Income Tax Transfer Pricing Regulations, 2014: Implementation Challenges and Way Forward

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Agenda

- Introduction
- Transfer Pricing Regulations 2014
- Implementation Challenges & Recommendations
- Conclusion

Introduction

- Transfer pricing refers to the price that related enterprises (associates) charge each other for goods, services, intangibles and financing between them.

Why is Transfer Pricing Important ?

- Transfer pricing arrangements are important because it is the transfer price charged between related entities which largely influence the amount of the taxable profits, hence the final taxes paid by MNEs or received by Governments.

- It is a significant cost for MNEs and probably the most important international tax issue. It is also a major compliance burden.

- Tax planning tool i.e. it enables MNEs to manage worldwide tax bill by allowing profits to be moved between countries with different tax rates.TP also affects investment decisions, cash flow, performance measurement etc.

Introduction

- **To TRA it is a high risk area for its tax revenues.** There has been a growing perception that MNEs are avoiding tax through transfer pricing arrangements.

- The above coupled with narrow tax bases underlines the need for the government to protect its tax base while at the same time focusing on attracting foreign direct investments.

- **Transfer pricing is also one of the major tax issue for African Countries.** African Tax Administration Forum (ATAF) highlighted transfer pricing as one of the five major tax concerns expressed by countries participating in its consultative process, the others being the **digital economy, taxation of the extractive industry**, **tax instruments and information and the informal sector.**

- The G20 requested OECD to develop a strategy to address base erosion and profit shifting. 15 action points -8,9,10 and 13 on transfer pricing.

Introduction-TRA Focus

- TRA has increasingly been engaging in intensive transfer pricing study and audits paying special attention on mining and telecommunication, financial and manufacturing sectors etc.

- TRA has also formed International Taxation Unit.

- It has also been focusing on specific risk areas:

- ✓ Technical and management fees: whether the services are actually performed and if fees are reasonable.
- ✓ Royalties: Justification for payments
- ✓ Loans issued at no interest: Requires arm's length interest charge

Introduction-TRA Focus

- Other risk areas

- ✓ Circumstances where the MNEs have reported losses for a number of years (but a profitable group);
- ✓ Sudden decrease in profit margins;
- ✓ Significant values of related party transactions compared to the taxpayers' turnover and operating profit;
- ✓ Significant transactions with related parties in tax havens or low-tax jurisdictions.
- ✓ Unrealistic profit trends compared to industry trends which lacks justifiable explanation;
- ✓ Lack of consistency between inter-company contracts, Transfer pricing policies and detailed transactional documents e.g. invoices and customs documents.
- ✓ Significant royalty payments to related parties etc.
- ✓ Others include entities with significant management fees payments; non-commercial intragroup loans; lack of agreements for intragroup finance, long term intercompany trade debtors with no interest.

Transfer Pricing Regulations 2014

- **Income Tax Act, 2004**
- Section 33 of the Income Tax Act, 2004 requires that transactions between associates to be conducted at arms' length. A thorough guidance in the form of Transfer Pricing Regulations were published in February 2014 and released in May 2014. The Regulations apply to domestic and international transactions between associates.

- **Transfer Pricing Regulations, 2014 Structure, Features**
- **Regulations: A set of 16 regulations arranged under 6 main parts**
- ✓ Part I: Preliminaries (Regulation 1-3)
- ✓ **Part II: Arm's Length Principle (ALP), Comparability, Methods, Documentation (Regulation 4-7)**
- ✓ Part III: Branch, HQ persons, OECD/UN documents (Regulation 8-9)
- ✓ **Part IV: Intragroup services, Intangible property (Regulation 10-11)**
- ✓ **Part V: Advanced Pricing Arrangements and Corresponding adjustments (Regulation 12-13)**
- ✓ Part VI: General (Powers of the Commissioner, Revocations)- (Regulation 14-16).
- **Guidelines: A set of 17 paragraphs**

Transfer Pricing Regulations 2014

- **Part II: ALP, Comparability, Methods, Documentation (Regulation 4-7)**
- **Arm's Length Principle (ALP)**
- The regulations requires transactions between associates to be consistent with the arm's length principle. **They empower the Commissioner to make adjustments when transactions are not in line with ALP.**

- **To establish if transactions are in line with the ALP principle appropriate transfer pricing method shall be used.**

- **Five TP methods:** Traditional Transaction Methods (Comparable Uncontrolled Price(CUP); Resale Price; Cost Plus;) Transactional Profit Methods (Profit Split; Transactional Net Margin Method;) Any other method prescribed by the Commissioner.

- **Non-compliance attracts a penalty of 100% of the underpaid tax - charged for any transfer pricing adjustment made as part of a tax audit.**

Transfer Pricing Regulations 2014

Comparability

- The method used should lead to a price that is consistent with the price charged between **independent persons** dealing with **comparable uncontrolled transactions** in **comparable circumstances**.

- Comparability should be assessed using 5 factors: Characteristics of Property or Services; Functional Analysis (functions performed, assets used & risks taken); Contractual Terms; Economic Circumstances; and Business Strategies.

- **Any uncontrolled transactions may be used as a comparable when there is similarity in the 5 comparability factors with the controlled transaction.** Differences should be ignored if not material to affect price, cost or profit of the transactions or reasonable accurate adjustments can be made to correct the differences.

Transfer Pricing Regulations 2014

Documentation Requirement

- **Contemporaneous transfer pricing documentation** is required to be prepared before the tax return is submitted.

- The regulations do not require the transfer pricing documentation to be submitted with the tax return, but stipulates that **it should be provided to the tax authority within 30 days when requested**. TRA has started requesting the documentation.

- **Non-compliance with transfer pricing documentation requirement attracts a penalty which includes imprisonment for a maximum of 6 months and/or a fine of not less than 50m Tanzanian shillings on conviction.**

Information to be included in the transfer pricing documentation include: the organizational structure; the nature of business or industry and market conditions, the controlled transactions, strategies and assumptions used to set the price; comparability, functional and risk analysis; selection and application of the transfer pricing methods etc.

Transfer Pricing Regulations 2014

- ❑ **Part IV: Intragroup services, Intangible property (Regulation 10-11)**
- ❑ **Intragroup Services and Intangible Property**
- ▪ Regulations 10 deals with intragroup services, intangible property and intragroup financing.

- ▪ **It requires a demonstration by a tax payer that intragroup services have been rendered and intangible property has provided economic benefit or commercial value to the business.**

- ▪ **Further, the charge made should be justifiable and at arm's length.**
- ❑ **Part V: APAs and Corresponding adjustments (Regulation 12-13)**
- ❑ **Advanced Pricing Agreements (APAs)**
- ✓ The Tanzania transfer pricing regulations allows taxpayers to apply for Advance Pricing Arrangements ("APA").
- ✓ APAs is a good provision given the increasing number of appeals against TRA adjustments. The APA shall only be valid for future periods and for a maximum period of 5 years with annual compliance requirements.

Transfer Pricing Regulations 2014

- ✓ APAs provide certainty to MNEs on the tax treatment on intergroup transactions (how TRA will handle its transfer pricing); possible time saving through prevention of an audit; creation of a better relationship with the revenue authority, avoidance of double taxation. APAs guarantees the revenue authority on certain streams of tax collection.

❑ Corresponding Adjustments (Regulation 13)

- The regulations allow corresponding adjustments with associates in countries with DTA with Tanzania.

❑ Powers of the Commissioner (Regulation 14).

- The Commissioner has power to make adjustments where he believes that transactions are not at arm's length.

Implementation Challenges & Recommendations

- **Lack of Comparable data**
- **Challenges**
- **Lack of local comparable** is a major challenge in tax audits. Companies' also faces resources challenges in accessing foreign databases for comparable. TRA has indicated that it is in the process of acquisition of databases for benchmarking in attempt to address the issue of lack of comparable.
- **Legal mechanism for information disclosure:** There is lack of legal mechanism to compel companies to disclose financial information for comparability purposes.

- In practice TRA **has been preferring local comparable** and requires **current year benchmarking** thus more cost to MNEs to update the comparable information.
- **Recommendations**
- TRA should to ensure that comparability analyses performed are transparent and understandable to taxpayers to reduce the number of disputes and appeals.

Implementation Challenges & Recommendations

- The Government and TRA should work with East African Community (EAC) and ATAF in developing regional price database to facilitate the determination of comparable arm's length prices.

- Tanzania should also consider development of computerized financial data for all companies in the country. **Legislation on this area should be given consideration.**

- Further, the regulations should be amended to provide guidance on what will be accepted as the arm's length range and which point in a range would the TRA target during an audit so as to provide certainty to tax payers.

- Regulations should require TRA to perform adjustment based on TP study

- Amend the legislations to allow the use of comparable from elsewhere.

- Remove the requirement for same year benchmarking especially for non-core services. This should be from 2 to 3 years.

Implementation Challenges & Recommendations

- **Documentation**
- **Challenges**
- **Contemporaneous documentation:** The requirement for contemporaneous transfer pricing documentation is one of the major challenges (finance, staff and time) to tax payers. This has a negative impact on the country's ability to attract foreign investment.
- **Recommendations**
- Review of the transfer pricing regulations should be done with a view to simplify compliance on documentation e.g. A disclosure form for instance may be introduced to be used as an alternative to a list of required documentation; reduction of penalty.
- MNEs should also ensure that the group transfer pricing policy are tailored to suit the requirements of transfer pricing legislations in the Tanzania.
- Amend transfer pricing regulations to require that a detailed transfer pricing report be submitted by the tax payer upon request; but should not be required on a contemporaneous basis.

Implementation Challenges & Recommendations

- **Ensure Proper Transfer Pricing Study and Adequate Documentation**

- To prove that transactions with associates are at arm's length **a Transfer Pricing Study** is required. This may involve 10 steps:

1) Decision on years to be covered
2) Industry analysis (a broad based review of tax payers economic circumstances)-To establish factors affecting arms length sources of comparable external data. E.g. size, geographical location, level of competition, business cycle etc.
3) Functional analysis-who does what, assets used and risks assumed
4) Review internal comparable (if available)
5) Collection of available external comparable data
6) Selection of an appropriate Transfer Pricing Method and financial indicator (for sales, manufacturing, services etc.)
7) Identification of potential comparable
8) Perform comparability adjustments if appropriate
9) Interpret data collected and establish the arm's length price
10) Documentation

Implementation Challenges & Recommendations

- **Intangibles and intragroup services**
  - **Challenges**
    - The regulations empowers the Commissioner to disregard any other services he may deem not appropriate. This discretion increases uncertainty to tax payers as no criteria/factors the Commissioner should consider.
    - Marketing Intangibles
  - **Recommendations**
    - Remove discretions by the Commissioner
    - MNEs should be aware of marketing implications
- **Advanced Transfer Pricing Agreements**
  - **Challenges**
    - **Failure to reach an agreement (time & money)**
    - **Disclosure of confidential information**. They may also actually enable the revenue authority to know how to audit them.

Implementation Challenges & Recommendations

- **Discretional power:** The regulations have also given power to the Commissioner on whether to accept an APA request and whether to accept the taxpayer proposal, modify it or completely reject it.

- **Resources:** TRA and MNEs lack adequate resources, guidelines and experience on drafting APAs.

- Recommendations

- If MNE's transfer pricing transactions are straight forward, there is no need to pursue an APA.

- For complex transactions and where there is uncertainty on which is the most appropriate transfer pricing method to apply or any other uncertainty then an APA should be pursued.

- For TRA-Assistance on this technical area should be obtained from countries which have successful implemented them e.g. APAs experience from India

Implementation Challenges & Recommendations

- **Knowledge, skills and capacity to deal with transfer pricing issues**

- **Challenges**

- Availability of competent and enough staff (tax, economists, valuers etc.) with experience and knowledge of transfer pricing remains a challenge to both MNEs and TRA.

- Though TRA has established ITU and trained staff to deal specifically with Transfer Pricing audits, the availability of enough staff remains a challenge. Training is also expensive and takes time.

- Further, there is lack of adequate working tools for instance Transfer Pricing Manuals to provide guidance for tax payers and **price database for practical application of the arm's length price.**

- **Recommendations**

- **Risk Profiling:** TRA should focus on **risk profiling** to help in deciding on which transfer pricing cases to abandon because of low risk, and which ones to be taken further because of high risk. This will address the challenge of **scarce resources** and ensure efficiency.

Implementation Challenges & Recommendations

- The Institute of Tax Administration should develop structured training programs on transfer pricing for both MNEs and TRA staff in collaboration with experienced external and internal tax trainers. **Capacity should be built on the development and use of databases for comparability and comparability adjustments.**

- The need to improve **staff remunerations** structures to ensure **retention. TRA and MNEs should also continue to develop tax teams with specialization on transfer pricing.**

- Further, secondment of experienced professionals from tax jurisdictions which are more experienced should also be considered and provision of structured training programs on these technical areas.

- TRA should also provide detailed, practical reference materials including Transfer Pricing manuals and guides.

- IMNEs with no capacity should use available Transfer Pricing Consultants.

Implementation Challenges & Recommendations

- **Corresponding Adjustments**
  - **Challenges**
    - Lack of adequate and updated DTAs which have been outlived by recent amendment in transfer pricing legislation and main Model Tax Conventions and Regional Cooperation Model.
  - **Recommendations**
- Tanzania should fast track the ratification of DTAs with EA countries to enjoy the DTAs benefits including facilitating trade in the region.
- Tanzania should also increase the number of treaties with major trading partners and seek support on drafting of treaties to ensure maximum benefits (cost and benefit analysis) are attained.
- Tanzania should also develop domestic rules, and treaty provisions, to prevent treaty shopping which aims at avoiding withholding taxes.

Implementation Challenges & Recommendations

- **Penalties**
  - **Challenges**
    - Severe penalty on non-compliance (documentation and ALP).
  - **Recommendations**
    - Remove special penalty for non-compliance e.g. Kenya has no special penalty

- **Other Challenges**
  - Lack of formal dispute handling procedures-Competent Authority.
  - Withholding tax credit when there is an adjustment
  - The use of OECD and UN Guidelines for guidance
  - Materiality thresholds not established (introduce safe harbor provisions)
  - Regulations do not address key challenges e.g. custom valuation.

Conclusion

- Tanzania transfer pricing legislation is at infancy stage and should continue leveraging the knowledge and experience and update transfer pricing legislations on the basis of this experience.

- Overall the regulations are good with modern TP features e.g. APAs but require amendments in key areas as suggested above.

- MNEs should ensure compliance with documentation requirements to avoid penalties.

Thank you

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