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Closing the Tax Gap

Developments in Transfer Pricing

Cristal Tax Series

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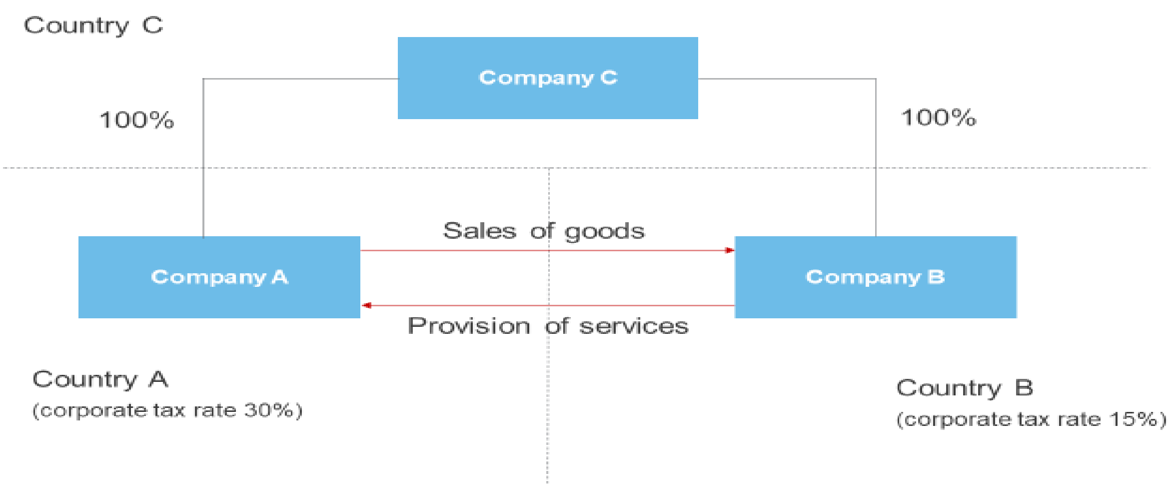
1. What is transfer pricing?

It is believed that somewhere between 60% and 70% of all cross-border trade in goods and services is between companies which form part of a multinational group. In a Ugandan context this might include:

- the export sale of coffee beans by a Ugandan grower to an international affiliate which manufactures instant coffee;
- the purchase and import of petroleum products by a Ugandan retailer from a foreign affiliate engaged in the international distribution of fuel and lubricants;
- the provision of management and administrative services to the Ugandan subsidiary of an international mining group by a group shared service centre in the Czech Republic; or
- intragroup trading between a Ugandan company and its local affiliates.

As business becomes more global, tax authorities have become increasingly aware of the opportunity that such transactions present for tax minimisation by overcharging for goods and services purchased from, or undercharging for goods and services sold to, parties in other tax jurisdictions which are under common control. This can be illustrated with the following simple group structure where Company A sells goods to and buys services from its affiliate B located in a lower tax jurisdiction. In the absence of any transfer pricing rules, it would be possible for the Company C group to minimise its overall tax bill by shifting profits to Company B through manipulation of the prices of goods and services passing between A and B.



2. Transfer pricing legislation

Many jurisdictions have therefore introduced detailed transfer pricing rules to enable tax authorities to review and, if necessary, adjust prices charged between affiliates in order to compute the taxable profits which would have arisen had the buyer and seller been acting independently. Kenya led the way in East Africa in introducing such rules in 2006, followed by Uganda in 2011 and Tanzania in 2014.

Uganda's transfer pricing regulations ("Regulations") supplemented the provisions of section 90 of the Income Tax Act ("ITA"). Section 90(1) of the ITA empowers the Commissioner to adjust profits accruing to a taxpayer from transactions with related resident and non-resident persons to reflect such profits that would have accrued if independent parties at arm's length conducted the transaction.

The Regulations apply to taxpayers dealing with related parties inside or outside of Uganda. Domestic aspects of transfer pricing typically do not pose a huge risk of loss revenue and most countries with transfer pricing rules focus on international aspects of transfer pricing, i.e. where the parties are located in different countries thereby creating a potential for shifting profits from one country to the other. Taxpayers are deemed related under the provisions of the ITA when a person acts in accordance with the directions, requests, suggestions, or wishes of the other person whether or not they are in a business relationship and whether those directions, requests, suggestions, or wishes are communicated to the first-mentioned person. Branches or permanent establishments (PEs) are for transfer pricing purposes separate and distinct entities from the head office, and are therefore regarded as related parties.

The Regulations recognise the application of the OECD Guidelines as well as the OECD Model Tax Convention on Income and Capital, except where they are inconsistent with the Ugandan Income Tax Act. (The OECD – Organization for Economic Co-operation and Development – is an international organization which has played a key role in creating international norms for taxation of cross-border transactions.)

3. Determination of transfer pricing

The key objective of transfer pricing regulations is to provide taxpayers and the tax authorities tools to determine the arm's length price in the case of transactions between associates on non-arm's length terms. The basis of transfer pricing is therefore reliance on the 'arm's length principle'.

Using the illustration above, this asks the taxpayers and the tax authorities to assume that Company C does not exist, and Companies A and B act independently of one another in agreeing the prices to be charged for goods and services (i.e. they act 'at arm's length'). Where Companies A and B buy and sell similar goods and services from unrelated parties as well as each other, this may be straightforward because there are comparable uncontrolled transactions which can be used to benchmark the arm's length prices. This is not often the case in multinational groups, which makes the application of the arm's length principle more complicated.

Additional complexity is added where goods and services are unique, such as those using proprietary technology or trademarks. To address this, other transfer pricing methods are available. Uganda's 2011 transfer pricing regulations, which are based on international norms, list four other methods. The first two focus on the pricing of an individual transaction:

- the cost plus method, where a margin is charged on the seller's costs based on the profit they would be expected to earn in an arm's length sale; and
- the resale price method, where the seller's profit is determined as an arm's length margin embedded in a third party sale price.

The other two methods focus on the overall profit generated from transactions:

- the transactional net margin method, compares the net profit margin from a related party transaction with that generated on similar transactions with a third party, or on similar transactions between two unconnected third parties; and
- the transactional profit split method, which looks at how unconnected third parties would split their overall profit on a transaction or series of transactions between them.

Transfer pricing legislation generally requires a taxpayer to select the most appropriate methods and apply them consistently to all related party transactions (including transactions within a legal entity between its head office and a branch in another jurisdiction). Comprehensive documentation is required to support the selection and application, and this should be available for inspection by tax authorities. A Uganda Revenue Authority ("URA") practice note of May 2012 sets out in detail what transfer pricing documentation should be maintained by Ugandan taxpayers.

4. Common problems in transfer pricing

Whilst transfer pricing can be explained relatively simply, its practical application can be very difficult for businesses and for tax authorities. Multinational groups have complex supply chains, and it may be very hard to find information on comparable transactions between unconnected third parties. Moreover, even where data can be acquired, transfer pricing studies will inevitably result in a range of acceptable arm's length prices, rather than a single 'correct' answer and determining where in such a range to fix a transfer price can itself give rise to disputes with tax authorities.

To minimise the risk of protracted disputes, transfer pricing rules often provide for taxpayers and tax authorities to reach an agreement prospectively on the pricing of related party transactions. Such advance pricing agreements ('APAs') can be time-consuming to negotiate, particularly if more than one tax authority is involved (bearing in mind that the tax liabilities of both buyers and sellers will be affected by an APA).

Transfer pricing affects both parties to a transaction and tax authorities in the respective jurisdictions where they are taxable will be interested in prices charged. In the diagram above, Country B's tax authority will wish to know whether Company B is overpaying for goods it purchases or being underpaid for services it provides. It is possible, even likely that a transfer pricing audit in Country B would lead to different conclusions than one conducted in Country A. For this reason, tax authorities in different countries may cooperate on large transfer pricing audits, but disputes, with a risk of double taxation are not uncommon. Double taxation agreements ('DTA') usually provide for the authorities to negotiate a common approach, but these discussions can be protracted. Uganda's transfer pricing regulations contemplate such a possibility, but do not provide any opportunity to obtain relief from double taxation in the case of a counter-party in a jurisdiction with which Uganda does not have a DTA.

5. An alternative approach?

Transfer pricing is a key issue in international taxation and the internationally agreed action plan to combat BEPS (Base Erosion and Profits Shifting) discussed in my previous article https://drive.google.com/open?id=163kw4F54hIYaa4VptS0jJQxjAiAMKoPm has given special emphasis to strengthening the tools available to tax authorities to apply the arm's length principle.

This approach is not without critics, however. Some commentators suggest that the arm's length principle is too cumbersome to apply to increasingly complex international business, particularly for developing countries, and the more effective approach to combating tax avoidance is to tax multinationals' profits using unitary taxation. This disregards the fact that multinationals do business via huge numbers of branches and subsidiaries each of which is a separate taxpayer.

Instead the total profits of a multinational are apportioned between all the countries where it does business and the relevant local tax rates applied to determine the relevant tax bills.Any intra-group transactions and the accompanying opportunities for 'tax optimisation' via transfer pricing and the use of low (or zero tax) jurisdictions become irrelevant. This approach is at the heart of the proposed Common Consolidate Corporate Tax Base ('CCCTB') being discussed by the European Union ('EU'). The CCCTB proposes one set of rules for calculating taxable profits across all a group's activities in the EU, for example national rules for calculating tax depreciation on capital expenditure would be replaced by a common system. Once taxable profits had been calculated they would be shared between member states based on 3 equally weighted factors:

- value of assets in each member state;
- number of employees and employment costs in each member state; and
- sales in the member state (based on the location of the relevant customer/activity).

The proposal remains controversial within the EU (at least partly because some jurisdictions believe they will lose significant tax revenues if it is adopted) and there is no clear timetable for its implementation. If it were to be adopted by EU states this would be a fundamental change in international taxation and might lead to wider adoption, though clearly there are very influential groups, such as the OECD, which remain committed to the arm's length principle and conventional transfer pricing.

6. The digital economy

One of the most difficult areas facing tax policy makers at present is how to tax the digital economy created by multinationals like Amazon, Facebook and Google. This issue draws in many aspects of the international tax system, not just transfer pricing. The heart of the issue is how to tax a business that may have a significant 'digital' presence in an economy, interacting with customers online, but has minimal (or even zero) physical presence, is not tax registered and does not meet the conventional definition of a permanent establishment

('PE') for purposes of taxing profits.

In the absence of a physical presence it is also difficult to require compliance with VAT or similar indirect taxes. No clear consensus has emerged on the appropriate approach. One might simply be to create a new sales-based tax for online transactions, to be collected at the point of payment by customers. Another might be to create the concept of a digital PE requiring companies with online sales in a country to register for tax. This would in turn create significant transfer pricing issues as the PE and tax authorities would need to determine an arm's length profit margin on those sales considering the appropriate deductions for direct and overhead costs, incurred at some central hub in a different jurisdiction. This before the question of appropriate deductions for costs of unique brands and complex technology is even raised. Given the complex issues it is perhaps not surprising that policy makers are taking their time to reach a conclusion.

7. Conclusion

A powerful international consensus has built up around the use of the arm's length principle and transfer pricing rules have been widely adopted by developed and developing economies. Whilst there are clearly many questions over their effectiveness, and alternatives are emerging, it is difficult to see any fundamental change happening rapidly. Multinationals therefore need to focus on compliance with the rules as they are, whilst keeping an eye open for changes ■

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From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

Bill is a graduate of Oxford University and completed his inspectors' training with the UK Inland Revenue in 1989. ■

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Denis is the Managing Partner at Cristal Advocates where he also leads the energy and tax practice. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates, he had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

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He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

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