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Cristal Knowledge Series

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1. Introduction

Transfer pricing is a critical area of taxation for complex businesses, particularly those that are present in more than one jurisdiction. It is also a key focus of the Base Erosion and Profiting Shifting ("BEPS") initiative[1] and the Uganda Revenue Authority ('URA') has established a specialist team to carry out transfer pricing audits. This team has been actively pursuing large transfer pricing adjustments and URA management expects their audits to raise many billions of shillings of extra tax revenues. The purpose of this article is to highlight the key issues that businesses need to address proactively to prepare for a transfer pricing audit and minimise the risk that this results in significant additional costs.

2. Understanding how transfer pricing rules may affect your business

A significant proportion of international trade in goods and services is between companies which are under common control, perhaps more than 60%. For this reason, governments across the globe have introduced comprehensive transfer pricing rules to require both parties to such transactions to fix their prices in accordance with the arm's length standard. These rules are designed to discourages groups of companies from shifting profits from high to low (or zero) tax jurisdictions. Initially transfer pricing rules were focused only on cross-border transactions, but most jurisdictions have now extended them to apply to domestic transactions, in order for example to deter the shifting of profits to entities in favourable domestic tax regimes, or with tax losses.

Under most transfer pricing rules, prices applied in transactions between parties under common control should be consistent with those that would be charged between independent persons dealing under the same conditions and acting at arm's length. This is termed the arm's length standard: it assumes that each party should act in what it sees as its own individual best interests regardless of the interests (or instructions) of any related party. Where this principle is not adhered to, tax authorities have the right to amend transaction terms for the purposes of computing tax and interest and penalties are also likely to apply.

Uganda introduced detailed transfer pricing rules to supplement the Income Tax Act in 2011. These are to be found in the Income Tax (Transfer Pricing) Regulations 2011 ('the Regulations') and are closely based on international practice, including adherence to the arm's length standard. The Value Added Tax Act contains similar principles and the URA as likely to consider VAT issues when carrying out transfer pricing audits. Withholding tax in respect of payments to related parties is also likely to be reviewed.

More complex Ugandan businesses need to be aware that their transactions with associates ('controlled transactions') will be reviewed in the future even if they are not under transfer pricing audit today. Most taxpayers will find it relatively easy to identify controlled transactions: typically these will be with companies which are majority owned (directly or indirectly) by the same ultimate parent company, either in Uganda or another jurisdiction. Care must be taken as Section 3 of the Income Tax Act has a wide definition of 'associate' so controlled transactions may also include, for example, those entered into with individuals who have controlling interests in a company, companies which are owned by the same individual, or certain joint ventures.

In addition to sales of goods and services, commonly encountered categories include management and service charges, royalties and licences, rental of equipment, loans and overhead allocations. Businesses must address transfer pricing proactively as part of the annual budgeting and planning process and key business decision makers should be involved.

3. Developing a transfer pricing policy

Once a business has identified all controlled transactions (i.e. all the transactions to which the Regulations apply) it is necessary to determine the appropriate transfer pricing methods for each. Five main methods are available under the Regulations[2] and it is up to each taxpayer to identify the most appropriate for each controlled transaction. The first three focus on individual transactions:

- 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 (an internal comparable) or between independent third parties (an external comparable).

[1] Base Erosion and Profit Shifting: a global initiative to combat aggressive tax planning and avoidance launched in 2012 by the G20. More details can be found in our publication. *What is the future for tax planning?* which is on the Cristal Advocates website (http://cristaladvocates.com/publications/)

[2] \ and can be found here: https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm

- 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.

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

- the *transactional net margin method*, compares the net profit margin from related party transactions 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 series of transactions between them.

The Regulations permit the use of a different method if none of the 5 methods "can reasonably be applied to determine whether a controlled transaction is consistent with the arm's length principle". The alternative method must, "give rise to a result that is consistent with that between independent persons engaging in comparable uncontrolled transactions in comparable circumstances". In practice most businesses use the 5 methods and there is limited precedence for the use of alternatives.

Selection of appropriate methods 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 this analysis will be to benchmark the prices applied to intra-group transactions against results for arm's length, i.e. transactions with, or between independent third parties. Such transactions are often referred to as 'comparable'. The benchmarking study can be carried out using information in the public domain which can be accessed via specialist databases. In practice this is challenging for businesses in Africa because of the lack of publicly available financial information, so in practice benchmarking studies tend of focus on emerging markets more broadly. Once this process is complete it is important to document it in a transfer pricing policy document that is regularly revisited to ensure that it remains aligned with how the business is run day-to-day. Such a transfer pricing policy document can form the basis for the documentation required by the Regulations (see next section).

4. Complying with documentation requirements

The 2011 Transfer Pricing Regulations require taxpayers to maintain "sufficient information and analysis to verify that the controlled transactions are consistent with the arm's length principle" (see Regulation 8). Documentation to demonstrate this for a year of income should be in place prior to the filing date for the relevant tax return (i.e. 6 months after the end of the year of income), but does not need to be submitted to the URA until specifically requested. The penalty for non-compliance is a fine of UGX 500,000 or imprisonment for up to 6 months, or both. The Regulation does not provide further detail on the required information however it empowers the Commissioner General to specify further details by notice. In response the URA issued a practice note on 5 May 2012 setting out detailed documentation requirements. The contents should include the following categories of information:

A. Company details;

B. Transaction details;

C. Determination of the arm's length price; and

D. "Summary and conclusion as to whether the controlled transactions comply with arm's length principle and whether any transfer pricing adjustments are required".

These headings are broken down into more detailed subcategories which may be used as a template for the contents of the document For most multinational groups, much of the required information will already be available as similar reports will be required by law in all the jurisdictions where they operate, including a master file covering the group's worldwide activities and local files dealing with individual jurisdictions. It is important to remember that the documentation should reflect the transfer pricing policies applied throughout the relevant year of income, rather than being a post-fact rationalisation of ad hoc decisions on pricing transactions with associates.

The company details required include the following:

- Ownership and organisational structure covering all associated parties;

- Identification of the parties to controlled transactions;
- Brief history of parties including details of "significant changes in relationships" (such as corporate reorganisations), dates of incorporation, shareholdings, etc;
- Operational aspects: functions performed, risks assumed and assets employed relevant to the transactions; and
- Description of factors that influenced the setting of prices for the taxpayer and the related party group as a whole.

Section B (transaction details) requires a comprehensive description of all the controlled transactions, identifying the parties, scope, type, timing, frequency, value, payment mechanism and terms and conditions. Copies of relevant intercompany agreements should be provided. The transfer pricing method adopted for each category of controlled transaction should be identified along with the justification for its use. This section should also include details of the benchmarking study including:

- a description of the comparables used and factors applied in determining comparability;
- calculations performed, including all relevant assumptions and information used;
- analysis of risks, assets and functions in respect of each party to the relevant transactions;
- details of business strategy and impact on pricing decisions;
- financial information re results of associated counter-parties; and
- details of capital structure and source of debt and equity funds.

There may be differences between the terms of comparable third party transactions and those which are being benchmarked, so adjustments can be made to pricing in order to take account of this (e.g. discounts or premiums to reflect differences in volumes, credit terms provided, etc.). It is also necessary to consider differences in market conditions between benchmarked transactions and the comparables and 12 different criteria must be documented including for example, the economic environment, any relevant market regulations, competition, market volume, etc.

The selection and application of appropriate transfer pricing methods relies on objective evidence but ultimately involves a degree of subjectivity. For example, a typical transfer pricing benchmarking 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 thorough contemporaneous documentation to justify the rationale for the selection made.

5. Managing a transfer pricing audit

As mentioned above, the URA has a dedicated transfer pricing team which has been supported by the African Tax Administration Forum ('ATAF'), OECD and World Bank. Tax Inspectors Without Borders ('TIWB')[3] has provided training, coaching and support with audits. The team has been operational for several years and has carried out audits of several large taxpayers in Uganda, some of which are moving towards the dispute resolution phase. We expect that most large taxpayers in Uganda will be regularly subject to transfer pricing audits in future. The URA expect that transfer pricing audits will yield significant additional revenues, and the disruption caused by COVID 19 has no doubt increased pressure on the team to fill the gaps in tax collections resulting from reduced economic activity since March 2020.

It is important for larger taxpayers, particularly those that are part of multinational groups, to be thoroughly prepared for a transfer pricing audit. Transfer pricing policies should be reviewed regularly to ensure that they are aligned to the reality of how controlled transactions are priced day-to-day in the business. Transfer pricing documentation should be prepared on a timely basis so that it can be provided to the URA when requested. It should be remembered that transfer pricing audits are likely to cover a number of years, and steps should be taken to retain 'corporate memory' where key staff move on to other roles, countries or organizations. This could be achieved by ensuring any finance, tax or commercial staff are debriefed in relation to decisions on the pricing of controlled transactions before they move on and the results are incorporated in the company's transfer pricing documentation.

The URA has an advantage over taxpayers as it has access to confidential information on all registered taxpayers and is therefore able to carry out its own benchmarking with information not available to taxpayers. There are limitations in the usefulness of this to the URA as such confidential information cannot be shared or used as evidence in formal dispute resolution

[3] TIWB is an international organisation supported by the United Nations and OECD, providing expertise of tax officials to developing countries. More details can be found here http://www.tiwb.org/about/

fora. Most businesses will have good commercial reasons for keeping an eye on their competitors but it is also advisable to build up an understanding of differences and similarities in business models used in the market so that competitor transfer pricing can be understood to the extent possible. Trade bodies may assist this.

A cooperative approach to dealing with the URA audit team is advisable. The URA has extensive powers under the Tax Procedures Code Act 2014 ('TPCA') which it may invoke if a taxpayer is perceived to be obstructive:

- taxpayers may be required by notice to submit information or attend meetings;
- information may be required under oath or verified by statutory declaration;
- the URA has wide powers to access premises and copy or seize documents and devices; and
- the URA's rights include access to information held by third parties.

When initiating a transfer pricing audit, the URA may also have information from other jurisdictions where the taxpayer's associates are resident, but this fact may not be disclosed to the taxpayer under audit. Double tax treaties generally provide signatory jurisdictions with the right to share information. Uganda has only a small number of such treaties[4], but it is a signatory of the Multilateral Convention on Mutual Assistance in Tax Matters which covers 137 jurisdictions, providing for wide-ranging administrative co-operation between states in the assessment and collection of taxes. This co-operation including exchange of information, cooperation on audits and the recovery of foreign tax claims.

Whilst it is preferable to settle tax audits by negotiation, given the subjective element in transfer pricing, this is not always possible. It is therefore advisable to involve litigators with transfer pricing expertise at an early stage to ensure that actions are not taken during the audit which prejudice subsequent litigation. This can also strengthen the taxpayer's negotiating position, encouraging the URA to settle rather than proceed to court.

If agreement cannot be reached, the URA has extensive power under the TPCA to make additional assessments and payment of disputed amounts of tax may only be waived pending the outcome of the dispute at the discretion of the URA. Once assessments have been issued it is important that the taxpayer pays close attention to the formal procedures and deadlines laid down by the law, in order not to lose the opportunity to present its case:

- objections to an assessment should be filed with URA within 45 days;
- the URA has 90 days to reach a decision but this may be waived in case further review of taxpayer records is required;
- the taxpayer has 30 days to appeal a decision on the objection to the Tax Appeals Tribunal ('TAT');
- decisions of the TAT can be appealed to the High Court.

Where a transfer pricing adjustment has been proposed by the URA in respect of a controlled transaction with a party based in a jurisdiction with which Uganda has a double tax treaty, the taxpayer may also consider involving the competent authority of that treaty jurisdiction under the Mutual Agreement Procedure ('MAP') if it considers the proposed adjustment to be unreasonable. The MAP under Uganda's treaties requires tax authorities to negotiate to attempt to find common ground but usually does not provide any dispute resolution mechanism if they cannot reach agreement. There is usually a 3 year deadline for invoking the MAP, which can be pursued independently from domestic dispute resolution mechanisms.

The Regulations provide a mechanism for taxpayers to reduce the risk of protracted transfer pricing disputes by seeking an Advance Pricing Agreement ('APA') to agree the basis for pricing future controlled transaction. The tax jurisdictions where the relevant counter-parties are resident may be involved in this process also. Negotiating an APA would itself be time-consuming and require submission of extensive documentation to the URA and any other tax authorities involved. The URA also has the right to set aside an APA if it considers that the terms have not been respected by the taxpayer or that full information was not submitted. Though APAs are becoming more common internationally, we are not aware that the URA has entered into any, and it seems likely that at present the URA would find it challenging to deploy sufficient staff to carry out its planned audit programme and negotiate APA.

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[4] Uganda has tax treaties with the following countries: Denmark, India, Italy, Mauritius, the Netherlands, Norway, South Africa, the UK, Zambia.

6. Conclusions

Transfer pricing audits have become a major source of additional tax revenue for tax authorities in many jurisdictions and the URA hopes to emulate them. More complex businesses in Uganda, including those which are part of international groups, need to take a proactive approach to transfer pricing. A well-prepared business:

- ensures that transfer pricing is integrated into its budgeting and decision making processes, involving senior management as well as the tax and finance team;
- maintains a transfer pricing policy covering all material controlled transactions;
- ensures that this is a 'living document' that reflects the way business is actually conducted;
- prepares transfer pricing documents required by the URA on a timely basis so these are readily available after the submission of the annual income tax return;
- expects a transfer pricing audit and ensures that documentation and resources are available to manage this as soon as it arises;
- knows its rights and obligations under the relevant laws so that it can proactively manage its risks throughout the business cycle.

Cristal Advocates as an integrated team of experienced litigators and international tax experts with extensive transfer pricing experience, ready to assist clients in this complex area. For more information on this vital topic, readers may also wish to read other recent articles on transfer pricing issues prepared by Cristal Advocates. These are available on our website (http://cristaladvocates.com/publications/).

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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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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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.

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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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