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Transfer Pricing Methods in Uganda

Keeping you informed

Cristal Knowledge Series

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1. Introduction

Uganda introduced detailed transfer pricing rules in 2011. These are closely based on international norms, particularly transfer pricing guidelines ('the Guidelines') prepared and regularly updated by the Organisation for Economic Cooperation and Development ('OECD'). An overview of transfer pricing and its application in Uganda can be found on our website at this link http://cristaladvocates.com/?mdocs-file=22205.

The key element of transfer pricing rules applied in Uganda and elsewhere is the requirement for prices used by taxpayers in relation to transactions with related parties to adhere to the arm's length standard: prices applied in respect of related parties should be consistent with those that would have been realised in a transaction between independent persons dealing under the same conditions and acting at arm's length. Each party should act in what it sees as its own individual best interests which should not be affected by the interests (or instructions) of any related party. Where tax authorities such as the Uganda Revenue Authority ('URA') consider that arm's length prices have not been applied in the case of transactions with related parties, they have the power to assess additional tax based on the results that would have arisen in an arm's length situation.

A key question for taxpayers and tax authorities is how to determine what the arm's length price of goods and services would be in the case of transactions with related parties. For this purpose, the Guidelines and Uganda's own 2011 transfer pricing rules prescribe five methods. This article provides an introduction to those methods.

2. Overview of methods

The first three methods focus on individual transactions:

a) the *comparable uncontrolled price*, which refers to the price charged (or payable) for comparable goods or services sold to (or acquired from) an unrelated party. This might be based on transactions between the taxpayer itself and unrelated parties or between independent third parties.

b) 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

c) the *resale price method*, where the seller's profit is determined as an arm's length margin embedded in a third party sale price.

Such granular detail of third party transactions may not be readily available for comparison, so two other methods have evolved that focus on the overall profit generated from groups of similar transactions, which may be more easily identified in publicly available information:

d) the *transaction 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

e) the *transaction profit split method*, which looks at how unconnected third parties would split their overall profit on a transaction or series of transactions between them.

3. Practical application

Under the Uganda transfer pricing rules, taxpayers are required to perform a transfer pricing study to select the most appropriate method for each related party transaction. Selection should take account of the terms of the transaction, the functions undertaken by each party, the risks each bears and the assets which it employs.

A critical part of the study will be benchmarking the prices applied to intra-group transactions against results for transactions with, or between third parties. The process of selecting a transfer pricing method and its application must be fully documented in accordance with a URA practice note issued in 2012.

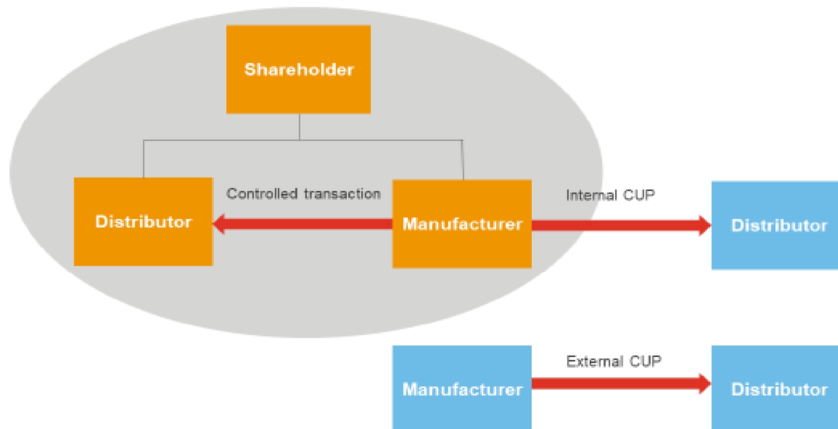
The URA may require such documentation to be provided to it once the relevant annual income tax return has been filed and there are stiff penalties for non-compliance, including imprisonment.

a) The comparable uncontrolled price ('CUP') method

The CUP is based on a comparison between the price applied in a transaction between related parties and that applied in a similar transaction with an unrelated party. Two categories can be used:

- an internal CUP is where similar goods and services are subject to transactions with both related and unrelated parties;
- an external CUP is where similar goods and services are sold between two third parties.

Comparable uncontrolled price method ('CUP')



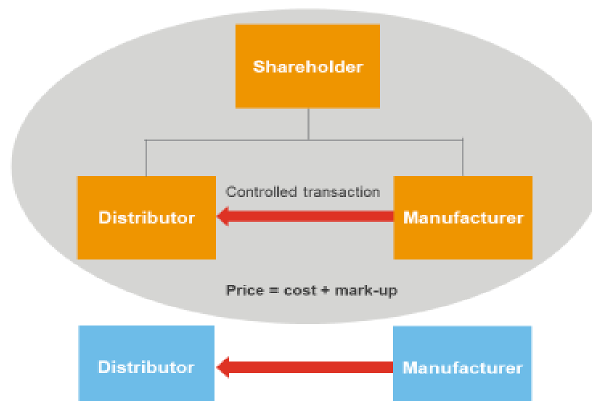
The OECD Guidelines refer to the CUP method as "the most direct and reliable way to apply the arm's length principle". However, it is also vital to ensure that the internal and external CUPs selected are truly comparable and this can be difficult in practice because granular detail of external CUPs is difficult to find in public information sources. In practice, this method is used for commodity transactions where goods are traded on exchanges so prices are discoverable, such as crude oil, metals or certain agricultural produce.

Even in such cases prices may vary materially depending on transactions terms (e.g. volumes, credit and currency risks, INCOTERMS applied, etc). It may be possible to make adjustments to take account of such factors, but this can be complex.

b) The cost plus method

This method requires a comparison between the mark-up applied to costs in respect of a transaction with a related party and the mark up applied in the case of a similar transaction between unrelated parties.

Cost plus method



It is important to identify all the relevant costs, both direct and indirect, to which the mark-up is applicable. In determining the appropriate level of mark-up, it is also important to understand fully the functions performed by the seller, the assets it uses and the risks that it undertakes: generally the more assets used and functions and risks undertaken by the seller, the higher the appropriate mark-up.

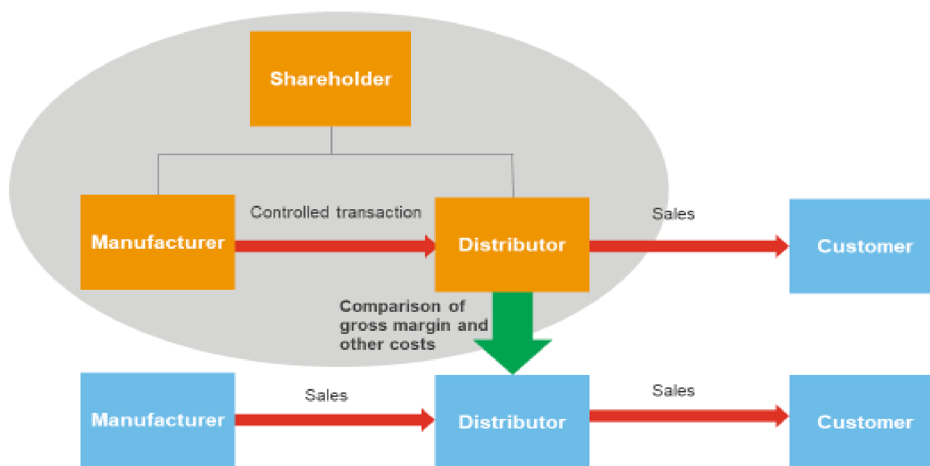
Intangible assets such as brands, patents and know-how play an increasingly important role in international business, so it is vital to ensure that the role of such assets is properly understood. For example, one would expect internationally recognised brands such as Coca-Cola or Apple to command a premium over similar generic products.

The cost plus method is often used in the case of intra-group support services, such as accounting, legal, information technology and communications services.

c) *The resale price method*

This method is often applied where a taxpayer buys goods from a related party and sells to an unrelated party. The ultimate third-party sale price is reduced by an arm's length margin in order to determine the appropriate purchase price. In order to compute an arm's length margin it is critical to identify the role of marketing intangibles such as reputation, brand or a loyal customer base. These can be difficult to identify based on a desk-top review of financial statements and tax returns: an in-depth understanding of the business is critical.

Resale price method ('RPM')



d) *The transaction net margin method ('TNMM')*

This method is a development of the cost plus method which compares the net margin earned in controlled transactions with the net margin on comparable third party transactions. Publicly available data can make it easier to identify the net profits earned by independent businesses, whilst sources like financial statements make it hard to identify costs and margins on individual transactions.

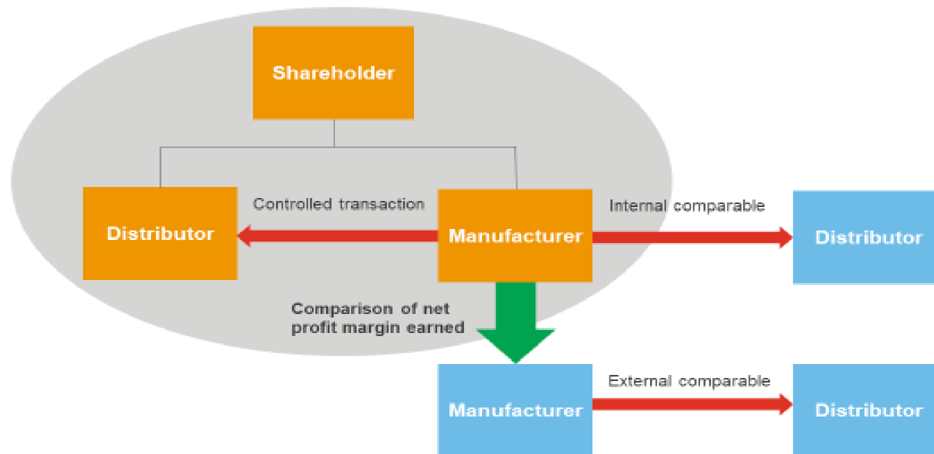
In practice transfer pricing analysis using TNMM tends to focus on the operating margins of similar businesses based on sales and returns on costs. It is a popular approach when dealing with intra-group services such as management services and routine research and development.

The main obstacles to successful application of this method are:

- Published data may not provide adequate detail to ensure that transactions undertaken by third parties are truly comparable in terms of functions and risks undertaken.

- It may also be difficult to identify the use of critical intangible assets such as reputation and market knowledge or the strategic contribution of senior management.

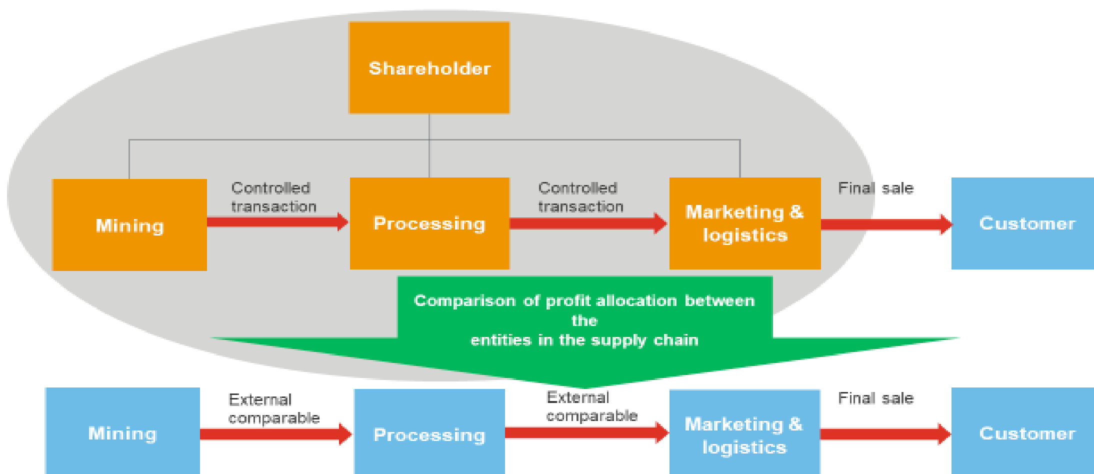
Transaction net margin method ('TNMM')



e) The transaction profit split method

The complex supply chains used by multinational groups usually employ multiple entities in different jurisdictions. The transaction profit split method has evolved to address this, though it is complicated to apply. According to The Guidelines, the aim of this method is to share the overall profit generated by the whole supply chain, 'on an economically valid basis that approximates the division of profits that would have been anticipated and reflected...at arm's length'.

Transaction profit split - example



The focus of the analysis is identifying the contribution that each party in the chain makes to the overall profit considering the functions, risks and assets of each. Once again, it is very important to identify the role of intangibles.

4. Conclusions

The selection and application of appropriate transfer pricing methods relies on objective evidence but ultimately involves a degree of subjectivity. A typical transfer pricing study will produce a range of potential arm's length prices for any category of transactions rather than a single figure. Selection of the optimal in terms of reducing tax liabilities may become a source of conflict with tax authorities in the event of a tax audit. This underlines the need for a detailed study and thorough contemporaneous documentation to justify the rationale for the selection made. It is essential that businesses take appropriate specialist advice on a timely basis to address transfer pricing compliance requirements.

Cristal Advocates accepts no responsibility for any loss occasioned to any person acting or refraining from acting as a result of material contained in this publication. Further advice should be taken before relying on the contents of this publication.

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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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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

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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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 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.

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