Global Tax Reset and Transfer price at a glance

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Uphold public interest

Global Tax Reset

Agenda

- The Global Tax environment
- Key Themes
- Kenyan Context
- Impact on Businesses
- An understanding of basic TP concepts
- The key principles of TP
- Analysis of the TP methods

The Global Tax Environment

❖ The Global Tax Reset is a new age of international tax consistency and sharing of information with and between tax authorities.

Why reset?

- International tax rules date back to 1920s - limited MNC activity
- Growth in cross-border trade; MNCs no, size and complexity
- Advent of the digital age
- Concern over gaps in international tax rules, exploitation of such gaps
- Ever increasing pressure for Gov’ts to collect additional revenue

Result

❖ Sweeping changes to tax laws (both international and domestic) and treaties

Tax Morality

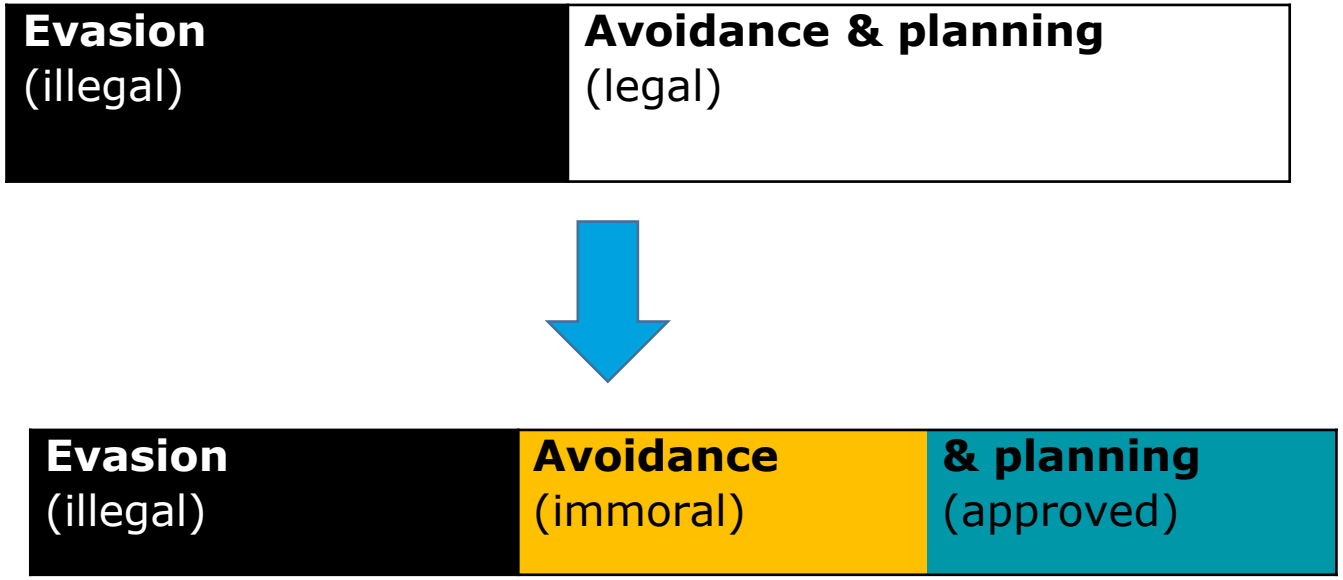
- Introduction of morality into tax in recent years
- Debate on morality heightened by the financial crisis and political pressure:
  - *Belt tightening, tax increases, and wider tax reforms*
  - *Multinational enterprises seen as paying (or being able to choose to pay) little tax; "unfair" burden on individuals and national businesses*
  - *International tax rules seen as out-dated*
- Tax debate (e.g. BEPS) part of a wider narrative around the developed versus developing world; developing countries heavily dependent on tax collections

Narrowing distinction between avoidance and evasion

OECD definitions:
"Evasion -- generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities."

"Avoidance -- generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow"

"Tax planning --Arrangement of a person's business and /or private affairs in order to minimize tax liability."



Tax transparency

- Information sharing between revenue authorities and governments
- Non-transparent jurisdictions/ tax haven now shunned
- Greater reporting obligations for multinationals, e.g. country by country transfer pricing reports
- Collaboration between revenue authorities – ATAF; TIWB

Tax competition and reforms

- Countries seeking to widen their tax base e.g. taxing digital transactions
- Countries still use tax to attract investment – lower corporate tax rates; incentives
- Lower corporate and customs duties imply higher consumption and personal taxes
- Innovation to generate “new” taxes – carbon tax, sugar tax, social media tax; digital tax

Global Tax Environment: The Kenyan Context

The key issues and themes shaping taxation in Kenya include:

- High level of debt exerting pressure on Government to increase tax revenue
- As a result, changes or new tax legislation inclined towards tax increases and reduction of incentives – VAT Act 2103; Finance Bill 2021, Excise Act; Betting and Gaming
  - Corporate tax – defying the global trends?
  - Consumption and individual taxes – upward trend?
  - Focus on multinationals – Transfer Pricing and International Tax
  - Taxation of digital transactions
  - Targeting both avoidance and evasion

Impact on Businesses
Is your Organisation Ready?

How will the changing tax landscape impact your business?

1. Reputational risk: increased focus on multinationals and adverse media coverage creates new and significant brand risk especially for businesses that operate globally

2. Increasing tax risk: complexity of new legislation and global frameworks create additional tax risks/ increase in tax controversy

3. Compliance: increased reporting and compliance costs

4. Business models: BEPS and TP changes affect business financing arrangements and operating models/ global supply chain

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How will the changing tax landscape impact your business?

5. Greater international tax consistency (positive for business) – however inconsistencies remain

6. Transparency and information sharing – risk of breach of confidentiality for commercially sensitive information

7. Potentially higher overall tax liabilities (ETR) and potential increase in double taxation due to unilateral tax changes

8. The new rules will affect more than the tax practices of organizations with multinational operations – they will have broad-based business and operational impacts.

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How should your business respond to the changes?

1. Reflect and evaluate on impact of the changes; scenario planning
2. Identify priority areas of concern to address
3. Invest in or realign relevant systems/ processes/ people
4. Initiate timely action where change in business model may be required
5. Involve stakeholders beyond tax/ finance. Input required from C-suite and the board

How to navigate the new tax environment

1. Increasingly important for board to set the right tone on tax strategy: a tone that's both prudent and sustainable. Determine the tax risk appetite

2. Boards should have sufficient expertise to understand tax strategy and its implications, particularly for long-term profitability and value

3. Obtain advice to properly evaluate the organization's tax strategy

4. Public disclosure of company's tax practices – policy, commitment, total tax contribution

Overview of Transfer Pricing

Overview of Transfer Pricing| What is 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)

A and B are related parties in different tax jurisdictions

Overview of Transfer Pricing| Importance of transfer pricing

How does transfer pricing differ from normal pricing?

- 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 recognised by entities operating in different taxing jurisdictions.
- This impacts on the income and expenses that they report and therefore their tax liability.

Overview of Transfer Pricing| The arm's length principle

Arms Length Statement: *Article 9 of the OECD Model Tax Convention*

Where

"conditions are <u>made or imposed</u> between the two enterprises in their commercial or financial relations which <u>differ from</u> 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"

- An arm's length price is the price at which a trade takes place between two independent enterprises
- Companies operate at arm's length if they are independent in their commercial and financial relations

Overview of Transfer Pricing| Controlled vs. Uncontrolled

Some common terms used in transfer pricing – controlled vs. uncontrolled

- **Uncontrolled transactions** – are those business transactions that take place between two unrelated entities. Types of uncontrolled transactions are
  - External uncontrolled transactions – occur between two unrelated or third parties
  - Internal uncontrolled transactions – occur between one of the related parties and a third party
- **Controlled transactions** – transactions that take place between related parties and are usually a focus of our transfer pricing studies. These transactions are also referred to as "**related party**" transactions.

Functional Analysis

Functional Analysis

- What is functional analysis?
- Where does functional analysis fit into TP?
- Why do a functional analysis?
- How to do a functional analysis?

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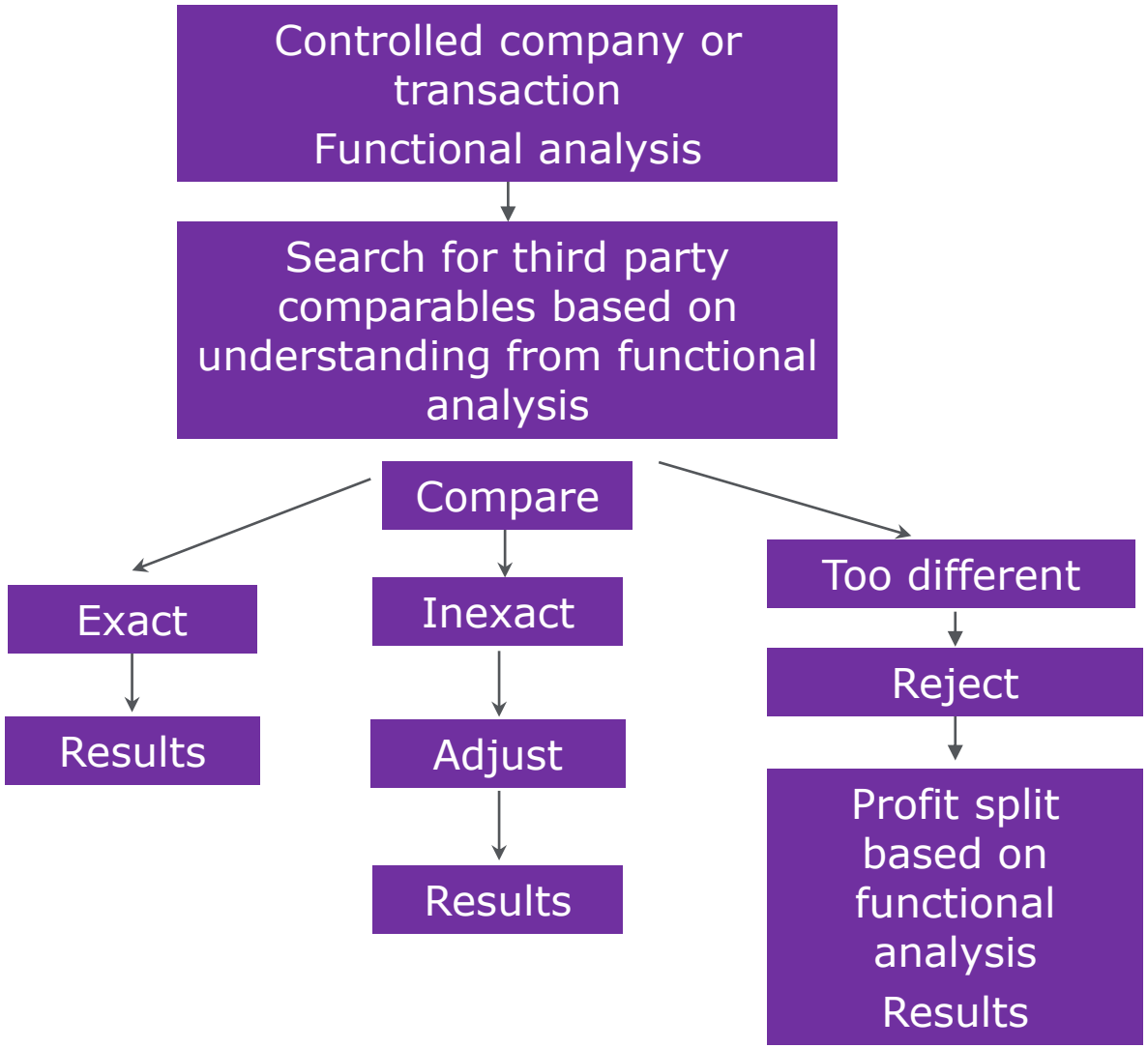
What is a functional analysis?

- The mapping of the **economically relevant** facts and characteristics of inter-company transactions with regard to their:
  - **Functions, Assets, Risks**

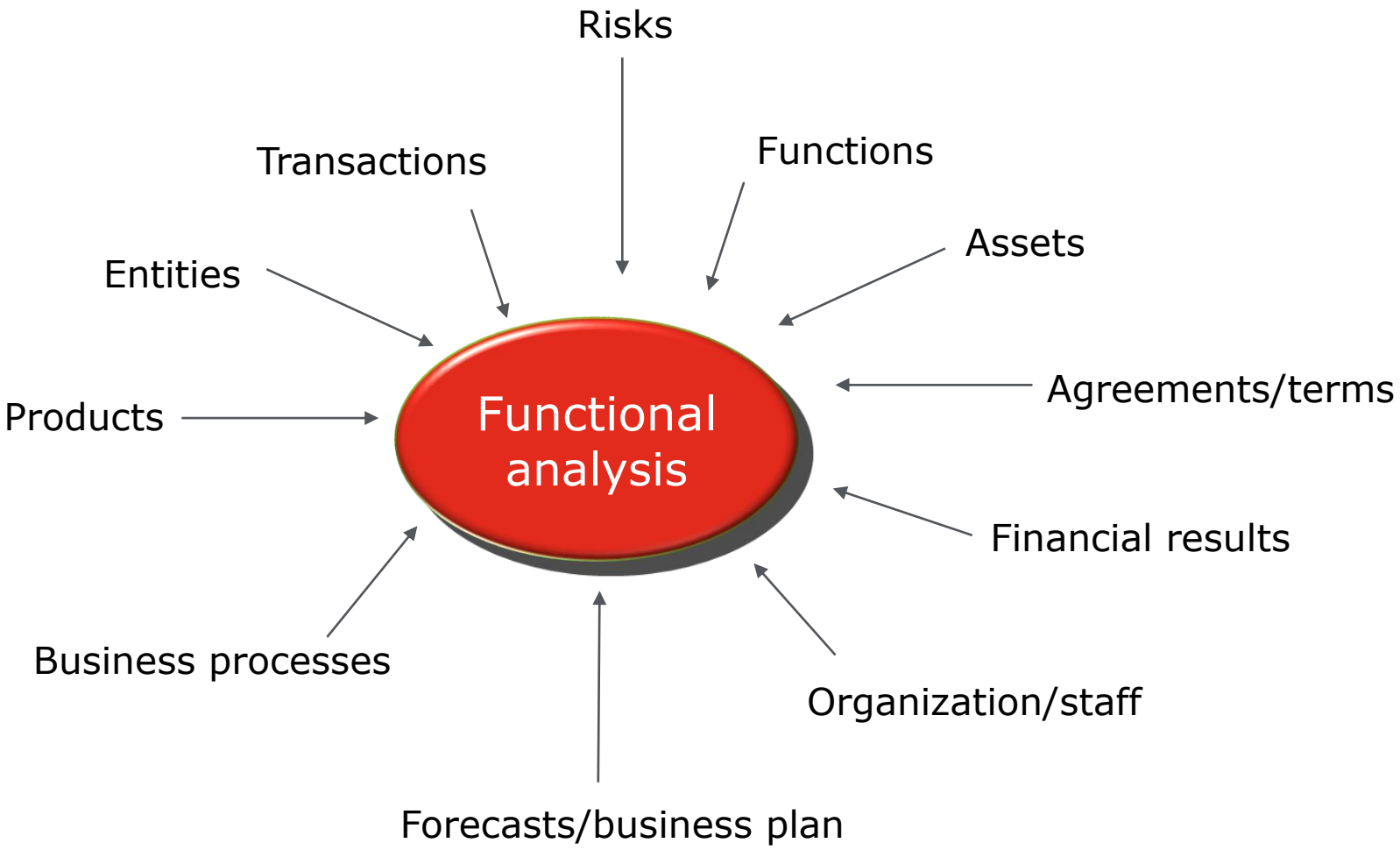
- The allocation of these activities between those entities involved in the transaction so each entity can be fully characterised

- Determination of an arm's length transfer pricing policy for the company

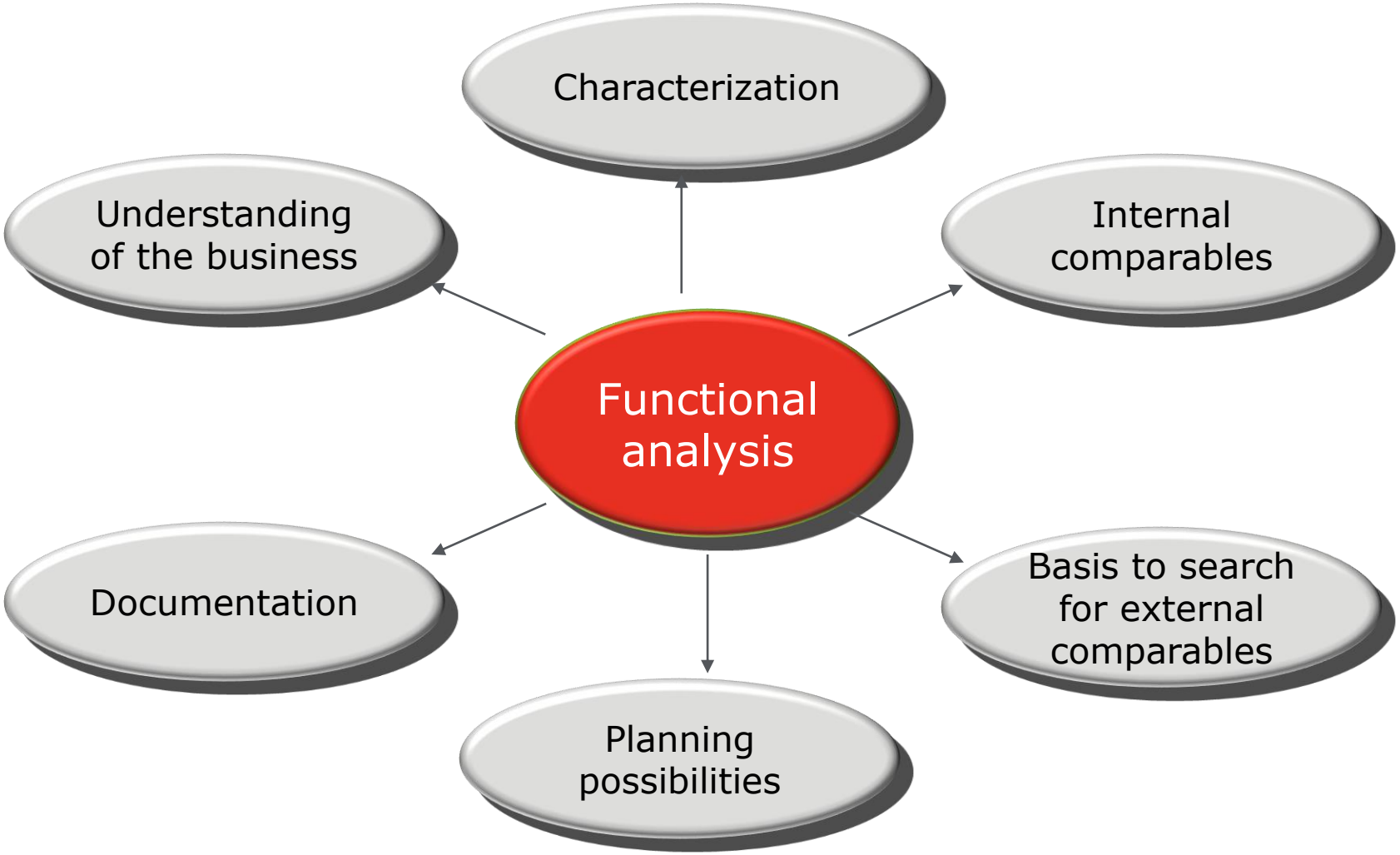
Functional Analysis in context



What goes into functional analysis?



What comes out of functional analysis?



Why do a functional analysis?

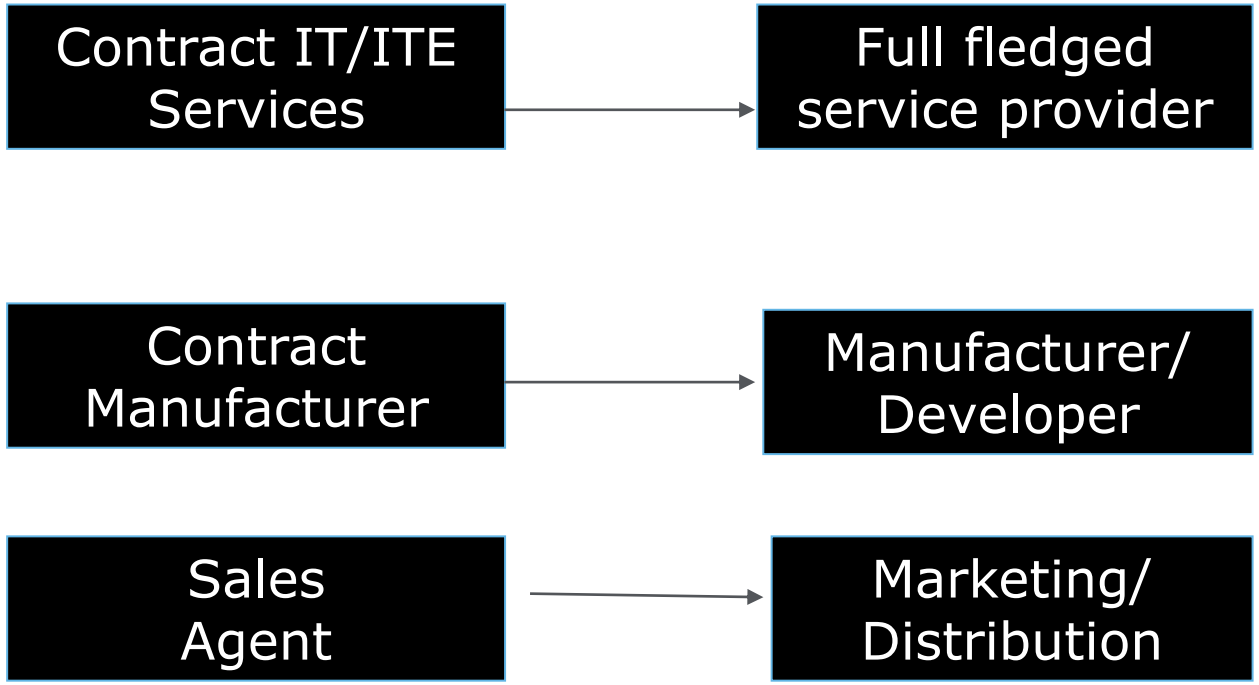
- An essential element of any transfer pricing study
  - planning
  - Defense

- Functional Analysis allows a full understanding of the economic value-added contributed by each entity and a characterization of it

- This understanding then allows you to judge **<u>comparability</u>**
  - an appropriate position in the arm's length range

Why do a functional analysis?-cont'd

- Allows characterization of the business
- Functional analysis scale



- Low function
- Low risk

- High function
- High risk

Transfer Pricing Methods

Transfer Pricing Methods| Overview

The objective of the methods is to provide a market based reference for comparison of the results of the controlled arrangement.

Traditional methods

Require the identification of price or margins from individual transactions or group of transactions between related parties. These results are compared to prices or margins information obtained relating to independent parties.

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

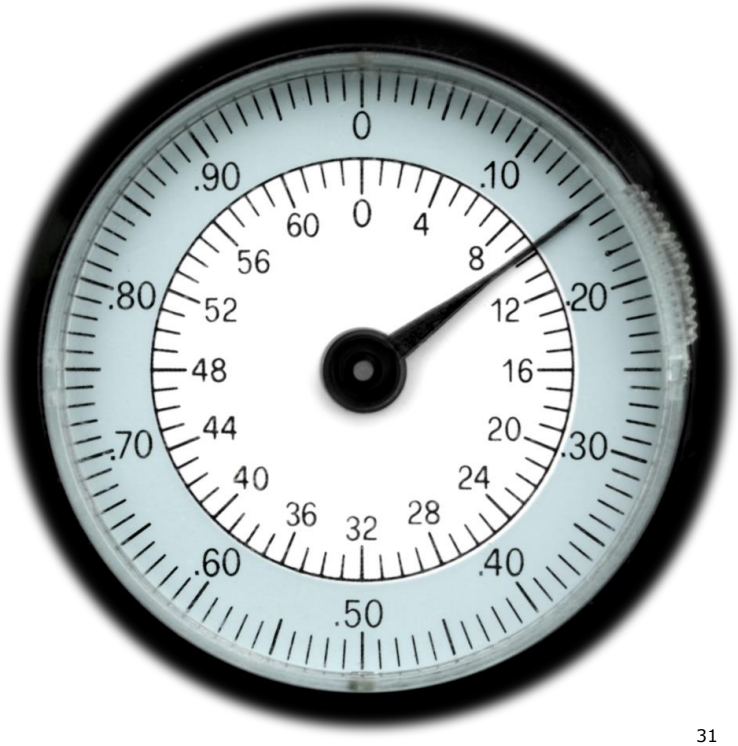
Transactional profit methods

Seeks to benchmark the overall profitability earned by controlled entities with overall profitability of third parties performing similar functions and incurring similar risk.

- Transactional net margin method
- Profit split method

Transfer Pricing Methods |Comparable Uncontrolled Price ("CUP")

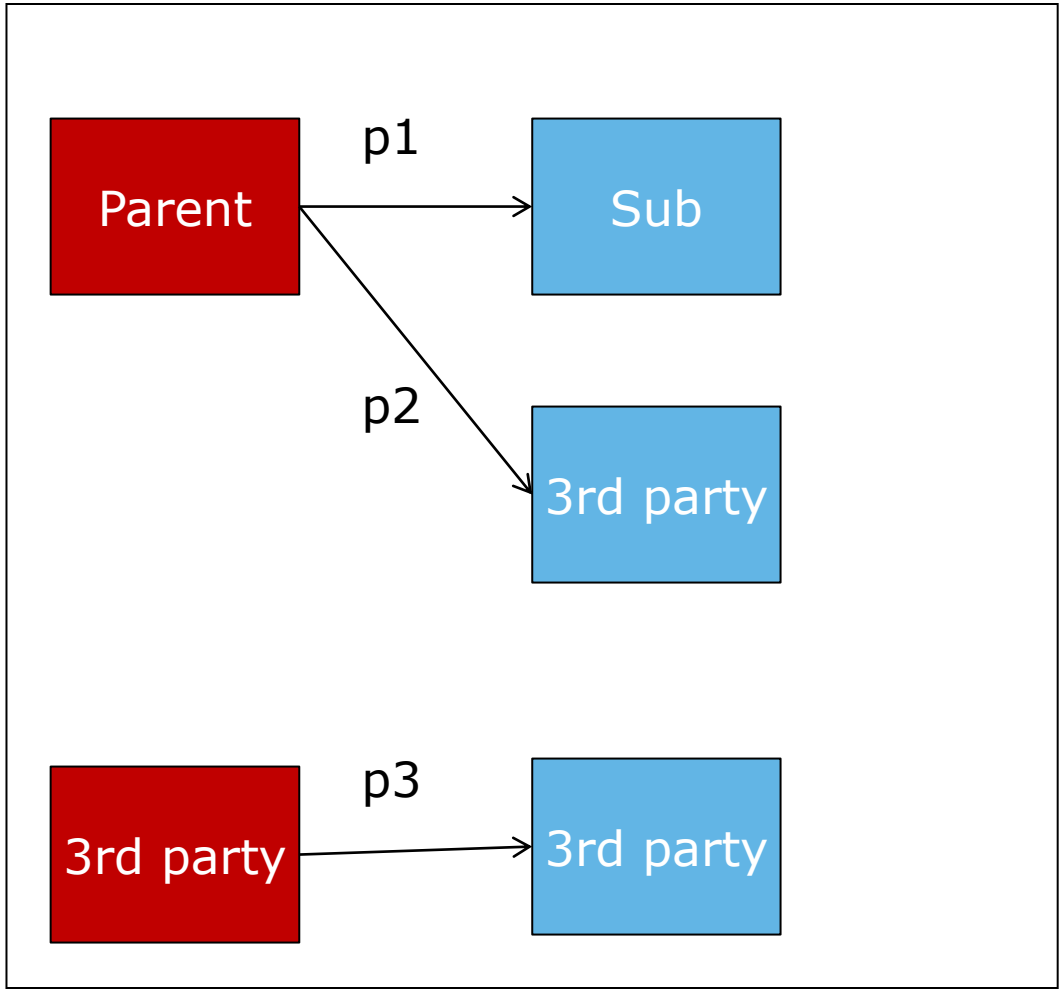
- **CUP** – compares the prices of goods or services in a transaction between related parties to the price of goods or services in comparable uncontrolled transaction in comparable circumstances.
- An uncontrolled transaction can be used as comparable uncontrolled transaction if either:
  - None of the difference between the transaction being compared in uncontrolled transaction could affect the market price of the transaction Or
  - Reasonably accurate adjustments can be made to eliminate any such differences
- Types of CUPs – internal CUP and external CUP



Transfer Pricing Methods | Comparable Uncontrolled Price ("CUP")

- Compares **the price** charged in a controlled transaction with the price charged in an uncontrolled transaction:
  - Between the tested party and an unrelated party (internal CUP – ***p2***) or
  - Between two unrelated parties (external CUP – ***p3***)

- Comparable only if tangible property and circumstances are "substantially the same" as in the uncontrolled transaction(s)



Traditional Transactional Methods- Resale Method

What is the Resale Method (RPM)?

- The Resale Method compares the gross margin earned in a controlled transaction to the gross margin earned in comparable uncontrolled transactions.

Transfer pricing method	Comparison factor	Tangible	Intangible assets
RPM	Gross margins	√	

- RPM is mainly applied for distributors who resell the product without physical alteration of the product. The method usually involves working back to the price
- E.g. A distributor purchases the same products from related party and related and unrelated supplier. The gross margin the distributor should earn on the sale of those products should be similar. The distributor should therefore set a **Resale price** so as to earn an appropriate gross margin.

Traditional Transactional Methods- Cost Plus Method

What is the cost plus method (CPM)?

The CP method compares the gross profit mark-up (i.e. ratio of gross profit to cost of sales) between a controlled and uncontrolled transaction.

Transfer pricing method	Comparison factor	Tangible	Intangible
CPM	Gross cost plus	√	

- The CPM method is mainly used to assess the mark –up earned by manufacturing entities or in the provision of services.

Transactional Profit Methods- Profit Split Method

What is the Profit Split Method (PSM)?

- The PSM allocates the combined operating profit or losses from controlled transactions in proportion to the relative contribution made by each party in generating the profit or losses.

Transfer pricing method	Comparison factor	Tangible	Intangible
Profit split method	profit or loss	√	√

- There are two types of profit split:
  - ✓ Comparable Profit Split
  - ✓ Residual Profit Split

Transactional Profit Methods | Transactional Net Margin Method

What is the TNMM?

Compares the net profit margin of controlled and uncontrolled transactions relevant to an appropriate base (sales, costs, assets);

- Looks at operating profits before interest and tax of comparable independent companies
- Applicable for any type of transaction and often used to supplement analysis under other methods

Thank you!

Discussion

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