Transfer Price at a glance

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Outline

- Transfer pricing concepts
- Transfer pricing methods
- TP documentation process
- TP application in Kenya
- Areas of focus

TP Application, Why and How

Application

- Dealings and transactions between related parties
- Transactions involving services, goods, loans, intangibles, etc.

Why

- Possibility of influence (mispricing) to the entities' advantage
- Need for equitable share of revenue across jurisdictions

How

- Pricing of transactions between related parties must be comparable to those made with independent parties
- Compliance with the arm's length principle

Relevant TP terms

Transfer Price – The price at which enterprises under common ownership or management transact with each other

Arm's length principle – The condition where parties to a transaction are independent and each is acting in his/her own best interest

Related Party – Established through management or control or capital or family ties

Controlled transactions – These are transactions between two enterprises that are associated with respect to each other

Uncontrolled transactions – Transactions between independent and unrelated enterprises

The Arm's Length Principle

The ALP is the basis for transfer pricing and requires that

- Controlled transaction to be made as if it was a transaction between independent parties under **similar comparable circumstances**
- Comparability analysis need to be based on **functions** performed, **assets** used and **risks** assumed
- Adjustments to be made for any material differences in the conditions and circumstances of the transactions that would affect their pricing

Overview of transfer pricing

TP generally refers to the pricing of cross border transactions between **two related entities**. The **elements** of a transaction with TP implications are:

- Commercial transaction
- Related entities – parties that are under common control
- Different jurisdictions (not always)
- Motive to avoid tax **<u>not</u>** a pre-requisite

A and B are related parties in different tax jurisdictions

Entity A

Goods/Materials

Intangible Assets

Services

Leases, Loans, Guarantees

Entity B

Overview of transfer pricing

How does transfer pricing differ from normal pricing?

Because the transactions occur between related parties, typical market forces that lead to negotiated prices between third parties may not apply. Accordingly, prices are considered to be controlled by the affiliated parties involved. Moreover, the price agreed between related parties may be motivated by tax reasons (e.g. shifting of income to low tax jurisdictions.)

Is transfer pricing important?

Yes. It is significant for both taxpayers and tax administrators because pricing within a controlled group affects the allocation of profits recognized by entities operating in different taxing jurisdictions. This impacts on the income and expenses that they report and therefore their tax liability.

Transfer pricing methods

OECD Transfer Pricing Methods

- ***Preferred Methods***
  - **Comparable Controlled Price** — Takes first preference; Most direct and reliable & comparability is critical for application
  - **Resale Price Method** — Mostly applied for routine distribution functions where there are no CUPs
  - **Cost Plus Method** — Mostly applied for routine manufacturing functions or provision of services
- **Transactional Profit Methods: *Last Resort Methods***
  - **Transactional Net Margin Method** — Examines the Net Profit Margin relative to an appropriate base (e.g. costs, sales, assets)
  - **Profit Split Method**
    - **Contribution Analysis**
    - **Residual Analysis**

The CUP and RPM

CUP Method The most direct and reliable method

- Internal CUPs – Between a group company and unrelated party
- External CUPs – Between two unrelated parties
- Comparable circumstances (Characteristics; Contractual terms and conditions; and Economic environment)

RPM Gross margin as the profit level indicator

- 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

The CPM

CPM

Appropriate for routine manufacturing activities and services transactions

- 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 (stage1)
  - 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

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 compatibility

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 comparables

Typical Transfer Pricing Document

- What are the forces driving the competitive intensity of the specific industry (KVDs)?
- To understand the environmental conditions in the controlled and uncontrolled transaction

Industry analysis

Company analysis

- What drives the specific company's performance within the industry

Economic analysis

- Which transfer pricing methods would simulate the way the transaction (s) will be priced at arm's length?
- Benchmarking analysis

Functional analysis

- What specific roles does each entity play in the controlled transaction;
- What is the economic significance of these roles;
- Entity characterisation

Who are Related Persons?

one enterprise participates in the ***management, control or capital*** of the business of the other either directly or indirectly

a third person participates directly or indirectly in the ***management, control or capital*** of the business of both enterprises

association by ***marriage, consanguinity or affinity*** by individuals in the management, control or capital of the two businesses

The Covered Transactions

- Sale or purchase of goods;
- Sale, transfer, purchase, lease or use of tangible and intangible assets;
- Provision of intragroup services;
- Lending or borrowing money; and
- Any other transaction that affects the profit or loss of the enterprises involved

Documents Required

- The selection of the transfer pricing method and the reason;
- The application of the method, including the calculations made and the price adjustment factors considered;
- The global organization structure of the enterprise;
- The details of the transactions under consideration; and
- The assumptions, strategies and policies applied in selecting the method as well as such other background information as may be necessary regarding the transaction

Areas of focus

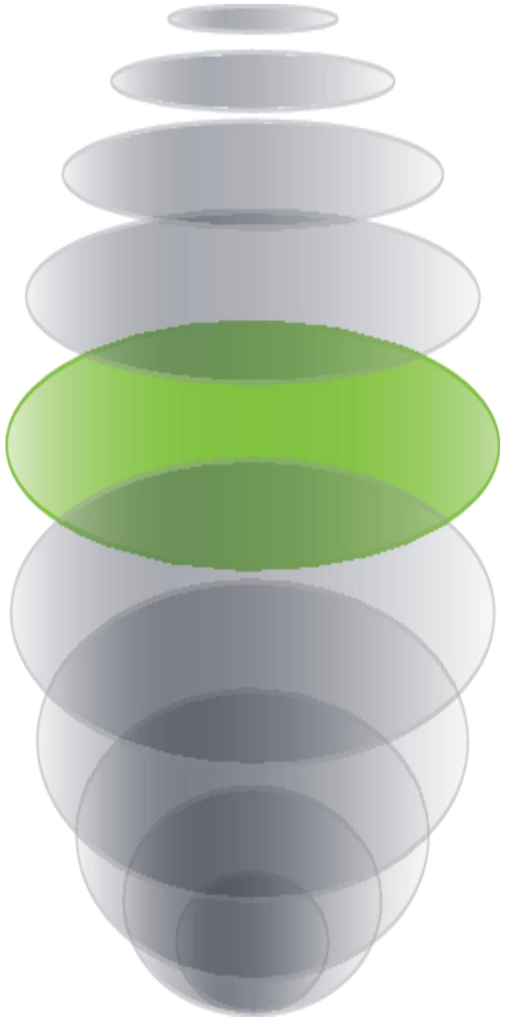
TP issues

Some of the areas of focus are:

- **Management and technical services fees**
- **Group head office costs**
- **Shared service costs**

Issues to consider

- Are they shareholder functions?
- Is there duplication?
- Does the recipient have the resources to obtain the services in house?
- What evidence is there of the services and its benefits to the recipient?
- Is the fee arm's length (% of turnover fees)?



TP issues

- **Intellectual property fees e.g. royalties**

Issues to consider

- Is there really any valuable IP that is being exploited?
- Has this IP been developed locally by the local company?
- Who is bearing the marketing and other brand promotion costs?
- Is the fee arm's length?

- **Other areas of focus** :

- History of very low profitability
- History of consecutive losses
- History of losses in certain companies and profits in one "special" company
- Aggressive intercompany arrangements that lack business purpose and economic substance – loans, management fees, offshore structures, etc.

TP issues

- **Other areas of focus** :
  - Inadequate and unup to-date TP documentation

Questions and Answers

Contact details

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