INTERNATIONAL TAXATION

INTRODUCTION TO TRANSFER PRICING

What is Transfer Pricing

- Transfer pricing … Refers to the setting of prices for transactions between **associated enterprises** involving the transfer of property or services.” (UN Practical Manual Para 1.1.6)
- Transactions between related parties are referred to as **‘controlled’ transactions**.

Transfer Pricing…Cont'd

- Transactions that require transfer pricing analysis include;

1. Sales of tangible goods.
2. Provision of services.
3. Transfer of intangibles.
4. Financial transactions

- Where the pricing is not in accordance with the arm's-length principle, the tax administration may consider this to be 'mis-pricing' and issues of tax avoidance and/or evasion potentially arise.

Objectives of a Transfer Pricing Analysis

1. Determine the proper prices for transactions.
2. Ensure that the allocation of income between taxing jurisdictions reflects the underlying economic activity
3. Reach cross border agreements on proper pricing among the taxpayer and the affected countries
4. Avoid double taxation.

TP Legal framework

- Legislation varies from one jurisdiction to another.
- The OECD guidelines gives the general guidance.
- The scope of transfer pricing legislation may also vary from one jurisdiction to another including;

1. The material scope (Transactions covered),
2. Personal scope (Definition of associated enterprises)

TP Legal framework in Kenya

1. **Section 18(3) of Income Tax Act (Arm's length principle)**
2. **Income Tax (Transfer Pricing) Rules, 2006**
3. **Tax treaties and the Model Tax Conventions**

- Tax treaties in Article 9 (Associated Enterprises) require application of the Arm's length Principle.
- Article 9 of the OECD Model Tax Convention

TP Legal framework in Kenya

4. **International guidelines on transfer pricing**

- **Unilever Kenya Limited v The Commissioner of Income Tax (Income Tax Appeal No. 753 of 2003)**
- Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
- United Nations Practical Manual on Transfer Pricing for Developing Countries

Income Tax (Transfer Pricing) Rules, 2006

- Scope of the rules
- Transactions subject to TP review
- Transfer pricing methods
- Requirement to maintain a transfer pricing policy document and avail it upon request by the Commissioner.
- Requirement to determine the arms' length price and avail documents to evidence the calculation.
- Power of the Commissioner to request for transfer pricing documents

Income Tax (Transfer Pricing) Rules, 2006

Scope of transfer pricing in Kenya

- Transactions between one party in Kenya and another member of an MNE group outside Kenya.
- Transactions between a permanent establishment in Kenya and its Head Office or other branches located outside Kenya.
- Transactions between a resident associated person and another resident associated person where one of the party is located in a preferential tax regime in Kenya e.g. EPZ or SEZ (Finance Act, 2017).

The Arm's Length Principle

- The arm's length principle states that the prices charged within MNEs must be comparable to those that would be charged between independent enterprises.
- The arm's length principle is contained in Article 9 of the OECD and UN Model Tax Convention (MTC)
- Purpose is to prevent the artificial manipulation of profits for tax purposes
- The ALP is codified in bilateral tax treaties and countries' domestic law.

The Arm’s Length Principle…Cont’d

- Treats the members of an MNE group as if they were independent of each other for tax purposes.
- Used to determine what profits each of the associated enterprises should make from the transaction by reference to independent enterprises.
- To meet the arm’s length principle, the price in a controlled transaction (transfer price) should be equivalent to the price that would have been agreed between transaction in comparable conditions.

The Arm's Length Principle…Cont'd

- **Article 9 of the OECD & UN Model Tax Convention (MTC)**

  "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 … and …conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which had been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, may be included in the profits of that enterprise and taxed accordingly.'

Key Concepts in Transfer Pricing

Article 9 of the Model Tax Convention contains key concepts in relation to Transfer Pricing such as

1. Associated enterprises
2. Arm's length principle
3. Elimination of double Taxation

- Enterprises are associated where one participates directly or indirectly in the management, control or capital of the other; or when the same persons participate directly or indirectly in the management, control or capital of both

The Arm's Length Principle…Cont'd

- **Section 18(3) of the Income Tax Act Cap 470**

  ‘*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 such that is produces to the resident person or the 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 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*’

The Arm's Length Principle…Cont'd

- The ALP is the generally accepted guiding principle in establishing acceptable transfer prices.
- Transactions between associated enterprises may not be directly affected by external market forces in the same way
- When transfer pricing does not reflect market forces, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted.

The Arm's Length Principle…Cont'd

- If an MNE cannot demonstrate the use of arm's-length pricing, then the tax authority may adjust the profits upwards.
- The ALP is used because markets govern transactions between unrelated parties
- determination of prices for related party transaction on the basis of the ALP will assure a market based allocation
- The 'separate entity' principle is the current global norm for taxing MNEs.
- Consistent application of the ALP may make it possible to resolve transfer pricing disputes and avoid double taxation.

Advantages of the ALP

1. When correctly applied, the ALP replicates market conditions in intra-group trade, thus value is allocated where it is created.
2. Currently used by a large majority of countries

Weaknesses of the ALP

1. It is based on the separate entity approach and may not account for economies of scale and the interrelations of integrated businesses
2. Related parties may engage in transactions that independent companied would not, thus it is difficult to apply
3. Often results in administrative burden as it requires evaluation of significant amount of information
4. Difficult to obtain necessary data due to confidentiality issues.
5. Time lag

The Arm's Length Principle...Cont'd

- **Definition of Terms**

1. **Controlled transactions-** Transactions between two enterprises that are associated enterprises with respect to each other.
2. **Uncontrolled transactions-** Transactions between enterprises that are independent enterprises with respect to each other.
3. **Comparable uncontrolled transaction -** Transaction between two independent parties that is comparable to the controlled transaction under examination

Applying the Arm's Length Principle

- Transfer pricing under the ALP is based on comparing controlled transactions to uncontrolled transactions.
- There are three key steps in a transfer pricing analysis

1. Getting the relevant facts – **Functional Analysis**
2. Identifying useful comparable transactions or relationships – **Comparability Analysis**
3. Selecting and applying the most appropriate transfer pricing method.

Comparability Analysis

- The ALP assumes that transactions between related parties should be consistent with **comparable** transactions between independent parties
- According to the OECD guidelines, controlled and uncontrolled transactions are comparable if;

1. There are no differences between the transactions that materially affect the condition being examined (e.g. price or margin)
2. Where such differences exist, reasonably accurate adjustments can be made to eliminate the material effects of such differences

Comparability Analysis

- Comparability analysis is thus a process of identifying all the economically significant factors of the controlled transaction and making further comparisons of these factors with the characteristic of the comparable uncontrolled transaction.
- It involves assessment of the factors affecting the controlled transaction and examination of the factors affecting potentially comparable uncontrolled transactions.
- **Comparables** are uncontrolled transactions used to assess the arm's length nature of the controlled transaction

Comparability Analysis

- Comparable uncontrolled transactions could be:-

1. Internal comparables

- Are comparable transactions between one party to the controlled transaction and an unrelated party.

2. External comparables

- Are comparable transactions between two independent parties, neither of which is a party to the controlled transaction

Comparability Analysis

- The OECD guideline identify 5 comparability factors to consider in evaluating comparability;

1. The **contractual terms** of the controlled transaction
2. The functions performed by the parties (taking into account assets used and risk assumed) in relation to the controlled transaction – **Functional analysis**
3. The **characteristics** of the property or services transferred
4. The **economic circumstances** of the parties
5. The **business strategies** pursued by the parties

1. Characteristics of property or Service

- Property, tangible or intangible, as well as services, may have different characteristics which may lead to a difference in their values in the open market.
- Characteristics to be considered:-

1. **Tangible property** - physical features, quality, reliability, availability & volume of supply
2. **Services** – nature & extent
3. **Intangible property** – form of transaction (licensing or sale), type of property, duration and degree of protection as well as expected benefits

- Depending on the transfer pricing method, this factor must be given more or less weight.

1. Characteristics of property or Service

- The requirement for comparability of property or services is the strictest for the CUP method.
- Under the RPM and CPM, some differences are less likely to have a material effect on the gross profit margin or mark-up on costs.
- Differences are even less sensitive in the case of the TNMM and PSM.

2. Functions performed (FAR Analysis)

- In transactions between independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed).
- FAR analysis is vital for **delineation of transactions** and for setting the basis for comparability analysis.
- Identifies and compares economically significant activities, responsibilities undertaken, assets used and risks assumed by the parties to the transaction.
- Determines compensation between companies to the controlled transaction.
- Understand the structure and organization of the group and how value is created within the group.
- More importantly, determine the contribution made by tested party to the overall value of the group.

3. Contractual terms of transaction

- In arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties.
- Written contract is often the starting point for determining the terms and conditions entered into by the parties.
- Where terms are not explicitly defined, then the terms have to be deduced from their economic relationship and conduct.

3. Contractual terms of transaction

- Its important to figure out whether the contractual terms between the associated enterprises are a “sham”.
- Generally contractual terms should be analysed as part of the functional analysis.
- Examples of relevant contractual terms:-

1. Incoterms (FOB or CIF);
2. Payment terms and Credit period;
3. Scope of terms of warranties provided;
4. Duration of licenses, exclusive/non-exclusive or other arrangement for intangible assets.
5. Volume of sales/purchases.

4. Economic Circumstances

- Arm's length prices may vary across different markets even for transactions involving the same property or services.
- The comparability of controlled and uncontrolled transactions requires a comparison to be made of the economic conditions that could affect the measure of an arm's length result under the transfer pricing method applied.
- Economic analysis deals with industry analysis and circumstances that may be relevant for determining market comparability.

4. Economic Circumstances

❑Key circumstances to consider in the analysis:-

- Geographic location of the market
- Market size
- Level of market (retail, wholesale)
- Extent of competition in the market
- Relative competitive position of buyers and sellers in the market
- Availability of substitutes of goods or services.
- The level of demand and supply in the market.
- Consumer bargaining power
- Level of government controls and regulations
- Cost of production

5. Business strategies of parties

- The business strategies affecting the controlled transaction?
- New product development
- Degree of diversification
- Expansion of market share
- Market penetration

Options Realistically Available

- The economically relevant characteristics only present part of the picture; in a thorough comparability analysis you must fully understand the options that were realistically availed to the parties.
- Independent enterprises would compare the transaction to other options that are realistically available to them and would only enter into a transaction if it represented the best opportunity to meet their commercial objectives.

Comparability Adjustments

- Comparability adjustments are done to improve the reliability of the comparables data, improving their relevance
- Common comparability adjustments include;

1. Adjustments for product, delivery, payment terms differences
2. Accounting adjustments for differences in accounting practices
3. Adjustments for differences in capital, functions, assets and risks

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TRANSFER PRICING
FUNCTIONAL ANALYSIS

Functional Analysis

- Functional analysis is a process of identifying and analysing ***economically significant*** functions executed by parties, risks taken and assets used in the transaction.
- The goal is not to identify and analyse all FARs but to focus on the most critical FAR
- An economically significant function, asset, or risk is one that, at arm's length, materially affects;

1. The price charged in a transaction
2. The profits and/or losses from a transaction

Functional Analysis

- Key elements of a functional analysis may include;

1. Understanding the overall process by which the MNE creates value and the key factors that contribute to the value creation.
2. Identifying the relevant cross border transactions between the associated enterprises
3. Identify the specific terms of the transactions by reference to written contracts and the conduct of the parties
4. Identifying specifically the functions performed, assets used and risks assumed by each of the parties in relation to the identified transaction – **Accurately delineating the Transaction.**

Functional Analysis … Cont'd

- Sheer weight of functions performed is not decisive in profit determination
- The relative importance of each function is what is relevant
- It's important to identify each party's contribution to every function performed
- The greater the significance of the functions performed are the greater the entitlement to the profit

Functional Analysis … Cont'd

- Examples of **functions** to be considered;

1. Research and development
2. Product design and engineering
3. Manufacturing, production, process engineering, and design work
4. Purchasing, material management, and other procurement activities
5. Manufacturing, production, or assembly work
6. Transportation, warehousing, and inventory
7. Marketing, advertising, publicity, and distribution
8. Market intelligence on technological developments
9. Intra-group services e.g. managerial, legal, accounting & finance, credit & collection, training & personnel management.

Functional Analysis … Cont'd

- Determine legal rights and obligation of the taxpayer in performing its functions.
- Economic significance of a function is more important than the number of functions performed. Nature, frequency and value of the function is therefore important.
- The process of identifying the economically relevant characteristics of the commercial or financial relations should include consideration of the capabilities of the parties.
- Functional analysis should consider the assets used

Functional Analysis … Cont'd

- Example of **assets;**

✓**Tangible**

1. Land and building
2. Furniture and fixtures
3. Computers
4. Plant and Machinery

✓**Intangible**

1. Patents
2. Trademarks
3. Brand names
4. Licences

Functional Analysis … Cont'd

- A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered
- In the open market, the assumption of increased risk would also be compensated by an increase in the expected return.
- Thus, its important to identify the economically significant risks in a controlled transaction.
- More importantly identify, which party contractually assumes the risk, which manages and controls the risk and which party has financial capacity to bear the risk.

Functional Analysis … Cont'd

❑**Risk management**

- The assumption of risks by one party or another may influence the price or other conditions of a transaction between associated enterprises.
- There are 2 fundamental questions to be answered during risk analysis

1. What are the (economically significant) risks in the transaction?
2. Which party to the transaction assumes these risks?

FAR: Risk management

- The party which performs risk management function should be identified and compensated. Key factors are:-

1. the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity,
2. the capability to make decisions on whether and how to respond to the risks associated with the opportunity,
3. the capability to mitigate risk, that is the capability to take measures that affect risk outcomes

FAR: Risk management

- The structured Risk Analysis would look like this;

1. Identify the risk- What is are the most economically significant risk?
2. Any profit seeking company will also seek whether and how business opportunities should be pursued in view of the identified inherent risk, and in developing appropriate risk mitigation strategies.
3. Risk is associated with opportunities and does not have downward connotations alone.

Functional Analysis … Cont’d

- There are several categories of risks;

1. Strategic & marketplace risks
2. Infrastructural or operational risks
3. Financial risk
4. Transactional risks
5. Hazard risks

Working Example

- CTL- Research, manufacturing and sale of pharmaceutical products based in Switzerland to distributors in Kenya.
- BIOKL- Markets the pharmaceutical products in Kenya.

Functional Analysis Illustration

FAR	CTL	BIOKL	Comments
Functions			
Assets			
Risks			