DECEMBER 2018

Update on Transfer Pricing: Compliance Requirements and the Changing Landscape

Outline

Sections	
1	Objectives
2	Overview of transfer pricing concepts
3	Legal basis for transfer pricing in Nigeria
4	Transfer pricing methods
5	Documentation requirements
6	Transfer pricing returns
7	Transfer pricing audit
8	Recent local and global developments in transfer pricing
9	Conclusion and case study

Objectives

At the end of this course, participants should be able to:

- Refresh their knowledge of the Nigerian Transfer Pricing Regulations
- Outline recent changes and compliance requirements
- Gain insight into the global trend in TP documentation

Overview of Transfer Pricing (TP) Concepts

<u>Transfer price</u> can be defined as the price at which services, tangible property and intangible property are traded between connected taxable persons.

<u>Transfer pricing</u> relies on the application of the arm's length principle.

TP and the Arm's Length Principle

<u>Arm's length principle</u> means that the terms and conditions applied in transactions between related parties should be comparable to those applied in transactions between independent parties.

<u>Adjustments</u> can be made by the FIRS where the related party transactions do not comply with the arm's length principle.

Overview of TP

INTERCOMPANY TRANSACTIONS

Entity A
Country A

Tangibles
Intangibles
Services
Loans

Entity B
Country B

REGULATIONS

Appropriate Allocation of Deductions and Income

OBJECTIVE OF TAX AUTHORITES

Maximize tax payments in their jurisdictions

OBJECTIVE OF THE TAXPAYER

Optimize effective tax rate

Rationale for TP Regulations

Scenario			
	Parent - Country A	Sub - Country B	Consolidated
Total profit reported on tax return (millions)	700	300	1,000
Tax rate	40%	10%	
Tax liability before change to transfer price	280	30	310
Global Effective Tax Rate (ETR)			31%
Effect of Transfer Mispricing			
	Parent - Country A	Sub - Country B	Consolidated
Total profit as a result of transfer mispricing (400 million shifted to country B)	300	700	1,000
Tax rate	40%	10%	
Tax liability after change to transfer price	120	70	190
Global ETR			19%

Rationale for TP Regulations (2)

Effect of Transfer Mispricing			
	Parent - Country A	Sub- Country B	Consolidated
Total profit reported on tax return (million)	300	700	1,000
Tax rate	40%	10%	
Tax liability before Country A's TP adjustment	120	70	190
Global ETR			19%
Impact of a TP Adjustment			
	Parent - Country A	Sub- Country B	Consolidated
Total profit after adjustment by Country A's tax authorities (addition of 400 million previously shifted; assumes no corresponding adjustment in B)	700	700	1,400
Tax rate	40%	10%	
Tax liability after Country A's TP adjustment (penalties and interest not included)	280	70	350
Global ETR			35%

Legal Basis for TP

S/N	Framework	Reference
1	General Anti-Avoidance Provisions	❖ Section 17 Personal Income Tax Act (PITA) ❖ Section 22 Companies Income Tax Act (CITA) ❖ Section 15 Petroleum Profits Tax Act (PPTA)
2	Income Tax (Transfer Pricing) Regulations 2018 (NTPR)	❖ Gazetted in March 2018 ❖ Revoked the NTPR of 2012
3	International Conventions	❖ Article 9 UN and OECD Model Tax Conventions on Income and Capital ❖ OECD TP Guidelines for MNEs and Tax Administrations ❖ UN Practice Manual on TP for developing countries

Application of Arm's Length Principle – Comparability Factors

It is important to consider the following five comparability factors:

- Characteristics of the property or service
- Functional analysis
- Contractual terms of the transaction
- Economic circumstances
- Business strategies

TP Methods

Traditional Transaction Methods

- Comparable Uncontrolled Price (CUP)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)

Transactional Profit Methods

- Transactional Net Margin Method (TNMM)
- Transactional Profit Split Method (TPSM)

Other Methods

- Other methods prescribed by FIRS from time to time

Documentation Requirements – TP Policy

- Not expressly required under the NTPR

- Implied by the requirement that related parties comply with the arm's length principle in transactions between them

Importance:

- Planning tool to help companies plan the prices to be applied in their related party transactions (RPT)
- Planning will help companies apply TP rules consistently and refer to them during price negotiations
- Provides a benchmark for testing whether RPTs have met the arm's length principle
- Helps reduce the costs and risks associated with TP audits

Documentation Requirements – Master File

The Master File provides a top-level view of the MNE group's TP practices in their global economic, legal, financial and tax context

The Master file should include the following information:

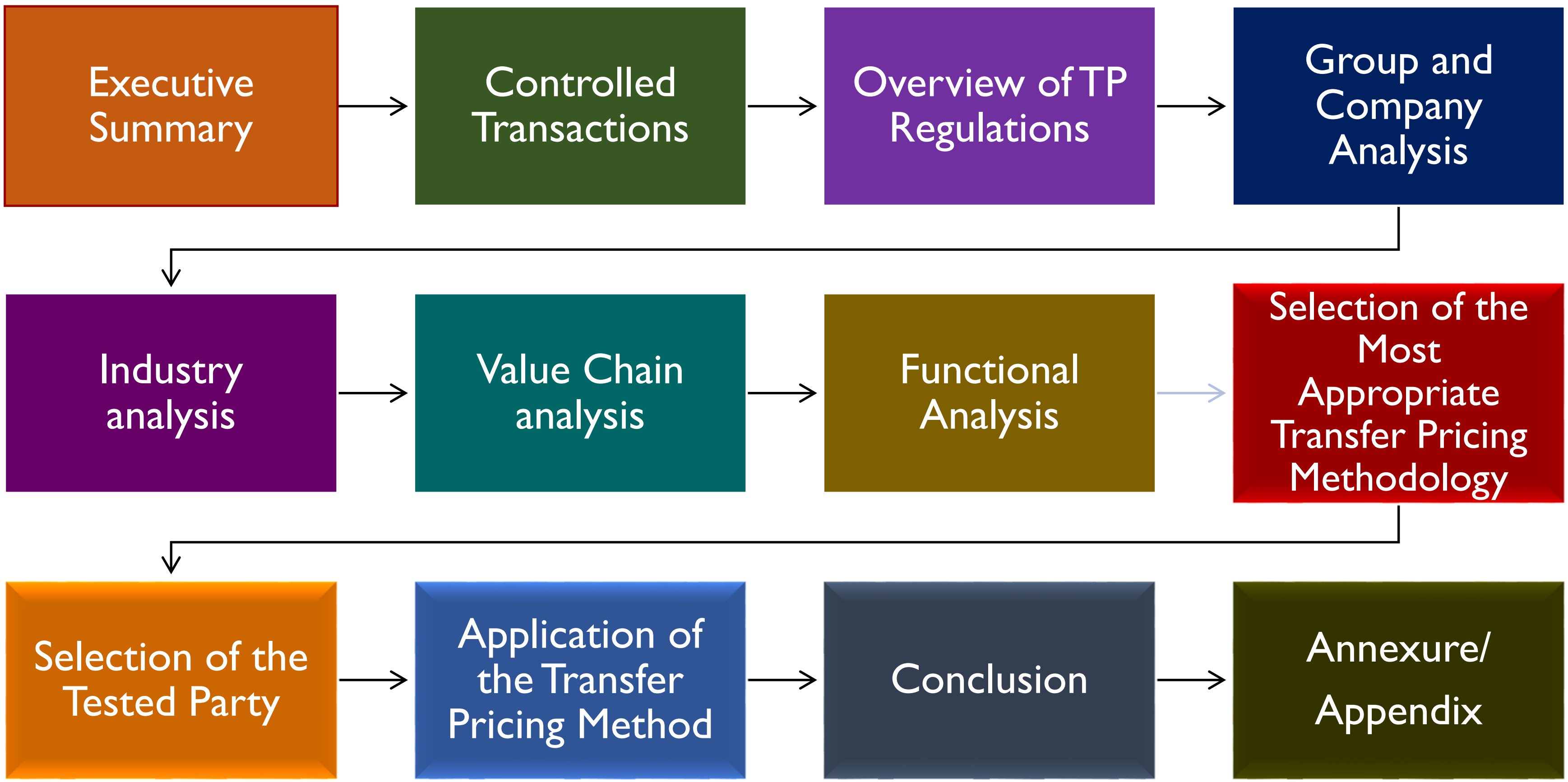
- A detailed description of the ownership structure of the taxable person
- A profile of the multinational group of which the taxable person is a part of
- The global organisational structure of the MNE group
- Description of MNE's business and the industry in which it operates in
- Information on the MNE's Intangibles
- The MNE's Intercompany Financial Activities
- Financial and Tax Position

Documentation Requirements – Local File

- The Local File contains the detailed description of transactions between the local entity and its associated enterprise(s)
- Includes analyses or records maintained by a taxpayer as proof that the arms' length principle was followed in the pricing of transactions between related persons.
- Documentation must be maintained contemporaneously for each transaction

Documentation Requirements – Local File

Together a typical TP Documentation (Master File + Local File) should have the following key sections



Documentation Requirements – Supporting Documents

The regulation requires tax payers to maintain the following supporting documents;

- ✓ Agreements and contracts entered into with connected persons
- ✓ Price publication; stock exchange and commodity market quotations
- ✓ Report of market research studies carried out by institutions of national repute
- ✓ Documents issued in connection with relevant transactions
- ✓ Letters and other correspondences
- ✓ Other documents considered relevant to the controlled transaction
- ✓ Published accounts and financial statements of connected persons

Documentation Requirements – CBC Report

The Country-by-Country (CbC) Report provides aggregated information by tax jurisdiction, showing the MNE's;

- Tax jurisdiction
- Revenues
- Profit (Loss) before Income Tax
- Income Tax Paid (on Cash Basis)
- Income Tax Accrued (Current Year)
- Stated Capital
- Accumulated Earnings
- Number of Employees

Documentation Requirements – Pitfalls

The following should be avoided when preparing the TP documentation:

- Failure to consider the five factors of comparability
- Failure to document search strategy
- Failure to undertake proper analysis on comparables
- Not covering all the affected transactions
- Incorrect application of the selected methods
- Differences between facts in transfer pricing document and actual business operations

Transfer Pricing Returns – Declaration Form

What it is?

- A return containing details of the structure of a group in terms of ownership, management, control and nature of business. The Declaration form should be submitted in the first year of filing a TP return.

Updates to declaration

Taxpayers will file an updated declaration form/make a notification upon the occurrence of any of the following;

- Mergers
- Appointment or Retirement of a Director
- Acquisition
- Any other change which influences whether a company will be considered to be connected to another person

When to file

- 6 months after the end of each accounting year OR 18 months after incorporation, whichever is earlier
- Usually filed along with taxpayer's tax returns for the relevant year of assessment

Transfer Pricing Returns – Disclosure Form

What it is?

- A return containing details of a taxpayer's related party transactions and the methods used to determine the arm's length nature of the transactions

When required

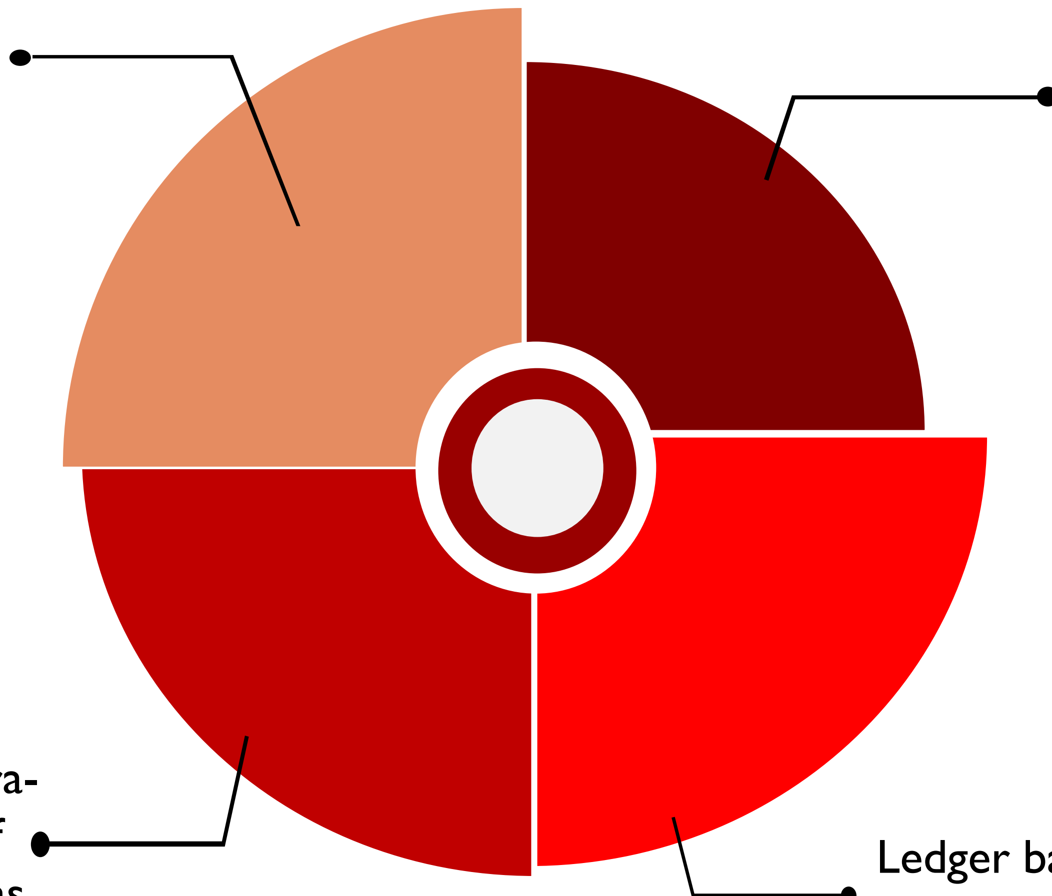
- Unlike the Declaration, taxpayers are required to prepare and file their disclosure forms annually

When to file

- 6 Months after the end of each accounting year OR 18 months after the date of incorporation
- Usually filed along with the taxpayer's tax returns for the relevant year of assessment

Transfer Pricing Returns – Challenges

Improper disclosure/ characterization of transactions on the financial statement for TP purpose

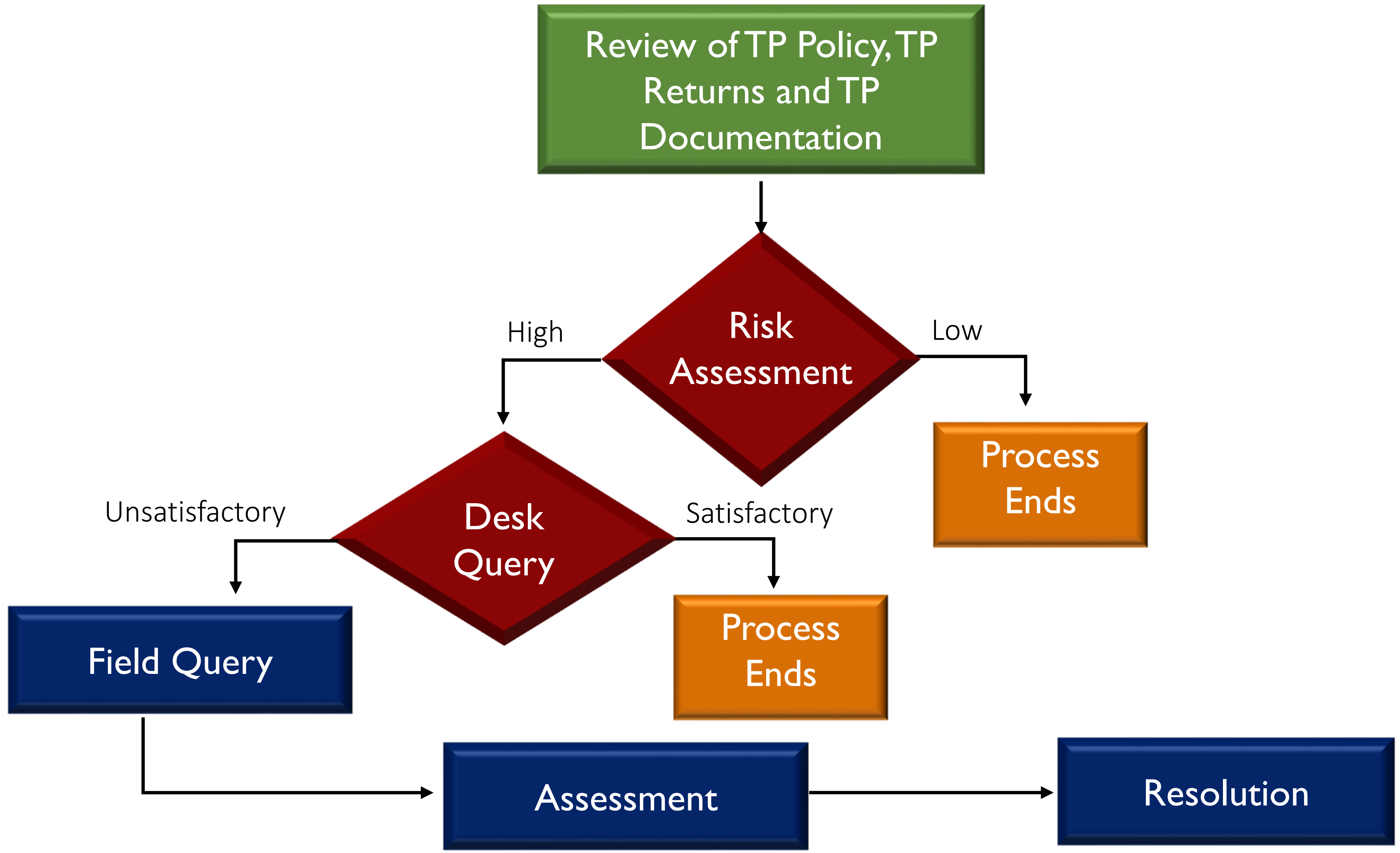


Delay in the finalization of Financial statements

Discrepancies in intra-company balances of connected persons as captured in the FS

Ledger balances versus Transaction figures

TP Audit - Overview of the TP Audit Process



TP Audit – Risk Triggers

TP Audit Risk Triggers

- Transfer of intangibles to related parties
- Reliance on NOTAP approved rate
- Poor results/loss making companies
- Procurement arrangement
- Related party transactions with greater marginal tax rate jurisdictions
- Intra-group service transaction
- Non-alignment of business and TP documentations
- Poor / Non-existent documentation
- High revenues, low profit, low tax and low employee count
- Excessive intercompany loans
- Low Effective tax rate
- Transactions with tax friendly jurisdiction and free trade zones

Recent Developments - Income Tax (Transfer Pricing) Regulations 2018

Updated Safe Harbor Provisions	▪ Exemptions to prepare TP Documentation applicable if controlled transactions are priced in accordance with guidelines published by the FIRS ▪ Exemptions applicable if pricing is done in accordance with APA or statutory provisions
Intra-group Services Transactions	▪ Intra-group services must pass performance, benefit, non-duplicative & non-shareholder test in addition to the appropriateness of allocation key
TP Documentation Exemption	▪ No requirement to maintain contemporaneous documentation if value of controlled transaction is less than ₦300 million ▪ However, taxpayer has 90 days to provide the FIRS with the documentation if requested

Recent Developments - Income Tax (Transfer Pricing) Regulations 2018

Limited Deductions for Royalty Payments	Allowable deductions for royalties paid on intangibles restricted to 5% of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
Quoted Prices as Applicable Pricing in Commodity Transactions	▪ Pricing applicable to commodity transactions between related parties now quoted prices as at transaction date. ▪ Adjustments to quoted prices only allowed where there is sufficient basis for the adjustment supported with adequate documents
Advance Pricing Agreements (APA)	▪ More detailed guidance on APA ▪ Further guidance to be provided before commencement

Recent Developments - Income Tax (Transfer Pricing) Regulations 2018

S/No	TP Offense	Penalty
1	Failure to file TP declaration within the specified period	₦10 million in the first instance with and ₦10,000 for every day the failure continues
2	Failure to file updated TP declaration/ notification about changes in directors	₦25,000 for each day in which the failure continues
3	Failure to file TP disclosures within the specified period	the higher of: ₦10 million or 1% percent of the value of the controlled transaction not disclosed, and ₦10,000 for every day the failure continues
4	Incorrect disclosure of information relating to the controlled transactions	the higher of: ₦10 million or 1% percent of the value of the controlled transaction incorrectly disclosed
5	Failure to file TP documentation upon request	the higher of: ₦10 million or 1% percent of the value of all controlled transactions and ₦10,000 for every day the failure continues
6	Failure to furnish information or document within the specified period	1% of the value of each controlled transaction for which the information or documentation was required and ₦10,000 for every day the failure continues

Recent Developments - Income Tax (Country By Country Reporting) Regulations 2018

Who should file?

- Ultimate Parent Entities (UPE) of MNEs with Consolidated Group Revenue (CGR) of ₦160 billion and have Nigeria as their tax residence
- Constituent Entities (CE) of MNE groups with tax residence in Nigeria and there is:
  - ✓ No obligation on the group's UPE to file in its tax residence
  - ✓ The UPE's tax residence is not part of the Multilateral Competent Authority Agreement (MCAA).
  - ✓ Systemic failure arising from the UPE's tax residence.

Notification

- CEs are required to notify the FIRS of their status
- within the group, whether UPE, Surrogate Parent
- Entity (SPE) or neither.

Recent Developments - Income Tax (Country By Country Reporting) Regulations 2018

Time to file	▪ Time to file: ▪ CbyC Report to be filed no later than 12 months after the last day of an MNE's accounting year. ▪ Notification to be filed no later than the last day of an MNE's accounting year.
Penalty for non-compliance	▪ Late Filing: ₦10 million in the first instance; ₦1 million for each month default continues. ▪ Incorrect or False CbyC Report: ₦10 million. ▪ Failure to file notification: ₦10 million in the first instance; ₦10,000 for each day default continues.


CASE
STUDY

Questions