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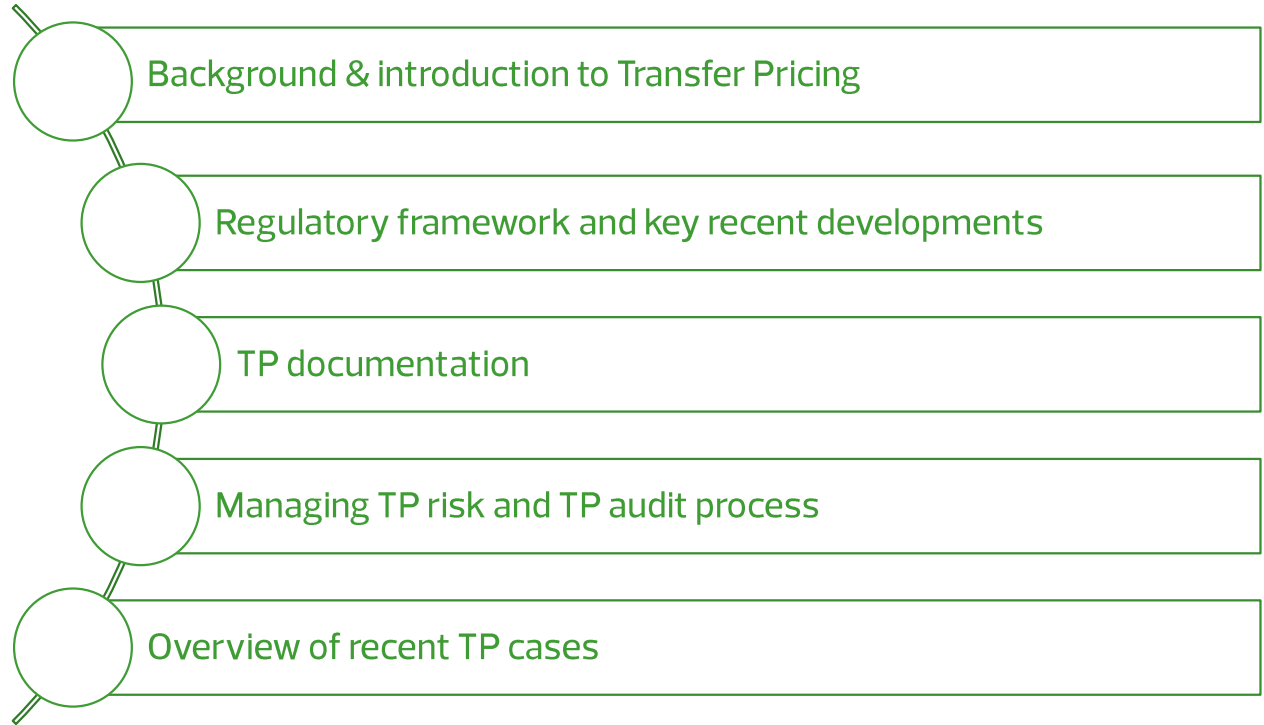
Global vision backed by local knowledge



RSM HYBRID SEMINAR – MANAGING TRANSFER PRICING RISK

Tuesday, 29 March 2022

Agenda



Amazon paid just £15m in tax on European revenues of £19.5bn

Online retailer's UK warehouse and logistics operation more than halved its corporation tax bill from £15.8m to £7.4m



Apple may face \$14.5 billion tax bill after EU rules Irish deal is illegal

Published: Aug 30, 2016 10:41 a.m. ET



Ireland ordered to recoup unpaid taxes from Apple



Technology

FINRA

Google's 'Dutch Sandwich' Shielded 16 Billion Euros From Tax

The method helped Google to pay a corporation tax rate of a little more than 6 per cent on its foreign earnings, compared to the 35 per cent headline rate in effect in the US at the time.

Tax shelter saved Google billions of dollars in 2010

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Starbucks' EU unit paid just 2.8% in UK tax last year

Michael Selby-Green

Sep. 19, 2018, 11:02 AM ▲ 963





BACKGROUND AND KEY TERMS

What is Transfer Pricing?

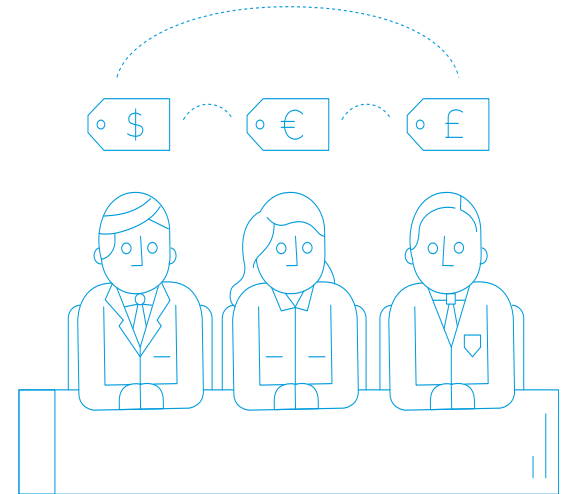
Transfer price – the value or price at which transactions take place amongst related parties e.g. if a subsidiary company sells goods/services to its holding company, the price charged is referred to as the *transfer price*

Transfer pricing – the rules and methods that guide pricing of transactions between related enterprises

Why are revenue authorities increasingly focusing on TP?

- TP's role in supporting Multinational Enterprises (MNE's) business
- About 60% of world trade takes place within multinationals
- Differences in tax regimes

The above, among other facts, create a tempting recipe for BEPS



Base Erosion & Profit Shifting (BEPS)

Base Erosion

Reduction of a company's tax bill below what it would be expected to pay by reducing the *tax base*.

Methods: Booking more expenses, under-reporting incomes, not reporting incomes, writing off expenditure against taxable income



Profit Shifting

Payments to group companies in order to move income/profit from one tax jurisdiction or company to another.

Intra-group payments (transfer pricing) royalties, interest payment, service fees, recharges of costs, purchase of goods and lease rentals

MNEs are deemed to have more risk of BEPS techniques due to the following factors:

- International operations (ready network through which group funds can flow)
- Capital to set up and maintain entities used for tax-deduction purposes
- Income that tends to be large enough to support multiple transactions

Key Terms

Related parties

- Common control/capital
- Common management

Controlled transaction

- An intercompany transaction
- A transaction between related parties

Uncontrolled transaction

- A transaction between unrelated or independent parties (open market)

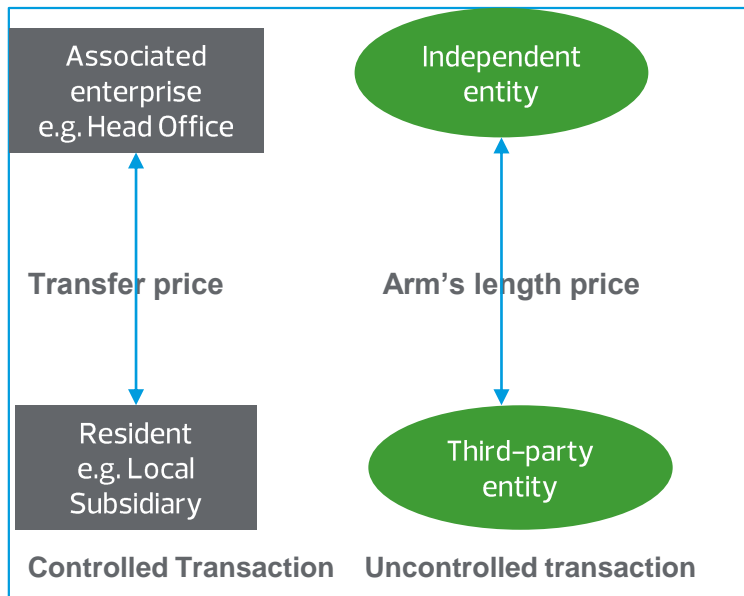
Arm's length price

- Price which is generally charged in a transaction between independent parties

Transfer mis-pricing

- The trade between related parties at prices meant to manipulate markets and to deceive tax authorities
- Non arms-length pricing or unjustified pricing

Arm's Length Principle (ALP)



Arm's-length principle

The *transfer price* should be **similar** to the *arm's length price* for similar transactions i.e.

- The price agreed in a transaction between two related parties must be similar to the price agreed between two unrelated parties for comparable transactions

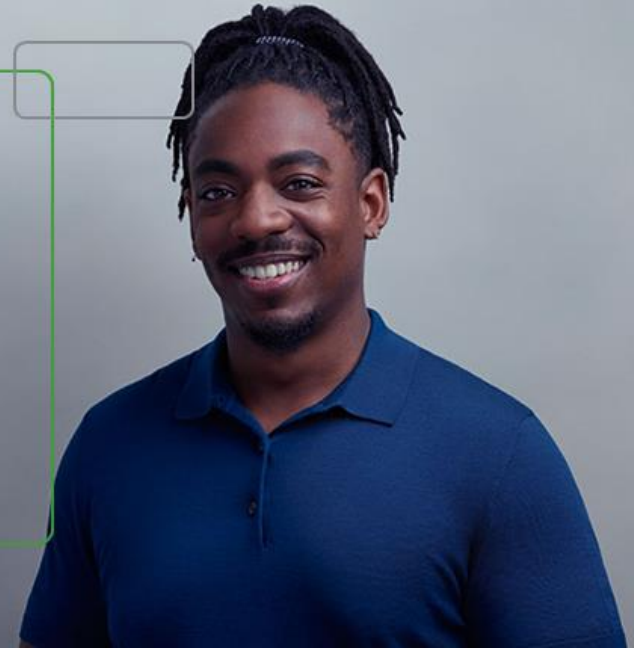
A TP adjustment is made to reflect the profits that would have been made if a similar transaction to the controlled transactions had been executed by independent enterprises

Arm's Length Principle (ALP)



Rationale

- Market-based allocation of income between the related parties
- Prevent BEPS
- Consistent application of the ALP (single set of rules) makes it possible to resolve TP disputes
- Avoid double taxation



REGULATORY FRAMEWORK AND RECENT CHANGES

Regulatory Framework and Recent Changes

International Guidelines

- The **OECD** (Organisation for Economic Cooperation and Development) Transfer Pricing Guidelines;
- OECD Model Tax Convention on Income and Capital;
- **UN** Practical Manual on Transfer Pricing for Developing Countries;
- UN Model Double Taxation Convention; and
- **BEPS** Action Plans: 1 – 13

Kenya	Tanzania	Uganda
<p><i>Income Tax, Cap 470</i></p> <p><i>18(3) – Gives the Commissioner the power to adjust the profit of a resident company which has transactions with non-resident related parties to reflect ALP</i></p> <p><i>Income Tax (Transfer Pricing) Rules, 2006</i></p> <p><i>Rule 10 – Requires any company with controlled transaction to prepare a TP policy and submit it to the Commissioner upon request</i></p>	<p><i>The Income Tax Act, Cap. 332</i></p> <p>33(1) – Any arrangement between related parties must result in incomes or payables that would have arisen for them if the arrangement had been conducted at arm's length</p> <p><i>Tax Administration (Transfer Pricing) Regulations, 2018</i></p> <p><i>Tanzania Revenue Authority (TRA) Transfer Pricing Guidelines, 2020</i></p>	<p><i>Income Tax Act, Cap 340</i></p> <p><i>Sections 90(1) and 164</i></p> <p><i>Income Tax (Transfer Pricing) Regulations, 2011 (Statutory Instruments No. 1 of 2011)</i></p>

Regulatory Framework and Recent Changes

Revised definition of Control in Kenya (Finance Act, 2021)

- At least 20% of the voting rights
- Loan equivalent to at least 70% of total assets
- Guarantor to a loan constituting – 70% of the indebtedness
- Appoints more than half of the board of directors
- Appoints at least one director or executive member of the governing board
- Licensed intangible property – wholly used in business operations
- Supplies at least 90% of purchases or influences the price/conditions relating to the purchases
- Sells over 90% to one client or influences the price/conditions in which such sales are made
- Other relationship, dealing or practice which *the Commissioner may deem to constitute control*

Expanded definition of Permanent Establishment (PE)

The Finance Act, 2021 enhanced the definition of scenarios Permanent Establishment (PE) in Kenya to include the following:

- General PEs;
- Construction site PE;
- Services PE;
- Exploration PE; and
- Dependent Agency PE

A PE is a '*taxable presence*' in a country which creates tax obligations for the foreign company in the local country

Regulatory Framework and Recent Changes

General PEs – A fixed place of business through which business is wholly or partly carried on (a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry) or any other place of extraction or exploitation of natural resources, a warehouse in relation to a person whose business is providing storage facilities to others, a farm, plantation or other place where agricultural, forestry plantation or related activities are carried on and a sales outlet

Construction site PEs – A building site, construction, assembly or installation project or any supervisory activity connected to the site or project, but only if it continues for a period of more than 183 days

Services PE – the provision of services, including consultancy services, by a person through employees or other personnel, for a period(s) exceeding in the aggregate, 91 days in the year of income

Exploration activities – An installation or structure used in the exploration for natural resources where the exploration activities continue for period (s) of at least 91 days in the year (of income)

Dependent agent PE – A dependent agent of a person who acts on their behalf in respect of any activities which that person undertakes in Kenya including habitually concluding contracts or playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the person

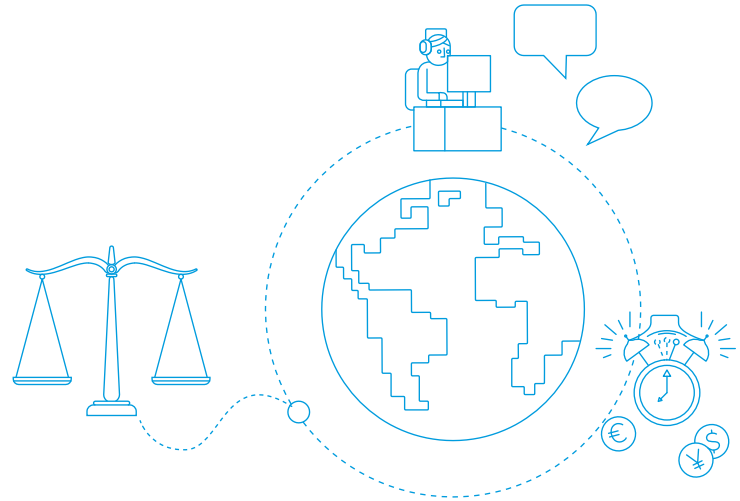
The determination of a PE excludes certain activities of a preparatory or auxiliary character

Regulatory Framework and Recent Changes

Central Management and Control (CMC)

(Residency of a Foreign Entity)

- A company *resides* where its CMC actually *abides*
- The CMC of a company vests in the company's top management and controlling shareholder(s)
- The place where they make key management and commercial decisions in relation to the company
- If CMC of a company is deemed to be in Kenya, the company would be subject to tax in Kenya



Regulatory Framework and Recent Changes

Economic Substance Requirements

To prevent shell companies, sham transactions and BEPS

For a transaction to be valid, it must have economic purpose (other than the tax motivation)

Physical substance

- Real presence of the company in a certain country (the presence of a real office, employees, director, etc.)

Economic substance (tax substance)

Actual activity of and the effective role a company plays in the broader context of an internationally operating company

- Real presence of the business of an entity – the actual activities of the company in the territory of a particular country

- The profit reported by an entity should be commensurate with its economic activities and substantial economic presence there
- The economic activities of an entity are measured by:
 - ✓ Its CMS;
 - ✓ Adequacy of staff, premises and expenditure; and
 - ✓ Actual functions it performs

Regulatory Framework and Recent Changes

Country-by-Country Reporting (BEPS Action 13)

Effective 1 January 2022, MNEs with headquarters in Kenya (and not owned by another entity) that has subsidiaries, branches or PEs in other countries will be required to submit a 'CbC' report/return to the Commissioner on an annual basis

Threshold– At least EUR 20 million (*KES 2.5 billion*)

The CbC report should detail information of each of the Group entities – revenue, income before tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees and tangible assets

Report to be submitted to the Kenya Revenue Authority (KRA) not later than 12 months after the end of the group's FY

The KRA will use the CbC report to assess TP and BEPS risk in Kenya

Aligning TP outcomes with value creation (BEPS Action 8 – 10)

The ALP is the cornerstone of TP rules

Actions 8 to 10 of the BEPS Action Plan aim to reinforce this principle by ensuring that the allocation of profits is correctly aligned with the economic activity that produced the profit

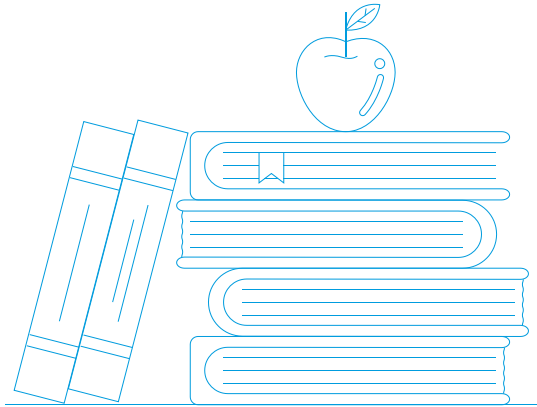
The ALP was deemed vulnerable (as it may rely on contractual allocation of FAR) which do not correspond to the value created by the economic activity carried out by the members of MNE e.g transactions involving intangibles



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TP POLICY DOCUMENTATION



What is a TP Policy?

A document that supports that transfer prices are just and reasonable

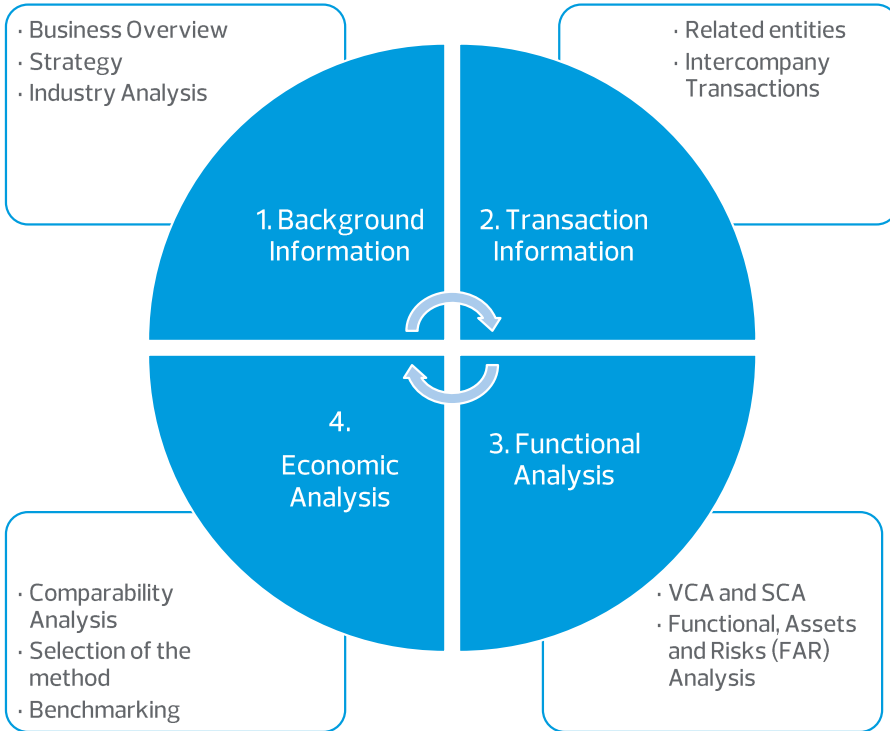
Sounds simple – why then is the document complex?

In preparing a TP Policy, you are developing a narrative of the company's transfer prices

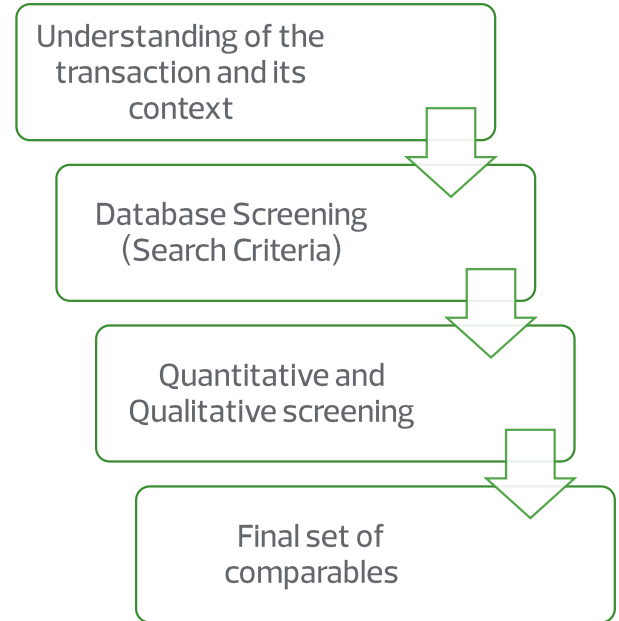
The price of a product/service is influenced by three key factors:

- The *status of the company*;
- The *status of the market* in which the company operates; and
- The detailed *nature of the product/service*

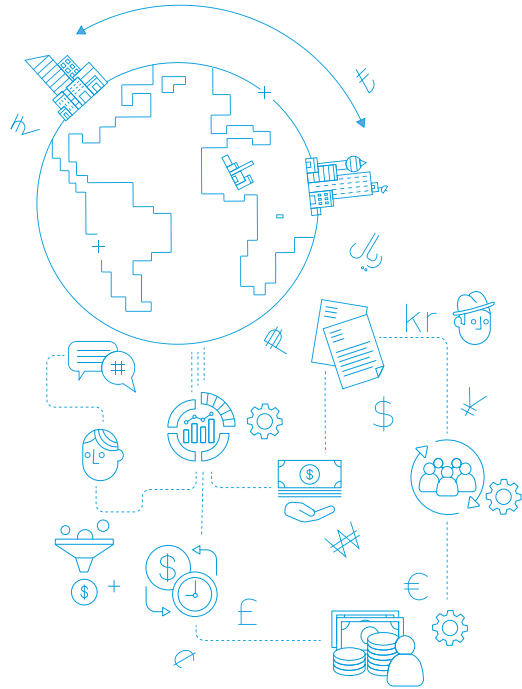
TP Documentation



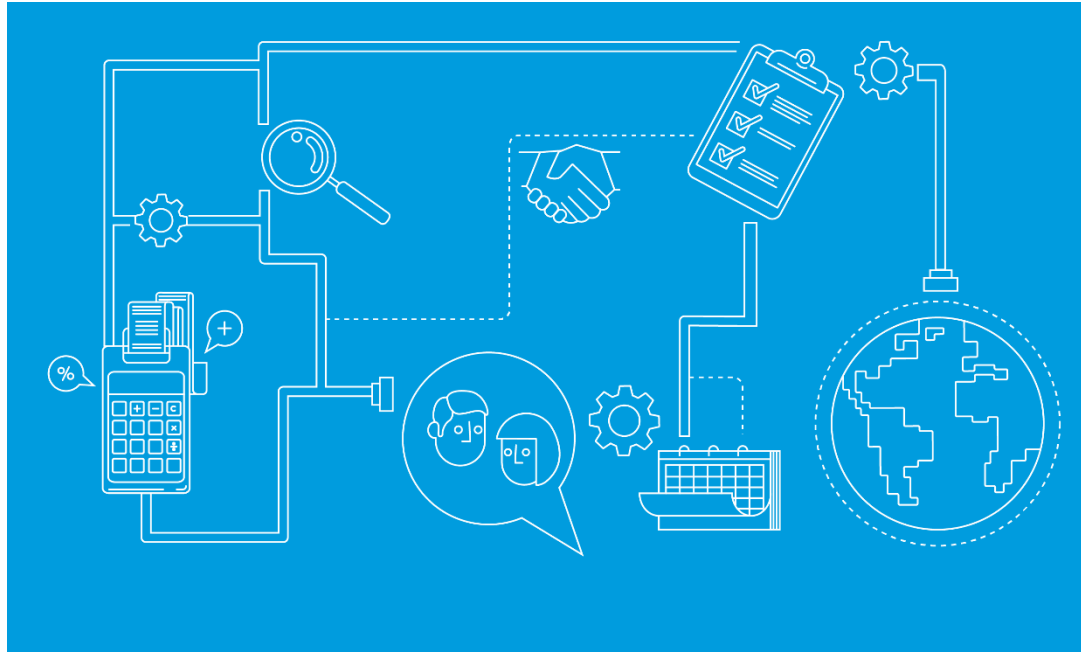
4. Comparability Analysis



Transactions Subject to TP Regulations



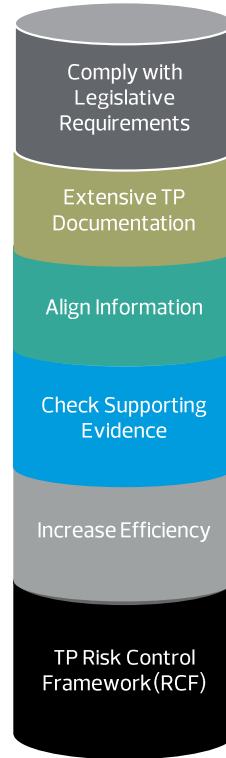
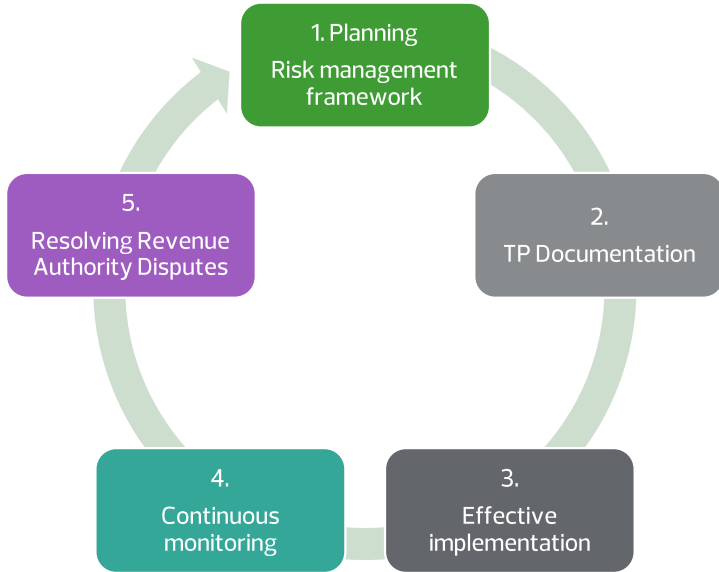
- Purchase and sale of goods (including assets);
- Rendering or receiving services;
- Agency arrangements, leasing arrangements, & license agreements;
- Financial transactions (loans) including guarantees and collaterals;
- Transfer of Intangibles including R&D;
- Management contracts; and
- **Any other transactions which may affect the profit or loss of involved entity**



MANAGING TP RISKS AND TP AUDIT PROCESS

Managing TP Risks and TP Audit Process

Transfer pricing life cycle



Ensure that your TP arrangements comply with the relevant guidelines as updated from time to time – local and international guidelines

Ensure you have a complete set of all information required by the local tax legislations and the OECD TP Guidelines

Consistency & harmonisation of the Master File, the Local File, intercompany agreement and actual business operations

Plan ahead by interrogating the firm's TP documentation
Collate evidence to support the TP policy in the event of a tax audit

Use technology to enhance information gathering, storage & analysis
Adds depth by evidencing decision making & control of risks

Effective RCF to track progress in areas of strategic importance.
Metrics on progress & outcomes to strengthen communications and build persuasive business cases for better operations

Monitoring & Compliance

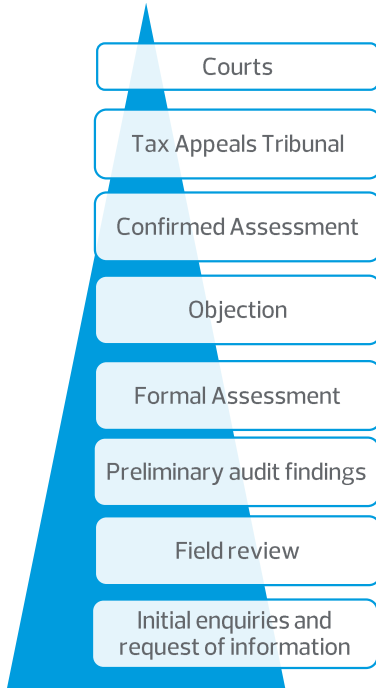
The benefits of a good management of TP risks are the *invisible gains* in the form of **risk mitigation** and **tax saving**, rather than any other apparent tangible benefits

Implementation of the TP Policy	Comprehensive Story and Support	Continuous Improvement
<p>Ensure the TP policy is air-tight and implemented to the letter</p> <ul style="list-style-type: none">• The intercompany transactions should result in the desired arm's-length outcome• Comparison of budget with actual outcomes• Adjustment capabilities to ensure transfer prices are adjusted timely• Full reconciliation of key data• Robust comparability analysis to support each transaction covered	<p>TP is fact-intensive</p> <ul style="list-style-type: none">• Ensure the Master file and the Local file speak the same story• Data consistency across all functional units• Ensure the intercompany agreements reflects the actual intercompany transactions executed• Maintain sufficient supporting evidence for all the intercompany transactions	<ul style="list-style-type: none">• Identify improvement opportunities• Update the TP Policy with changes• Regularly conduct TP health checks and risk reviews• Respond to tax authorities queries



Managing a TP Audit Process

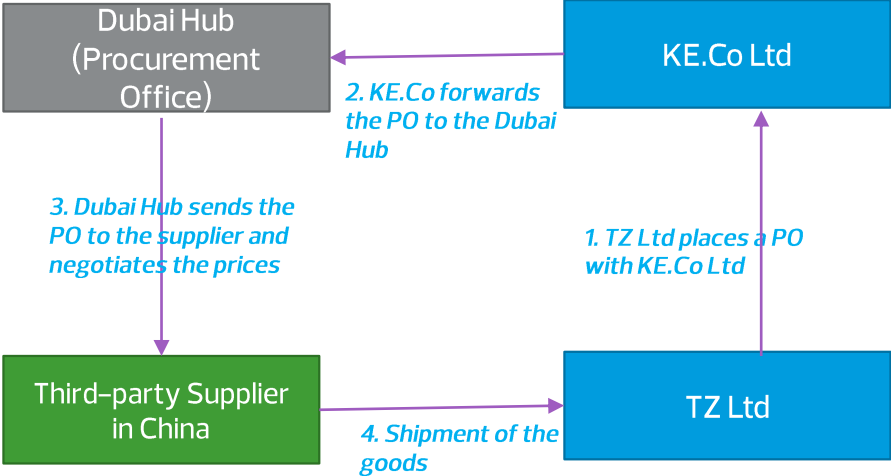
Solid documentation – well-prepared and substantiated TP documentation enables you to defend your TP policies



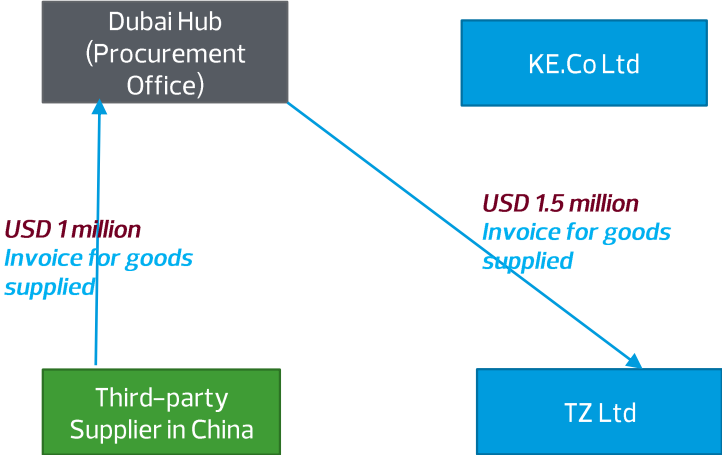
Record Keeping	Submission of information	Engaging the revenue authority
<p>Clear and broad commercial understanding of the business – Finance Team</p> <p>Be compliant – TP file, tax returns, necessary disclosures</p> <p>Ensure disclosures on tax returns are correct and complete</p> <p>Make sure you keep control of the process</p>	<p>Be clear of the audit scope before sharing any information</p> <p>Submit all relevant and reasonable information requested and keep copies on file. Clearly mark information shared</p> <p>Ensure documentation and contracts all align</p>	<p>Review your strategy and seek advice; is it a matter of principle to be defended at all cost or is it a matter of comparables with room for negotiation</p> <p>If interviews are requested, ensure your staff are well briefed</p> <p>Ensure all discussions minutes are kept and provided to the tax authority for agreement</p> <p>Non-aggressive position, aimed at management of the Revenue Authority's perception of the Company's affairs</p> <p>Identify any weaknesses and plan to defend these</p> <p>Engage your tax advisors in the documentation on defense process</p>

Transaction Flow and Financial Flow of a Transaction

Example: Transaction Flow



Example: Financial Flow



Supporting the Intercompany Transactions

Intercompany provision of services

Revenue authorities focus on whether the service was actually provided prior to evaluating whether the cost that was paid for the services is just and reasonable.

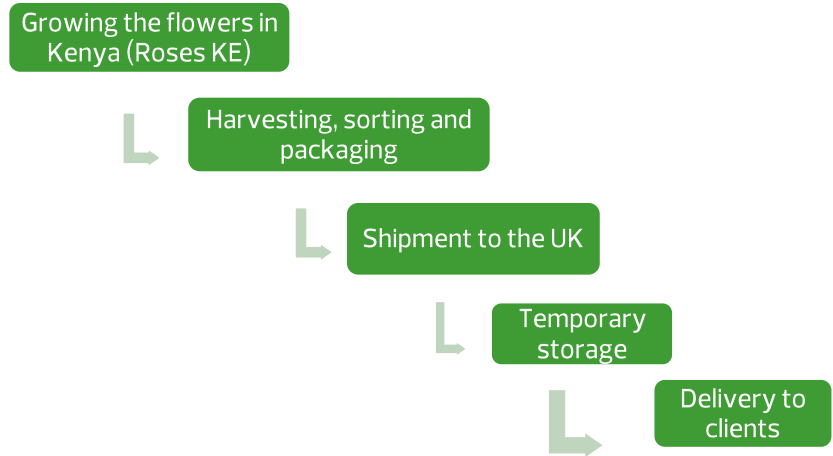
Reality Test	Benefit Test	Duplication Test	Shareholder Activity
<p>Mode and place of service delivery</p> <p>Supporting evidence to proof service was delivered</p> <p>Capacity of the provider to provide the service</p>	<p>Economic value of the service (how it advances the taxpayer's economic position)</p> <p>Demonstrate the benefit derived from the service</p>	<p>Are there employees at the local level providing or capable of providing a similar service?</p> <p>The taxpayer receives a similar service from a third party at the local level</p> <p>Distinguish the services received from related entities from those available at the local level.</p>	<p>Activities relating to ownership interest in the group entities</p> <ul style="list-style-type: none">• Meetings of shareholders of the Parent Company• Costs of the supervisory board• Parent Company's investor's relationship e.g AGMs• Preparation of consolidated accounts for the group• Compliance of the parent company with tax laws

Supporting the Intercompany Transactions

Sale of tangible goods

Revenue authorities focus on the supply chain of the transaction and the key value adding activities performed by the parties to the transaction.

- What is the supply chain of the transaction? Supply Chain Analysis (SCA)
- What are the functions performed by the parties? (Value Chain Analysis)
- Do they have capabilities (staff and assets) to perform the functions they purport to perform?
- Where are the staff performing those functions based?
- Is the TP method adopted appropriate to compensate each of the parties based on the functions they perform?



Supporting the Intercompany Transactions

Intangible property/assets

- Trademarks, trade names and brands
- Right to use a software, platform or technology
- Patents
- Know-how and trade secrets
- Business formulas and franchising arrangements
- Rights under contracts and government licenses

For transactions involving the licensing of intangible assets, the licensees pay a royalty or license fee for the use of the IP.

Tax authorities consider the following:

- Legals vs economic owner of the IP;
- The party that performs the DEMPE functions in respect to the IP; and
- Whether the fee paid is just and reasonable



Development



Enhancement



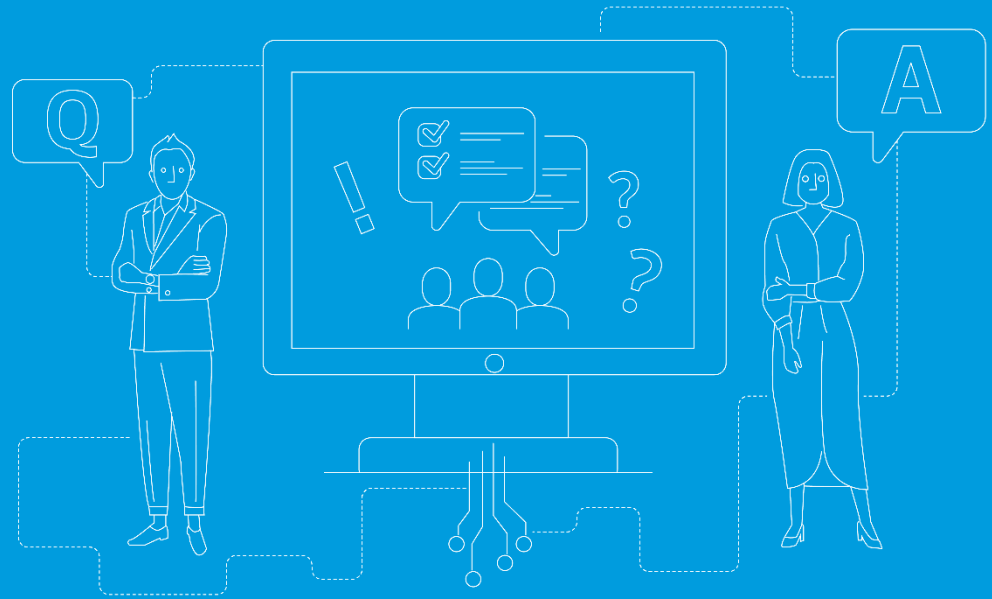
Maintenance



Protection



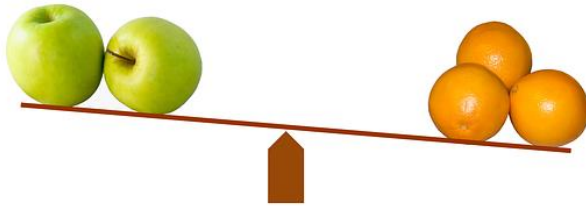
Exploitation



TRANSFER PRICING METHODS

Comparable Uncontrolled Price (CUP) Method

Compares *prices* of *similar products*, in *similar circumstances*

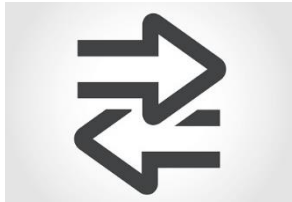


Most direct method of comparability analysis
Require high level of comparability between the products to produce reliable results

Price of the product in open market (third parties or uncontrolled transactions)	XX
+– Adjustments for material differences between uncontrolled and controlled transactions	XX
+– Adjustments for material differences of the entities	<u>XX</u>
Arm's length price as per CUP method	XX

Resale Price Method (RPM)

Used to determine ALP when *goods purchased from related parties are resold without material modification*



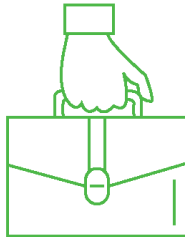
Involves working backwards from resale price received from unrelated parties to arrive at the arm's length price

Resale price of the product by related party	XX
Less normal gross margin on similar transactions	(XX)
Less expenses in connection with the purchase	(<u>XX</u>)
Arm's length price as per RPM	XX

Cost Plus Method (CPM)

Used to determine ALP when goods and services are sold to related entity

Compares the Gross Profit mark-up (GPM) earned by the related entity with GPM earned by third-party companies (comparable companies)



Direct and indirect costs incurred in respect to the goods and services	XX
Add: Normal GPM earned by independent companies in similar transactions	XX
+/- Adjustments on account of differences in the transaction or the entities	<u>XX</u>
Arm's length price as per CPM	XX

TNMM and Profit Split Method

Method	Summary
TNMM	<p>The profitability (net profit) of a controlled taxpayer or one of its business units is compared to the profitability of comparable uncontrolled taxpayers</p> <p>Net profit margin (OM)</p> <p>Net profit mark-up (NCPM)</p> <p>Return on Sales (RoS) or Assets employed</p>
Profit Split Method (PSM)	<p>Applied where transactions are very interrelated such that they cannot be evaluated reliably on a separate basis.</p> <p>Contribution Analysis vs Residual Analysis</p>

Summary of the TP Methods

Summary of an Income Statement	TP Method
Revenue (Quantity*Selling Price)	XXX CUP Method (Compares the prices)
Cost of Goods Sold (COGs) (Quantity * Buying Price)	<u>(XXX)</u>
Gross Profit (GP)	XX CPM (GP/COGs) RPM (GP/Revenue)
Operating Expenses	<u>(XX)</u>
Operating Profit (NP)	XX TNMM <ul style="list-style-type: none"> • OM (NP/sales) • NCPM (NP/Total costs) PSM (Contribution or Residual)



RSM's Transfer Pricing Services

TP Policy Documentation

TP Policy Review

TP Health Check

- TP policy implementation review; and
- High level TP policy review

Dispute Resolutions

- Revenue Authority audits

TP Related Advisories

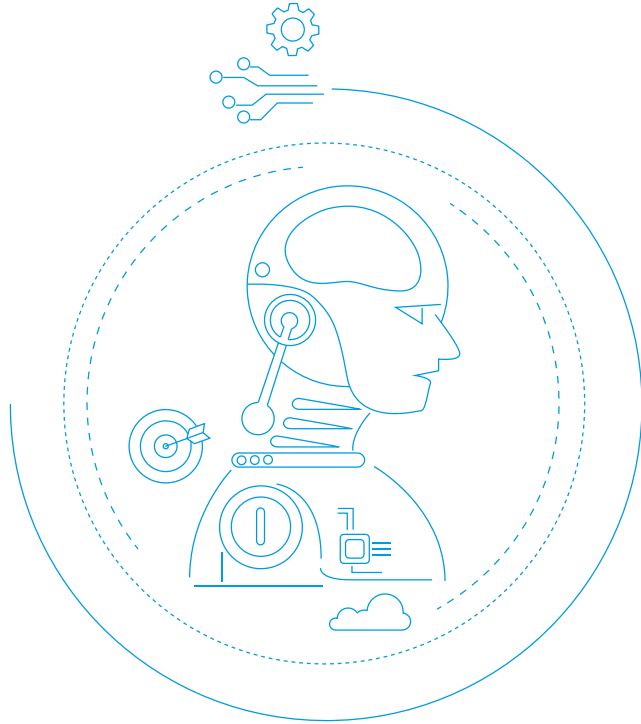
- Intellectual Property – Royalties, License Fees and Franchise arrangements;
- Centralised IP HoldoCos, Procurement Companies and Central Service Centres

Group Restructurings;

- Shared Services and Cost Allocation Models



Key points to remember



- The **arm's length principle** is the heart of transfer pricing
- TP is not a science – it's **principle based**
- A sufficiently documented TP policy serves as the taxpayer's first point of defense in the event of an audit

Questions
and answers?



Thank you
for your time
and attention

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