functions, assets, risks & economic conditions

## Step 9

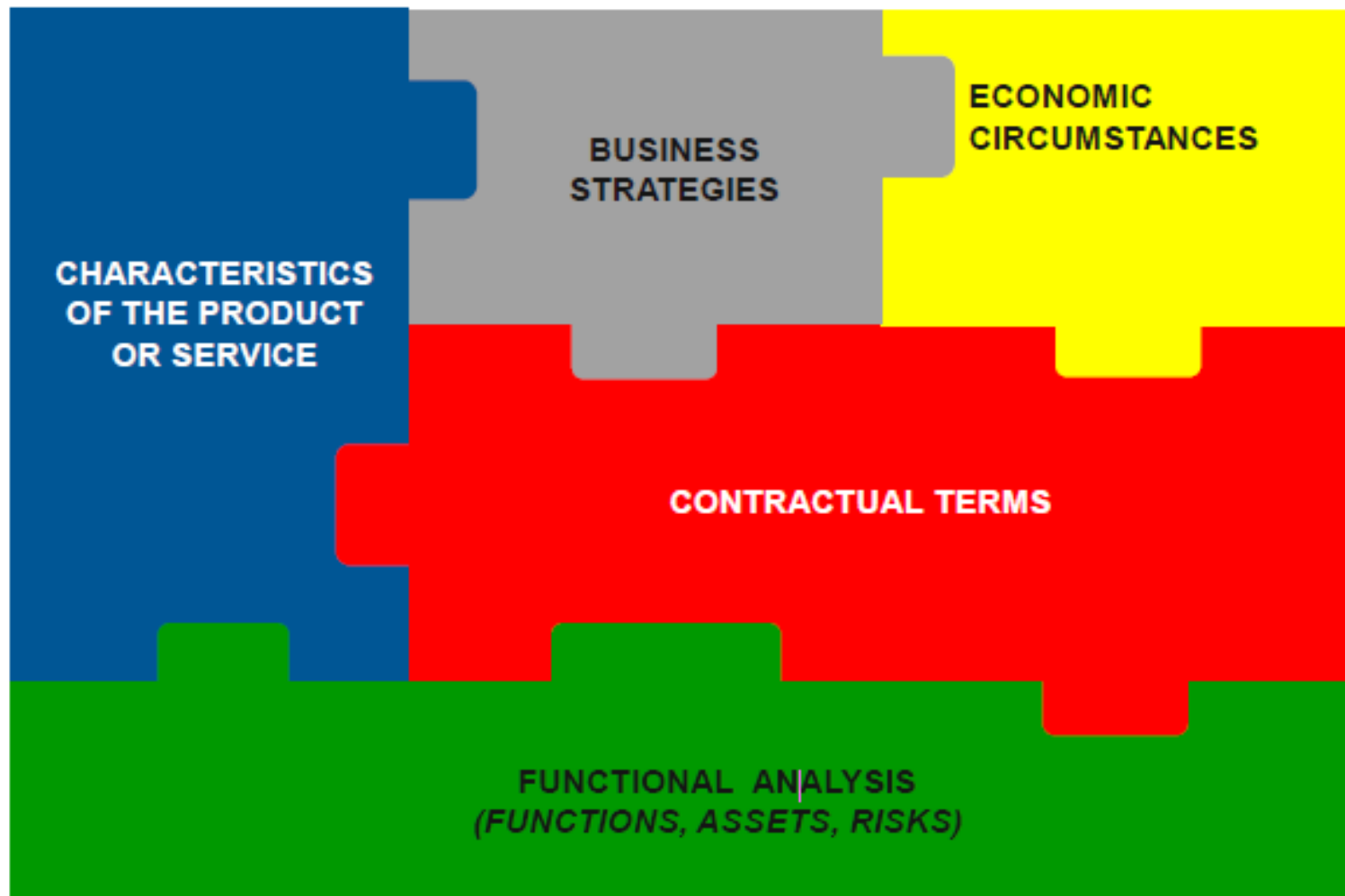
- Compute the arm's length charge based on data collected
  - Interquartile range of the PLI's of the comparable

# Structure of a transfer pricing document





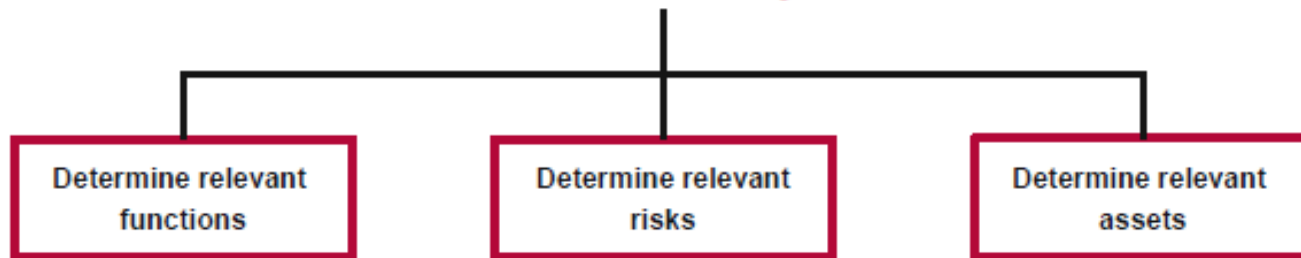
# Thorough identification of Relevant Characteristics of the Transaction



# Functional Analysis



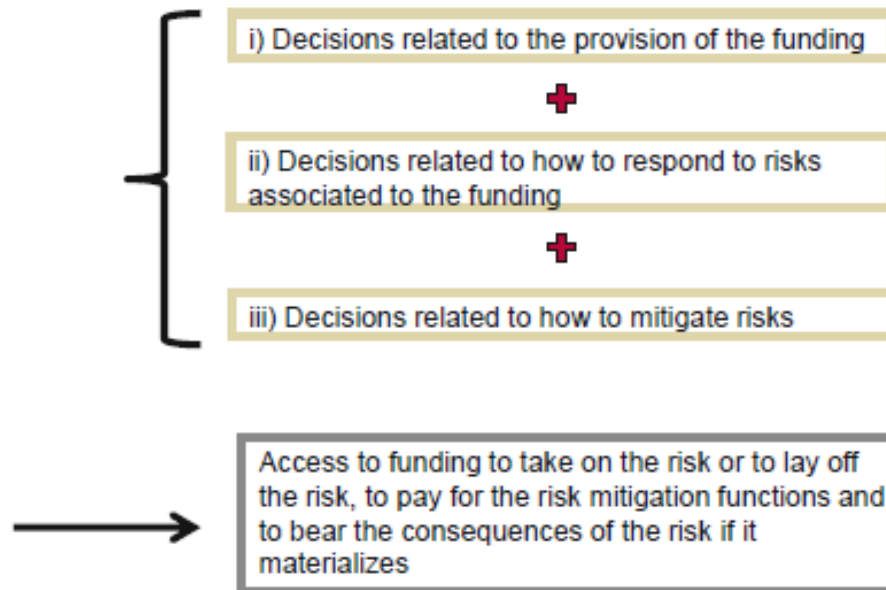
## Functional analysis



**Control over risk**  
(Capability and functional performance)

and

**Financial capacity to  
assume the risk**



# BEPS Action 13 – TP documentation and CbCR



## Master file

High-level information about MNC's business, transfer pricing policies and agreements with tax authorities in single document available to all tax authorities where MNC has operations.

## Local file

Detailed information about MNC's local business, including related party payments and receipts for products, services, royalties, interest, etc.

## Country-by-country report (CbCR)

High-level information about jurisdictional allocation of profits, revenues, employees and assets.

# Master file – information required



Organizational Structure	Business description	Intangibles	Intercompany financial activities	Financial and tax positions
Structure chart: ► Legal ownership ► Geographic location	Important drivers of business profit	Overall strategy description	Financing arrangements for the group (related and unrelated lenders)	Annual consolidated financial statements
	Supply chain of: ► Five largest products/services by turnover ► Products/services generating more than 5% of turnover	List of important intangibles and legal owners	Identification of financing entities	List and description of existing unilateral advance pricing agreements (APAs) and other tax rulings
	Main geographic markets of above products	List of important intangible agreements	Details of financial transfer pricing policies	
	List and brief description of important service arrangements	R&D and intangible transfer pricing policies		
	Functional analysis of principal contributions to value creation by individual entities	Details of important transfers		
	Business restructuring/acquisitions/divestitures during fiscal year			

# Local file – information required

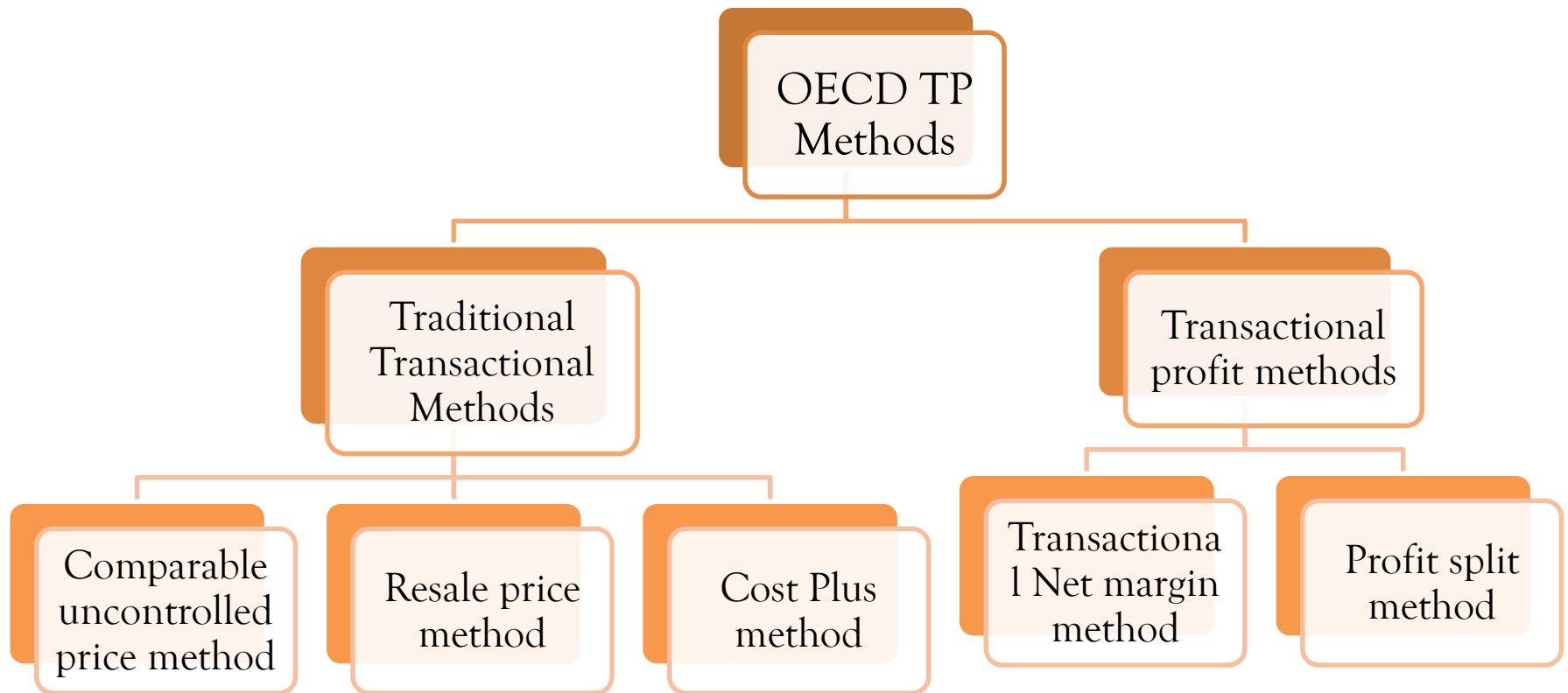


Local entity	Controlled transactions	Financial information
<ul style="list-style-type: none"> <li>▶ Management structure</li> <li>▶ Local organization chart</li> <li>▶ Details on individuals to whom local management reports</li> </ul>	<ul style="list-style-type: none"> <li>▶ Description of material controlled transactions and context in which they take place.</li> <li>▶ Identification of associated enterprises party to controlled transactions and relationship</li> <li>▶ Functional analysis</li> <li>▶ Transfer pricing methods used</li> <li>▶ Comparables and details of methodology</li> </ul>	Local entity financial statements
Description of business and business strategy pursued	Amounts of intragroup payments and receipts for controlled transactions (products, services, royalties, interest etc.)	Reconciliation to show how financial data used in applying the transfer pricing method ties to the financial statements
Details of business restructurings and/or intangible transfers	Unilateral and bilateral/multilateral APAs and other tax rulings related to the controlled transactions	Summary of relevant financial data for comparables and sources from which data was obtained
Key competitors		R&D and intangible transfer pricing policies
		Details of important transfers

# Transfer pricing methods



# Transfer pricing methods



# CUP and RPM



## CUP Method

**The most direct and reliable method**

- Internal CUPs – between the related party and third party
- External CUP – between independent and unrelated parties
- Requires highest degree of comparability – the product/service, the characteristics, contractual terms and conditions, economic /operating environment

## RPM

**Mostly applied for routine distribution functions where CUP is unavailable**

- Considers the price at which a product, that had been bought from a related party, is sold to a third party.
- The price is adjusted by an appropriate gross margin to cover reseller expenses and appropriate profit
- Other costs to adjust include import duties to determine the arm's length original price



# Cost plus method



## Cost Plus method

Routine manufacturing functions and provision of services

- Considers the costs incurred by the supplier to produce the good or services
- An appropriate mark-up is added to the costs to make an appropriate profit
- Considers the functions performed and the market conditions
- The resulting price may be regarded as an arm's length price for the controlled transaction
  - However
    - Differential treatment of costs as direct, indirect or operating expenses (inconsistencies in accounting)
    - May affect comparability of the cost base

# The PSM and TNMM



## PSM

### Highly integrated and valuable contributions

- Contribution analysis – based on functions performed, assets used and risks assumed
- Residual analysis – profit allocated in two stages
  - Remuneration for non-unique contributions or routine activities (stage 1)
  - Remuneration for unique contributions from the residual profit (stage 2)

## TNMM

### Comparability analysis at the net profit level

- Net profit relative to an appropriate base (e.g. costs, sales, assets) used as the PLI
- Preferred because net profit indicators are less affected by transactional differences

# Typical transactions and methods



Type of Transaction	Possible transfer pricing method
Tangible goods – manufacturing (e.g. final or intermediate products, components)	CUP, CPM,
Tangible goods – distribution	CUP, RPM, TNMM
Services (e.g. Management, shared service centers, R&D)	CUP, CPM, TNMM
Intangibles (e.g. technology, manufacturing know-how, brands)	CUP, TNMM, Profit Split
Finance (e.g. loans, cash pooling, guarantees)	CUP, CPM

# Comparability



# Background



- ❑ The arm's length principle needs comparables in order to be applied
- ❑ Comparables are lacking in some regions of the World, for instance Africa
- ❑ This has adverse consequences both for tax payers and tax administrations, rendering TP administration and audit difficult
- ❑ The Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, by the Platform of Cooperation on Tax (IMF, OECD, UN, WBG) is the most comprehensive document to date on the subject
- ❑ Should we use foreign comparables, if so, what jurisdictions are acceptable?

# Background

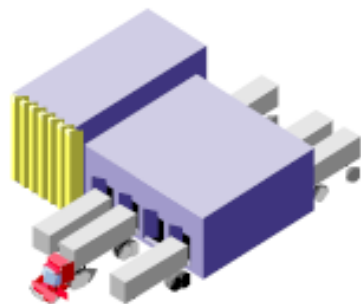


- ☐ Foreign Comparables can be used
- ☐ If used, adjustments need to be performed:
  - ☐ Country risk adjustments – as a means of getting round the differences in the economic circumstances in which the tested party and the comparables operate (e.g. Africa vs. Western Europe)

# Case study



## The African tested party



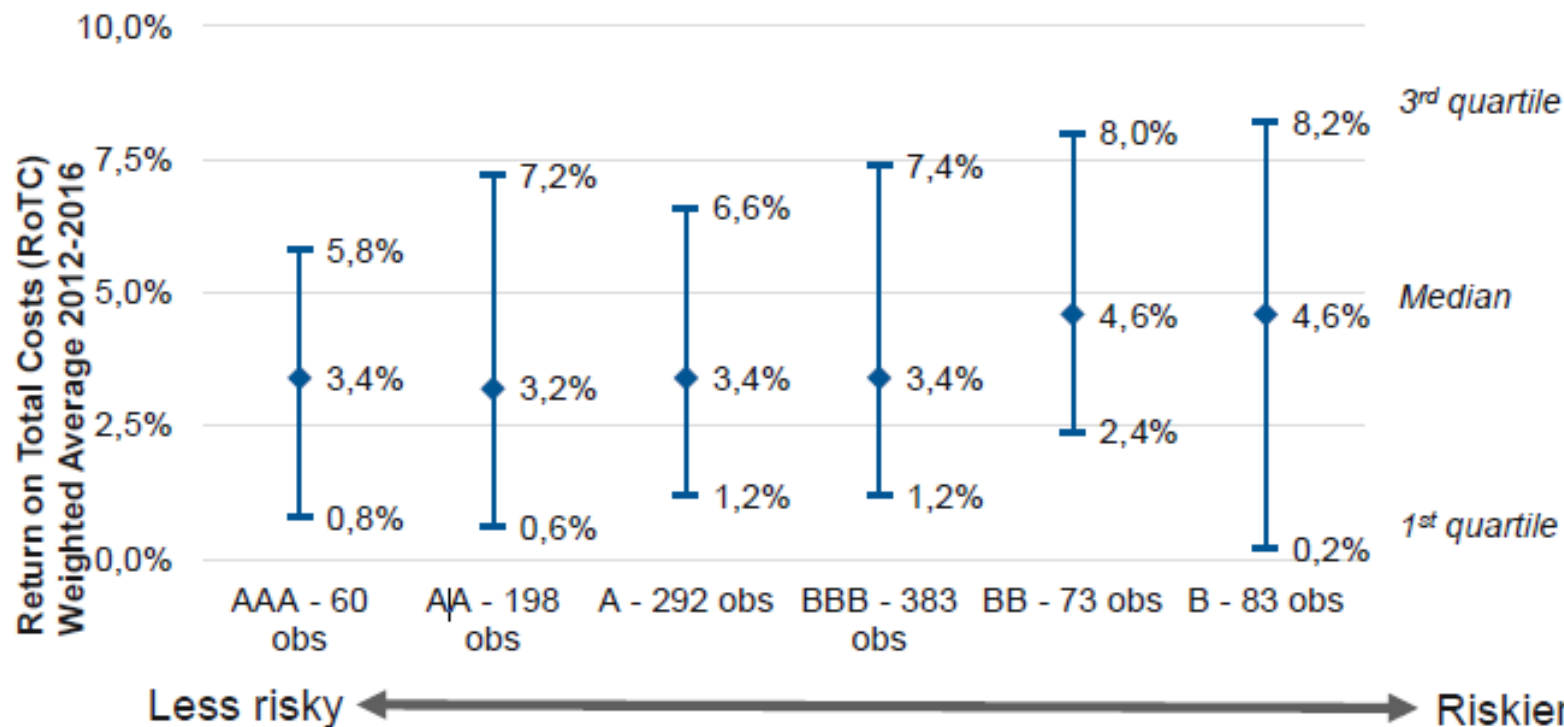
A subsidiary of fruits/vegetables processing in Africa, that sells 100% of its production to the Group

	African Tested Party
Industry	Manufacturing/Processing of fruits/vegetables
Role in the Value Chain	Upstream / sells its production to the Group
Functions performed	Procurement, Production, Supply Chain (no 'sales')
Assets owned	Plant, Know-How

# Empirical data on country risk rating



**Sample:** 1,086 independent firms in the food processing industry, worldwide  
**Group:** Based on the sovereign rating of the country where the company is located (S&P)



Source: TP Qube

Note: Data from Bureau Van Dijk Orbis database, independent companies with BvD Independence rating of A+, A or A- and in the 2-digit NACE Code 10 "Manufacture of food products"



# Proposed process for using foreign Comparables in Africa



	Region	Country Risk	Adjustment
#1	Tested Party's Country	-	-
#2	Africa	High	No
#3	Rest of the World (or specific region)	High	No
#4	Rest of the World (or specific region)	Low	Yes

If no reliable comparable move to step#2

If no reliable comparable move to step#3

If no reliable comparable move to step#4

# Proposed process for using foreign Comparables in Africa



## ► Application to the Food processing case (ex: Ghana)

	Region	Country Risk	Countries in scope (for which financial data is available)	Number of comparables	Adjustment
#1	Ghana	-	-	1	-
#2	Africa	High Risk Countries (BBB/BB/B)	4 countries : Egypt, Kenya, Nigeria, South Africa	13	No
#3	Rest of the World (or specific region)	High Risk Countries (BBB/BB/B)	28 countries: Bahrain, Bangladesh, Bosnia and Herzegovina, Brazil, Bulgaria, Colombia, Croatia, Cyprus, Greece, Hungary, India, Indonesia, Italy, Jamaica, etc.	526	No
#4	Rest of the World (or specific region)	Low Risk Countries (AAA/AA/A)	35 countries: Australia, Austria, Belgium, Canada, Czechia, Denmark, Finland, France, Germany, Hong Kong, Israel, Korea (Republic of), Netherlands, New Zealand, Norway, etc.	546	Yes

Note: Data from Bureau Van Dijk Orbis database, independent companies with BvD Independence rating of A+, A or A- and in the 2-digit NACE Code 10 "Manufacture of food products"<

# Proposed adjustment formula



- ❑ Country-risk adjustments are grounded in Finance Theory
- ❑ Proposed country-risk adjustment is an extrapolation of Finance Theory:
  - ❑ Assume UK comparables (“UK comparable”) selected for the purpose of benchmarking a tested party in Ghana (“Ghana company”)
  - ❑ “Target” remuneration of tested party in Ghana is based on foreign European comparables financials increased by the incremental profit that an investor would require from investing in a riskier country:
    - ❑  $OperatingProfit_{Ghana\ company} = Operatingprofit_{UK\ Comparable} + IncrementalOperatingProfit(Risk)$
    - ❑  $IncrementalOperatingProfit(Risk) = \checkmark Sovereign interest rate Ghana -$

# Proposed adjustment formula

## *Illustration of the country-risk adjustment*



<u>UK Company</u>		
Sales	(1)	100,0
<b>Operating Profit (OP)</b>	<b>(2)</b>	<b>3,0</b>
OP/Sales	(3)=(2)/(1)	3,0%
Capital Employed	(4)	50,0
Country Risk Premium UK	(5)*	0,56%
Country Risk Premium Ghana	(6)*	7,34%
Incremental Risk Premium	(7)=(6)-(5)	6,78%
<b>Additional 'expected' remuneration</b>	<b>(8)=(7)*(4)</b>	<b>3,4</b>
<b>Expected Adjusted OP</b>	<b>(9)=(2)+(8)</b>	<b>6,4</b>
Expected Adjusted OP/Sales	(10)=(9)/(1)	6,4%

\* Source: Damodaran, 1/1/2019

# Summary



# Guidance material



- ☐ Local legislation and guidelines on transfer pricing
- ☐ OECD and UN Transfer Pricing (TP) guides-manuals
- ☐ Big 4 and number of consultants' tax audits guides are available on-line
- ☐ Tax Jurisdiction's websites -to check TP legislation and whether OECD/UN recommendations are enshrined in local legislation
- ☐ HMRC's International Manual and IRS' Transfer Pricing Examination Process
- ☐ BEPS Action 13 -Handbook on Effective Tax Risk Assessment gives guidance on how to test risks
- ☐ The African Tax Administration Forum (ATAF) TP risk toolkit - guidance on audit for mining industry

# Questions



# THANK YOU

