# TRANSFER PRICING AND THIN CAPITALISATION

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CITN 2013 Tax Conference

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# Why Transfer Pricing?

- Globalisation and Digitalisation

  Expansion of international trade and commerce due to:

  - Division of labour, specialisation and principle of comparative advantage (exchange of goods and services across borders inevitable)
  - Inorganic growth of MNEs through mergers, takeovers and acquisitions across the globe
  - Technological advancement (drawing distant territories closer)
  - Political & economic alliances among nations
- Financing for Development Issue
  - Increasing fiscal responsibilities of governments and need for more revenue
  - Prevalent competitive edge of foreign enterprises over domestic business
  - Importance of MNEs and need for Foreign Direct Investment (DFI)

# Why Transfer Pricing?

- Growing influence of MNEs
  - Budgets bigger than that of most countries – 51 of the largest 100 economies in the world are companies rather than countries
  - Hold 90% of all patents
  - Control 70% of world trade and 80% of DFI
- Pricing of Intra Group Transfers
  - Dispersal of economic functions across the globe and building entities around those functions
  - Performance measurement and internal pricing policy
  - Responsibility accounting; jettisoning the concept of cost centres for profit or investment centres)
  - Different tax regimes in various jurisdictions – tax rates, tax incentives etc
  - The loyalty question

# Useful Definitions

- Associated, related or connected persons:
  - Enterprises that are "associates", as defined in the relevant tax laws; and
  - persons that are business associates in any form, where –

    (a) one enterprise participates directly or indirectly in the management, control or in the capital of the other, or

    (b) the same person or persons participate directly or indirectly in the management, control or in the capital of both enterprises;

# Useful Definitions

- **Transfer Price**

  the price at which goods, services, intangibles, intellectual property rights or loans are exchanged between related entities or responsibility centers within an entity.

- **Inter-company transfers**

  Movement of goods, services, intangibles, intellectual property rights or loans between related entities

- **Intra-company transfers**

  Movement of goods, services, intangibles, intellectual property rights or loans between responsibility centers within an entity.

# Useful Definitions

- Safe Harbour

  Exemption from documentation requirements
- Controlled transactions

  Commercial or financial transaction between associated, related, connected or dependent persons.
- Independent enterprises or persons

  Enterprises or persons that are not connected, related or otherwise associated with one another
- Comparable Uncontrolled Transaction

  Uncontrolled transaction that —

  (i) does not differ significantly from a controlled transaction in a way that could materially affect the financial indicator applicable under the method; or

  (ii) differs from controlled transaction, but reasonable accurate adjustments can be made to eliminate the effects of such differences.

# The Arm's Length Principle

- The "arm's length principle" means the principle that the conditions of a controlled transaction should not differ from the conditions that would have applied between independent persons in comparable transactions carried out under comparable circumstances.
- It requires that inter-company transactions be priced as with those between independent enterprises conducted in similar circumstances.
- An arm's length price for a transaction is what the price of that transaction would be on the open market.
- It is the basis for enforcing tax laws in most countries as defined in Article 9 of the OECD and UN Model Tax Conventions as well as OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

# Transfer Pricing

- Transfer Pricing
    - process of determining the price of exchanges among related business entities.
    - It is the inter/intra-company pricing arrangements for transfers of intellectual property, goods, services and loans among connected taxable persons.

# Transfer Mispricing

- Transfers of goods, services and intangibles at prices not commensurate with the economic contributions of each party
- Prevalent where one party to the transfer is resident for tax purposes in a high tax-rate jurisdiction while the other is resident in a low tax-rate jurisdiction
- Reasons for Transfer Mispricing
  - Corporate tax differential – rate, reliefs, incentives etc.
  - High customs duty and other indirect taxes
  - Restriction on profit repatriation
  - Ownership restrictions

# Problem of Transfer Mispricing

- Transfers of intangibles to related enterprises – difficulty in valuation
- Specific payments (e.g. interest, insurance premiums, royalties to related parties – how to quantify value added
- Shared services – relationship with resulting income
- Business restructurings – appropriate prices for used items
- Loss merging – liberty of investors to pool subsidiaries scattered in various jurisdictions together for tax purposes
- Effective tax rate (defending the optimum effective tax rate)
- Poor/non-existent documentation
- Excessive debt – challenge of technology companies

# Thin Capitalization

- A situation whereby an enterprise employ more debt than equity to finance its business activity (highly geared).
- Why Thin Capitalization
  - Thinly Capitalized enterprises enjoy tax reliefs on interest charges unlike dividend
  - This is because interest is tax deductible and paid before the profit of the borrowing company is determined.
  - This makes debt financing more attractive to associated companies with the intention of shifting profits from one country or centre to another for the purpose of tax avoidance.

# Thin Capitalization

- Thin Capitalization Rules
  - Most jurisdictions have prescribed rules to deal with debt/equity mix by placing a ceiling on debt/equity ratio.
  - Some relies on the Transfer Pricing rules to determine acceptable debt/equity mix
  - Examples of countries that have prescribed Thin Capitalization rules with the respective 'Safe Harbours' debt/equity ratio are:
    - USA, France – 1.5:1
    - Canada, Ghana – 2:1
    - Netherland, Australia, Japan, South Africa, Kenya – 3:1
    - China – Financial Institutions 5:1, Others 2:1
    - Germany – deductibility of interest of up to 30% of income
    - UK – no safe harbour with regards to financial ratio

# Significant Tax Issues in TP and Thin Capitalisation

- Prices adopted by an entity have a direct bearing on its profit (Profit = P – C) and tax payable – if any of the elements is artificial, the profits declare cannot be real so also the tax
- Incidence of shifting revenue from one state to another or total revenue loss if income is shifted to a tax haven
- Absence of absolute rules for the pricing of transfers between associated enterprises creates room for constant disagreement between the taxpayer and tax authority
- There are increasing cases of tax evasion arising from transfer pricing issues
- Eliminating the effect of economic double taxation (corresponding adjustments)

# Effects of Transfer Pricing and Thin Capitalization Manipulations

- Distortions in Balance of Payments – overpricing of imports
- Inequity of the poor subsidising the rich
- Unintended funding for renegade regimes
- Market distortions due to unfair competition
- Blockade of fresh capital inflow (recycling of internal funds)

# Transfer Pricing Methods

- Comparable Uncontrolled Price (‘CUP’) Method
  - TP method in which the price charged for property or services transferred in a controlled transaction is compared with the price charged for property or services transferred in a comparable uncontrolled transaction;
- Cost Plus Method
  - TP method in which the mark up on the costs directly and indirectly incurred in the supply of goods, property or services in a controlled transaction is compared with the mark up on those costs directly or indirectly incurred in the supply of goods, property or services in a comparable uncontrolled transaction

# Transfer Pricing Methods

- Resale Price Method

  TP method in which the resale margin that a purchaser of property in a controlled transaction earns from reselling the property in an uncontrolled transaction is compared with the resale margin that is earned in a comparable uncontrolled purchase and resale transaction

- Transactional Net Margin Method

  TP method in which the net profit margin relative to the appropriate base, including costs, sales or assets that a person achieves in a controlled transaction is compared with the net profit margin relative to the same basis achieved in a comparable uncontrolled transaction;

# Transfer Pricing Methods

- Transactional Profit Split Method

  TP method in which the division of profit and loss that a person achieves in a controlled transaction is compared with the division of profit and loss that would be achieved when participating in a comparable uncontrolled transaction;

- Residual Profit Split Method

  TP method in which routine costs are identified and tested under one of the other transfer pricing methods and residual profits are split according to the transactional profit split method

# The Nigerian Experience

- Legislative provisions on artificial transactions/arm's length principle:
  - PITA – Section 17
  - CITA – Section 22
  - PPTA – Section 15
  - CGTA – Section 22
  - VATA – Section 5
- Ineffective application of arm's length principle due to absence of Transfer Pricing and Thin Capitalization rules prior to 2012
- Gazette of Income Tax (Transfer Pricing) Regulation No.1, 2012 to give effect to the legislative provisions.

# Features of Nigerian Transfer Pricing Regulations

- The Income Tax (Transfer Pricing) Regulation No.1, 2012 was published in 2012 with commencement date of 2nd August, 2012. It is effective from the basis period commencing from 2nd August, 2012
- Its provisions are not restricted to cross-border transactions; they also cover domestic intra/inter company transactions
- The objective of the TP Regulations:
  - Provide an appropriate basis for taxing economic activities of associated enterprises
  - Provide tools for fighting tax evasion
  - Reduce risk of economic double taxation
  - Provide level playing field between MNE and independent enterprises
  - Provide certainty of TP treatment in Nigeria

# Features of the Nigerian Transfer Pricing Regulations

- Scope
  - Sale and purchases of goods and services
  - Sales, purchase or lease of tangible assets
  - Transfer, purchase, license or use of intangible assets
  - Provision of services
  - Lending or borrowing of money
  - Manufacturing arrangements
  - Any transaction incidental, connected or pertaining to the above transactions
- TP Adjustments
  - It requires compliance with arm's length principle and empowers FIRS to make adjustments where necessary to make a controlled transaction consistent with the arm's length principle
  - Provide for corresponding adjustment in respect of taxpayers in treaty country

# Features of the Nigerian Transfer Pricing Regulations

- The Regulations permit the use of any of the five (5) common methods
  - Comparable Uncontrolled Price (CUP)
  - Cost Plus
  - Resale Price
  - TNMM
  - Transactional Profit Split
- Any other method that may be prescribed by regulations made by the Service from time to time
- Any other method that can be justified by the taxpayer
- In all cases, the method used must be appropriate to the particular transaction bearing in mind the relative strength and weakness of each method, the nature of the transaction, availability of reliable information and degree of comparability.

# Features of the Nigerian Transfer Pricing Regulations

- A taxpayer is obliged to keep records of transactions with associated taxable persons and make them available to FIRS on request
- Language of documentation is the English language
- Taxpayer required to ensure consistency with arm's length principle in its dealings with associated persons
- TP documentation to be in place prior to the due date of filing income tax returns
- TP declaration form to be appended to annual income tax returns

# Features of the Nigerian Transfer Pricing Regulations

- TP documents and analysis to be provided to FIRS within 21 days of request subject to the discretion of the Service on extension
- Burden of proof of compliance with arm's length principle is on the taxpayer but discharged upon the provision of relevant documentations
- TP disclosure should be in line with self assessment regime.
- FIRS can enter into APA with taxpayers (for future transactions) on request subject to single minimum transaction value of ₦250m total deductible cost or taxable revenue among connected taxable persons

# Features of the Nigerian Transfer Pricing Regulations

- Request to be accompanied with relevant documentations and analysis
- An APA ruling has a maximum life span of 3 years
- An APA is cancellable by FIRS before expiration where:
  - taxpayer failed to comply with its fundamental term – effective from the date specified by FIRS in the notice of cancellation
  - material breach of any of the critical assumptions – effective from the date of the material breach
  - change in tax laws materially relevant to the APA – effective from the date specified by FIRS in the notice of cancellation
  - misrepresentation, mistake or omission by the taxpayer – cancelled ab initio

# Features of the Nigerian Transfer Pricing Regulations

- Cancellation of APA may be by notice from the taxpayer and effective from the date stated in the notice where:
  - there is material change in the premise of the APA
  - the APA become irrelevant based on significant change or changes to the structure of the controlled transaction
  - changes in applicable tax law in the jurisdiction of the controlled transaction
- Comparability factors
  - Physical characteristics of the item transferred
  - Functions performed based on assets used and risks assumed
  - Contractual terms of the transaction
  - Economic circumstances under which the transaction was undertaken
  - Business strategy pursued by the connected taxable persons

# Features of the Nigerian Transfer Pricing Regulations

- Decision Review Panel
  - established as administrative body within the Service for the purpose of resolving any dispute or controversy arising from the application of the provisions of the Regulations.
  - Members:
    - The Head of the Transfer Pricing Department of the Service
    - Two other employees of the Service who shall be at least of the rank of Deputy Director.
  - Taxpayer has 30days to refer dispute on assessment or TP adjustments to Panel
  - Decision of the Panel is final and conclusive
  - Decision of the Panel may be subjected to judicial resolution.

# Features of the Nigerian Transfer Pricing Regulations

- Precedence of Traditional Methods over Profit Methods
  - controlled transaction shall first be compared with identical transaction between independent persons carrying out business under sufficiently comparable condition.
- Offences and  Penalties
  - as prescribed in the relevant provision of the applicable tax laws.
- Safe Harbour – where;
  - Price is in accordance with the requirement of Nigerian Statutory provisions
  - Price approved by other Govt regulatory agencies/authorities established Nigerian law and FIRS is satisfied that the price is at arm's length.
- Usage of documentation
  - limited to establishment of arm's length price
- Retention of records
  - 6 years from the date of returns

# The Way Forward

- Tax Administrator
  - Establish framework for field implementation of TP
    - Design TP forms, questionnaire etc
    - Provide Returns filing platforms
    - Establish price ranges and database for comparables
    - Provide guideline for APA, decision review.
    - Establish TP audit function and selection criteria
    - Provide Taxpayer Services – education, assistance and advisory
  - Establish Thin Capitalization rules

# The Way Forward

- MNEs
  - Establish Group TP policies
  - Align group TP policies with the Regulations
  - Set up internal structures to handle TP policies, documentation and reporting
  - Design internal control and reporting system for controlled transactions
  - Secure services of TP professionals to handle negotiation, documentation, analysis and filing of activities
  - Ensure that the contracts for all intra-group transfers are properly documented
  - Secure TP compliance personnel

# Conclusion

Proper implementation of the Transfer Pricing and Thin Capitalization rules in Nigeria will lead to the realization of the theme of this year's CITN Annual Tax Conference "Global Stability, Revenue Generation and Economic Growth"

# Thank You

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