NEW TRANSFER PRICING REGULATIONS

By Maxwell Ngorima

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INDEPENDENT
TRANSFER
TAXPAYER
PRICING
ALLOCATED
UNRELATED

1. TRANSFER PRICING OVERVIEW

1.2 What is Transfer Pricing?

1 TRANSFER PRICING OVERVIEW
1.1 What is transfer pricing?

Definition

- Transfer pricing is the pricing of intercompany transactions that take place between affiliated enterprises or between headquarter and branch. The transfer pricing process determines the amount of income that each party earns.

- Involves the pricing of goods or services outside normal commercial parameters so as to gain some tax advantages

1 TRANSFER PRICING OVERVIEW
1.1 What is transfer pricing?

What are the aims of transfer pricing regulations?

Transfer pricing provisions aim to adjust prices in order to reflect an arm's length price which would have applied had the transaction been concluded on normal commercial grounds between unrelated parties.

1 TRANSFER PRICING OVERVIEW

1.2 ARMS LENGTH PRINCIPLE

1 TRANSFER PRICING OVERVIEW
1.2 What is the arm's length principle?

Definition

The arm's length principle requires that compensation for any intercompany transaction shall conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same.

(Definition: Art. 9 para. 1 OECD-MC: para. 1.6 OECD-Guidelines)

Important factors influencing the determination of arm's length compensation

- Type of transaction
- Economic circumstances surrounding the transaction

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1 TRANSFER PRICING OVERVIEW
1.2 What is the arm's length principle?

Problems related with the arm's length principle

- lack of agreement as to what constitutes an arm's length transaction
- lack of comparable transactions (little or no evidence of what conditions would have been established by independent enterprises)
- information difficult to obtain for reasons of confidentiality
- accessible information may be incomplete or difficult to interpret

1 TRANSFER PRICING OVERVIEW

1.3 TAX AUTHORITY REACTIONS

1. TRANSFER PRICING – OVERVIEW
1.3 Tax Authority Reactions

Tax authorities worldwide are scrutinizing transfer pricing more closely than ever.

1. TRANSFER PRICING – OVERVIEW
1.3 Tax Authority Reactions

- **DOCTRINE OF ECONOMIC SUBSTANCE**

This concept ensures that Tax is paid where the business activity that generated those profits occured.

How do you tax E- commerce transactions ?

1. TRANSFER PRICING – OVERVIEW
1.3 Tax Authority Reactions

- US:
  - IRS hiring 1,500 devoted to international tax

- Canada:
  - CRA committed to spending $30 million annually on international tax teams
- UK: January 2016
  - Google agrees to pay $185 million in UK. tax settlement

1 TRANSFER PRICING OVERVIEW

1.4 INTERNATIONAL PERSPECTIVE

1 TRANSFER PRICING OVERVIEW
1.4 International Perspective

- Transfer pricing in the tax world is governed by specific rules and has specific methods to determine what is arm's length.
- These have been set out in:
  - the OECD Guidelines, subject to periodic revision and expansion and are OECD accepted methods; and
  - the UN TP Guidelines. Substantially overlap to OECD:
    - i) 5 factors of comparability
    - ii) 5 methods

1 TRANSFER PRICING OVERVIEW
1.4 International Perspective

(i) OECD Guidelines

Organisation for Economic Co-operation and Development

- International Economic Organisation located in Paris, created in 1961
- Provides setting for international discussion
- Co-ordinates domestic and international policies
- 34 members signed the OECD Convention
  - Produce two thirds of world's goods and services
- OECD Guidelines are not legislation but sets out commonly agreed principles
- Encourages member and non member countries to follow guidelines
- Zimbabwe is not a member country of the OECD

1 TRANSFER PRICING OVERVIEW
1.4 International Perspective

(iii) Transfer Pricing in the BRICS:

- All the BRICS, except Brazil, take the OECD TP Guidelines as a starting point;
- The BRICS noted individually country practices and challenges in the 2011 UN Practical Manual on Transfer Pricing for Developing Countries;
- The BRICS are going to require additional taxpayer information when OECD style country-by-country transfer pricing reporting becomes effective;

1 TRANSFER PRICING OVERVIEW
1.4 International Perspective

(iv) Current international developments:

- GG20/OECD focus on addressing tax planning strategies used by multinationals (Base Erosion and Profit Shifting – BEPS – Project);
- Focus is on industries that rely on intangible assets to create value (e.g. e-commerce and pharmaceuticals);
- Further sophistication and complexity in TP Guidelines will follow, meaning a continued battle of the experts;
- Davis Tax Committee in South Africa recommends adoption of G20/OECD BEPS work to date.

2. TRANSFER PRICING LEGISLATION

Transfer Pricing Legislation - Zimbabwe

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

No specific transfer pricing regulations were in place although the country relied on the provisions of section 19, 24, 98 as well as the 4th Schedule and 5th Schedule of the Income Tax Act.

2.1 Trading Transaction

For all trading transactions, the Commissioner is empowered to use anti tax avoidance measures if transactions are not at arm's length.

(i) Section 19 of the Act deals with the provisions relating to persons carrying on business which extends beyond Zimbabwe.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.1 Trading Transaction (Cont'd)

(ii) Section 23 (1) deals with sales of any property, movable or immovable, at less than fair market price. In determining the taxable income or assessed loss of any person trading in Zimbabwe, the Commissioner may…

- Increase the seller's price to fair market price (without increasing the price paid by the purchaser).
- Decrease the purchaser's price to fair market value (without decreasing the price received by the seller).

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.2 TRANSFER OF ASSETS

(i) Paragraph 7A of the Fourth Schedule and paragraph 8 of the Fifth Schedule give the Commissioner powers to re-allocate the purchase price (with or without a section 23 adjustment) in a transfer of assets which rank for the capital allowances.

(ii) These powers are mandatory. They would not be applicable where the transfer is made under cover of the elections contained in these Schedules which allow the transfer of the assets to be made at their written down tax values. Paragraph 8 of the Fifth Schedule can also operate to adjust the amount which is to be treated as a recoupment of the allowances in the hands of the seller.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.3 Interconnected persons

- Section 24 operates where there are business or financial relationships between interconnected parties here and outside Zimbabwe. Its provisions are repeated in double taxation agreements entered into by Zimbabwe with other nations in terms of section 98.

- If conditions are imposed which are not at arm’s length, the Commissioner may determine the taxable income as if the conditions did not exist.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.4 Tax Avoidance provisions – S98

- Section 98 deals with tax avoidance schemes involving transactions which are abnormal or not at arm's length.

- Problem in applying Section 98 is for ZIMRA to prove that "transaction was entered into with the main or sole intention of avoiding or post pone the payment of tax".

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.5 Thin Capitalisation

- Relates to the funding of a business with a disproportionate degree of debt in relation to equity so as to provide the foreign investor the benefit of having the interest income derived therefrom exempt whilst at the same time enjoying the benefit of tax advantage relating to the deductibility of interest payment of debt.

Section 16 (1) (q)

- Any expenditure incurred by a local branch or subsidiary of a foreign company, or by a local subsidiary of a local company, in servicing any debt or debts contracted in connection with the production of income to the extent that such debt or debts cause the person to exceed a debt to equity ratio 3:1.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.6 Excess Management Fees [Section 16 (1) (r)

- Where management fees are payable between group companies, a restriction of roughly 1% of tax deductible expenses is imposed on the amount that can be allowed as a deduction.

- The disallowed portion of the management fee is deemed to be a dividend and subject to a further withholding tax.

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2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.7 Income Splitting

- With effect from 1 January 2014, new transfer pricing regulations were introduced which empower the Commissioner to adjust the taxable income where there is income split between a taxpayer and an associate.

- No specific guidelines were provided on how this could be done.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.8 Section 2A and 2B

- New legislation introduced with effect from 1 January 2014
- Being applied retrospectively
- The following definitions were added
  - When persons deemed to be associates (S 2A)
  - When person deemed to control company (2B)

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2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.9 Section 98A

- Income splitting
  - Transfer of **income** directly or indirectly to an associate
  - Transfer of **property** that produces income (directly or indirectly to an associate)
  - For the sole or main reason of a tax benefit
  - Commissioner may adjust the taxable income of the taxpayer and the associate

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.10 Section 98A (Cont'd)

- Transactions between associates, employers and employees
  - Transactions to reflect the arm's length principle
  - Income from transfer or licence of intangible property
- The Commissioner has the right to:
  - distribute, apportion, allocate income, deductions or tax credits
  - Re-characterize the source of income or nature of payment.

This section repealed with effect from 1 January 2016.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.11 Section 98B

- Section 98B requires the arm's length principle to be applied in any transaction, operation or scheme between associated parties. It should be noted that in our context, this shall apply to both resident parties and non-resident parties.

2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.12 Section 98B (Cont'd)

- Section 98B (4) gives the Commissioner the power to apply the arm's length benefit where a Zimbabwean resident engages in a transaction with an unrelated non-resident if the latter is in a jurisdiction which the CG considers to provide a taxable benefit in relation to that transaction. Applicable if not an associate.
- Taxpayer required to keep documentation prescribed in 35th Schedule to enable ZIMRA to ascertain whether arms length principle was applied.

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2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.13 35th Schedule

- The Thirty-Fifth Schedule gives the guidelines as to how the transfer pricing regulations will be applied.

- The arm's length price – determined by applying the most appropriate methods in the circumstance. The Comparable Uncontrolled Price Method (CUP) will be the preferred method if it gives equally reliability to the other methods.

- The other primary methods shall be the Resale Price Method and the Cost Plus Method.

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2. TRANSFER PRICING LEGISLATION - ZIMBABWE

2.14 35th Schedule

- The Schedule also spells out the Transactional Net Margin Method and the Transactional Profit Split Method as the other preferred methods.

- The Schedule also accepts any other method where the approved methods cannot be reasonably applied provided the CG is satisfied that it will achieve a result consistent with that achievable with an independent party in a comparable uncontrolled transaction.

- New guidelines to determine arm's length price of service, intangible.

2. TRANSFER PRICING LEGISLATION

2.5 Examples of transactions subject to the TP Legislation

- Purchase and sale of products, components or raw materials
- Provision of services
- Financial transactions (incl. Gurantees)
- Intangible assets transactions: acquisition/sale, licensing, joint development
- Share transactions (incl. Internal restructuring)
- Transactions in kind (incl. capital contributions/dividends)
- Salaries paid to and other transactions with administrators and shareholders

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3. TRANSFER PRICING SERVICES

PARA 8 – 35^{TH} SCHEDULE

3. TRANSFER PRICING SERVICES

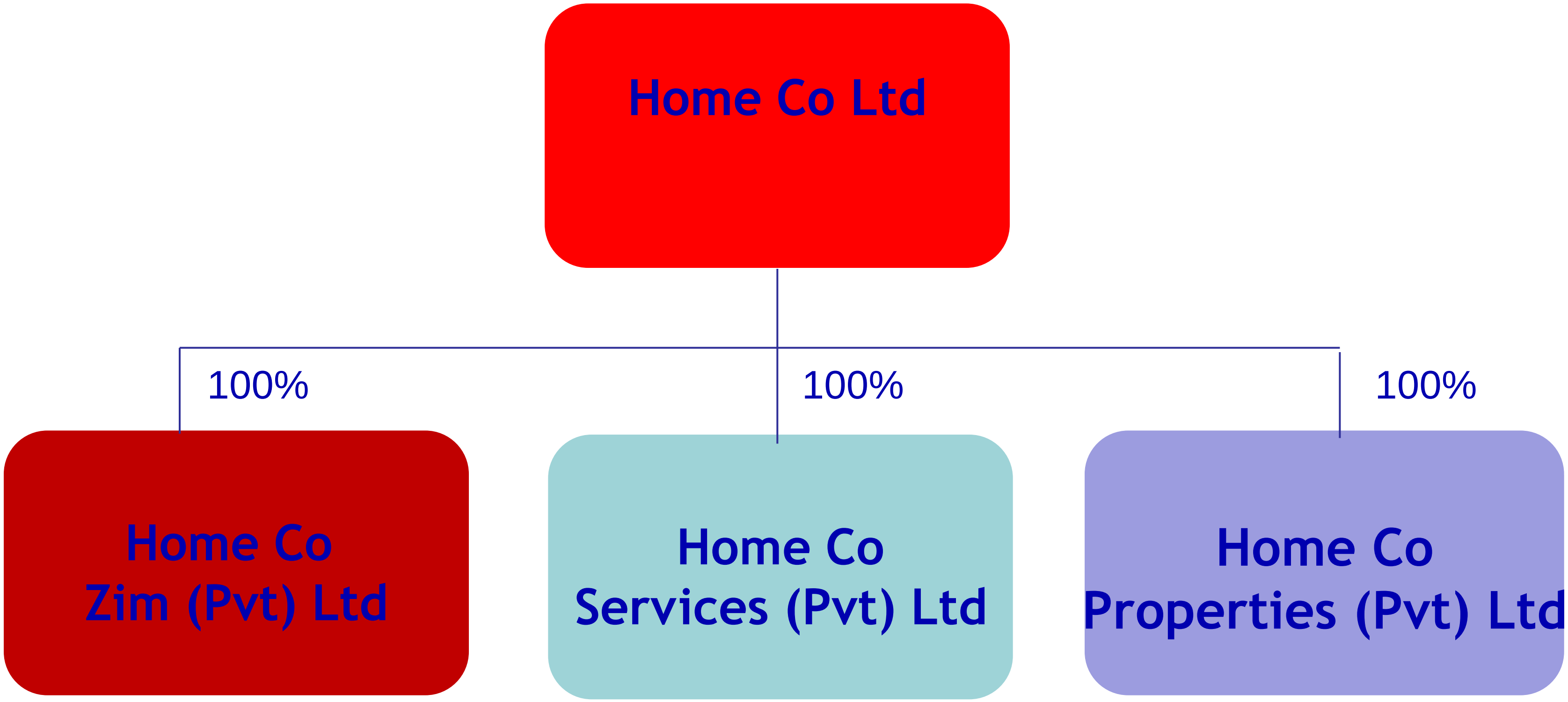
3.2 Types of Services

Standard services provided among multi-national group entities

- Types of services usually provided within a group of enterprises:
  - Management services
  - Business consultancy
  - Supporting services (accounting, tax services, public relations, personnel services, controlling, IT etc.)
  - Distribution and commission services
  - Leasing
  - Treasury
  - Staff leasing services

3. TRANSFER PRICING SERVICES

3.5 Inter-Group Transaction – Dividends



3. TRANSFER PRICING SERVICES

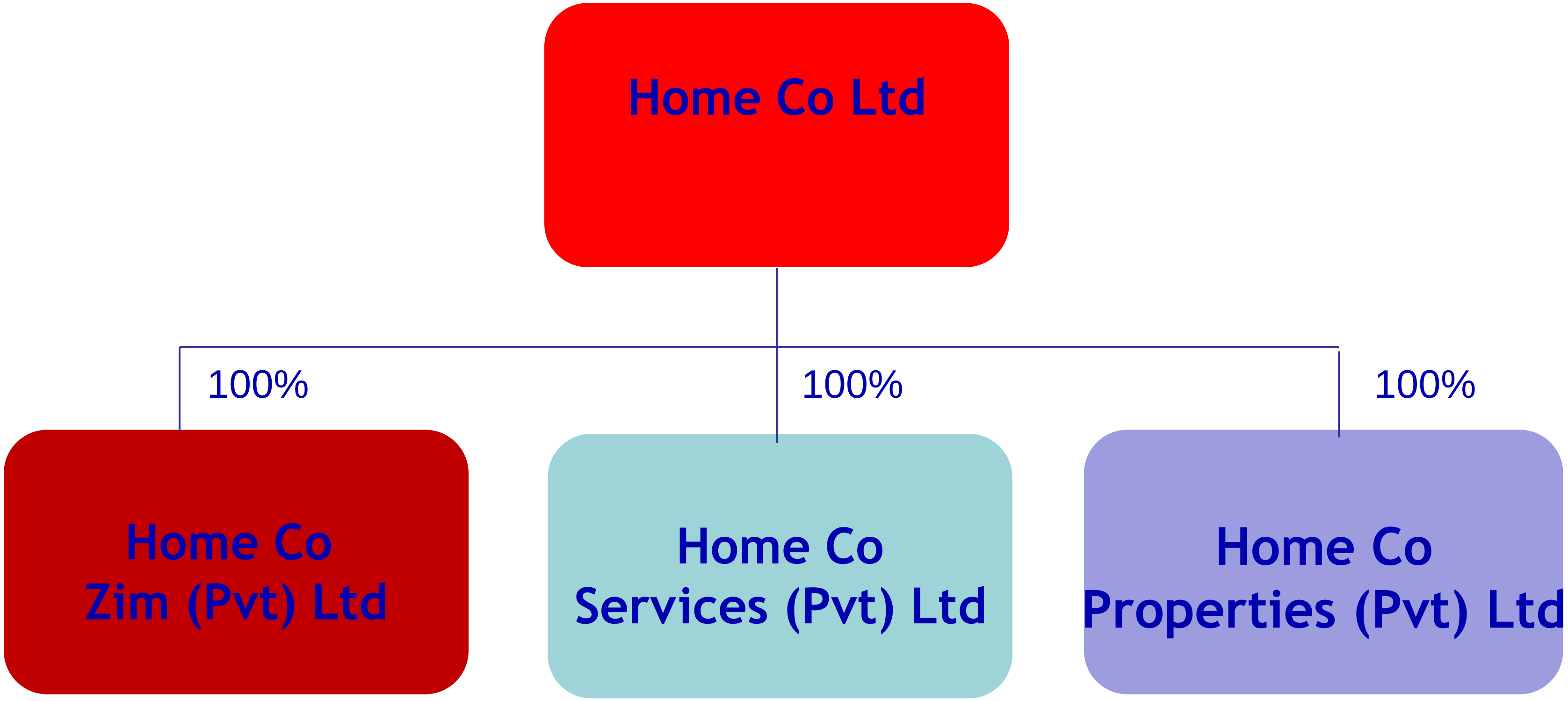
3.6 Cost basis: Shareholder costs – Para 8 (2)

Definition

- Costs of activities relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board;
- Costs relating to reporting requirements of the parent company including the consolidation of reports;
- Costs of raising funds for the acquisition of its participations.
- **Shareholder costs should not be charged to other group members when**
- shareholder costs are incurred for the sole benefit of shareholders
- group members obtain incidental benefits attributable solely by being part of a larger concern,

3. TRANSFER PRICING SERVICES

3.5 Inter-Group Transaction – Management fees



3. TRANSFER PRICING SERVICES

3.1 Services between Associated Enterprises – Para 8 (1)

Special TP-considerations for services : Arm's Length if:

8 1 (a) Substance test

- whether the services were actually provided

8 1 (b) Benefit test

- *whether the services bring declared benefits to all interested parties better than any other transaction could*

8 1 (c) Arm's length test

- whether price for the services correspond with those which would be made between independent enterprises

8 1 (d) Comparability list

– would have been agreed by independent enterprises for comparable services in comparable circumstances

TP documentation should be complemented with information package proving that these tests were actually met.

3. TRANSFER PRICING SERVICES

3.3 Characterization of entities

Special services and providers
Management services

- Usually provided by parent company to subsidiaries
- Management according to strategy of group
- Reduction of rivalry among subsidiaries, contributes to efficiency of whole group

3. TRANSFER PRICING SERVICES

3.8 Management fees

- **Management fees are routinely challenged by tax authorities**
- **Major challenge around proof of receipt of services and benefits**
- **Documentation request proving to be administratively challenging**
- **No serious consideration to practicality – all documentation is being requested including invoices, trial balances, copies of passports, evaluation reports, etc.**

- Management fees that a percentage of revenue challenged
- Agreements – there is usually disconnect between agreements and how the business is carried out. ZIMRA focuses on certain aspects of the agreements to come to their conclusions
- Cost allocation – detailed working required, support for costs may not be readily available.

7. POSSIBLE IMPACT OF NEW TRANSFER PRICING RULES
7.3 Transfer pricing investigations/Audits

TP Audits – Major Focus Areas

(ii) Management services

- Is there an agreement in place?
- Are the parties complying fully with the terms of the agreement?
- Were the services actually rendered? Evidence that services were provided
- If yes, were they needed?
- Does the recipient have capacity in-house to provide services?
- If yes, is there a risk that activities are being duplicated?
- If no, is the fee charged appropriate?

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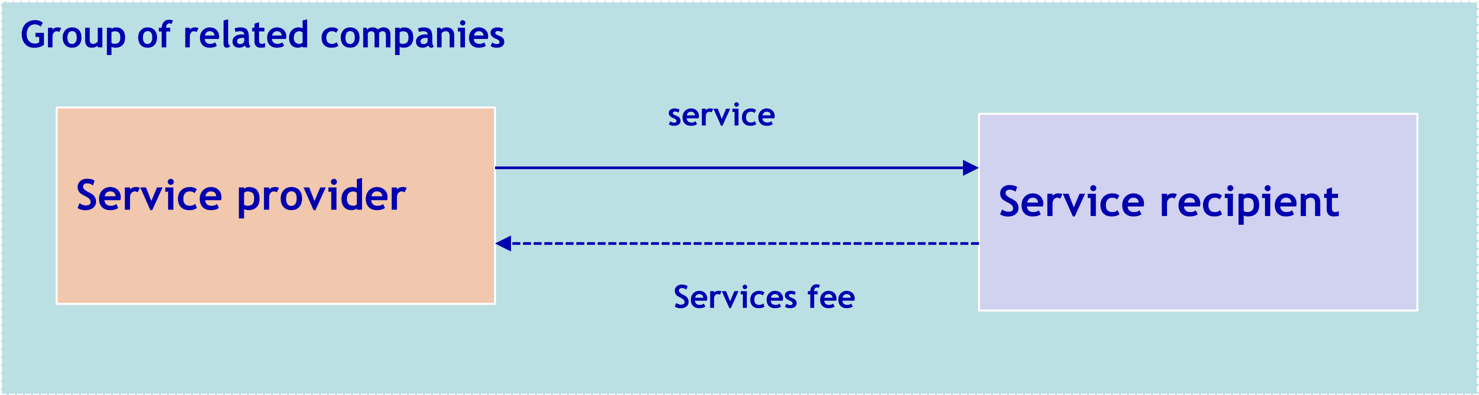
3. TRANSFER PRICING SERVICES

3.4 Cost Allocation Agreement

Services for consideration and benefit for recipient



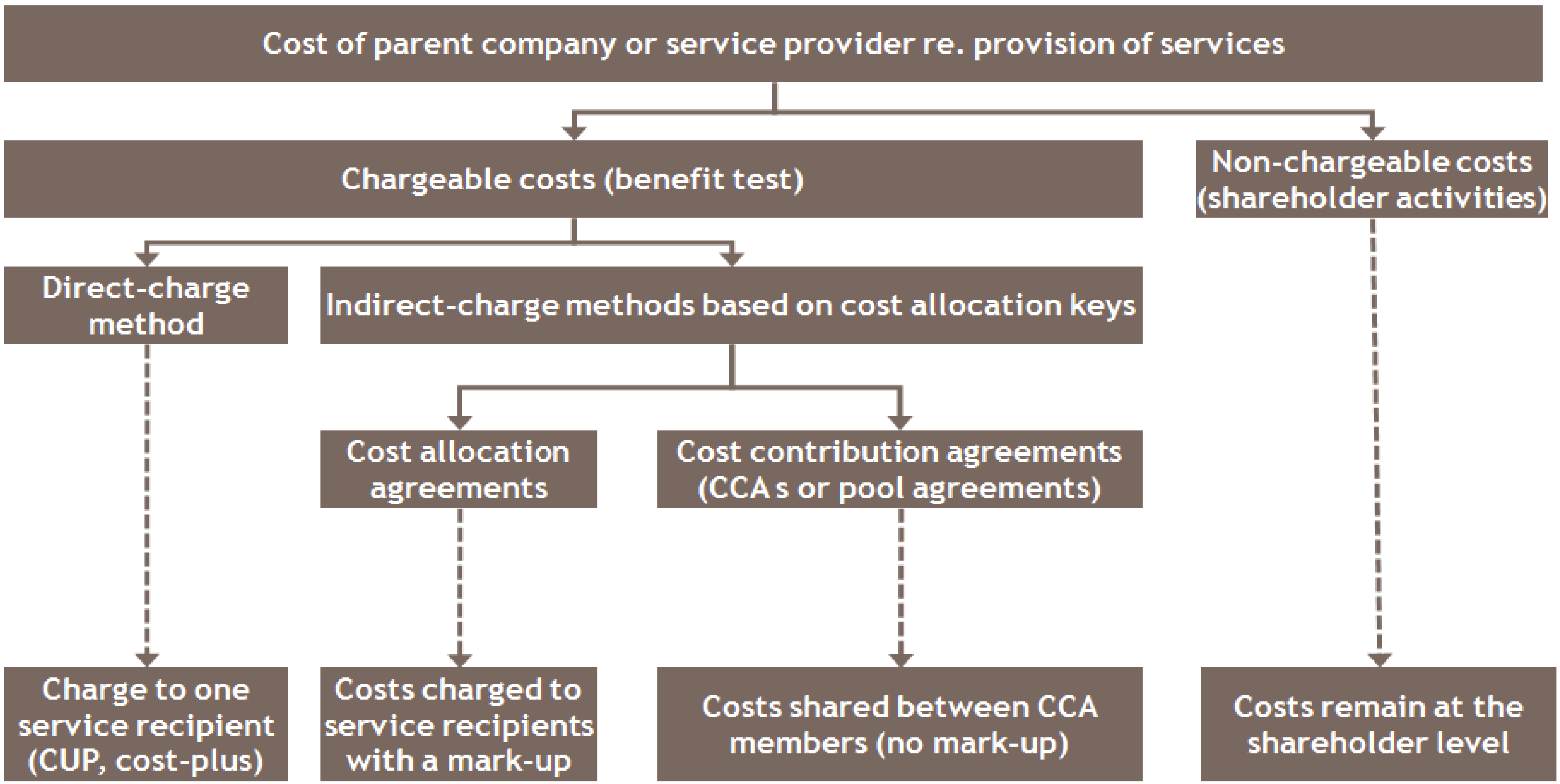
Service recipient needs to derive an economic or commercial benefit

1. Consider whether an independent enterprise would have been willing to pay
2. 2. Identification of benefits!
3. 3. Incidental benefits are not sufficient!

3. TRANSFER PRICING SERVICES

3.9 Settlement of services charges

Approach



3. TRANSFER PRICING SERVICES

3.10 Cost Allocation Agreements

Methods applied to compute amounts to be charged

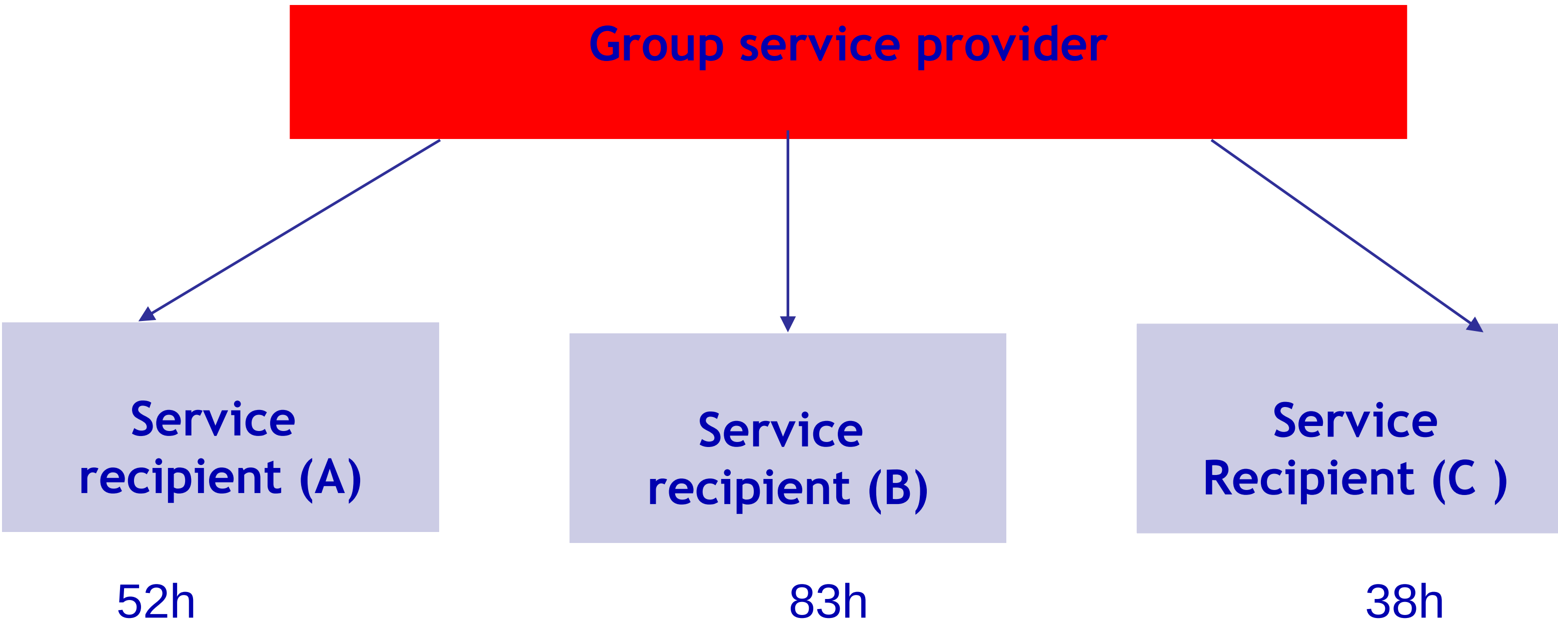
- Direct-charge method
  - Relatively exact method
  - Very demanding on administration
  - Usually used for charging for specified services provided by junior administrative staff only in practice
- Indirect-charge methods
  - Less exact method than direct-charge method
  - Less demanding on administration than direct-charge method (timesheets are not necessary)
  - Usually used for charging for services provided by parent companies to subsidiaries.

3. TRANSFER PRICING SERVICES

3.11 Cost Allocation Agreements

Example: Direct charge method (1/2)

- **based on keeping accurate time records (timesheets)**



4. TRANSFER PRICING DOCUMENTATION

4. TRANSFER PRICING DOCUMENTATION

Documentation requirements [Section 98B Para 5]

Obligation to document the transactions between related persons or entities, or with non-related persons or entities resident in tax havens (even if no relationship exists).

The taxpayer must keep the following documentation at the disposal of the Tax Authorities:

- Group-level documentation (master file)
- Taxpayer documentation

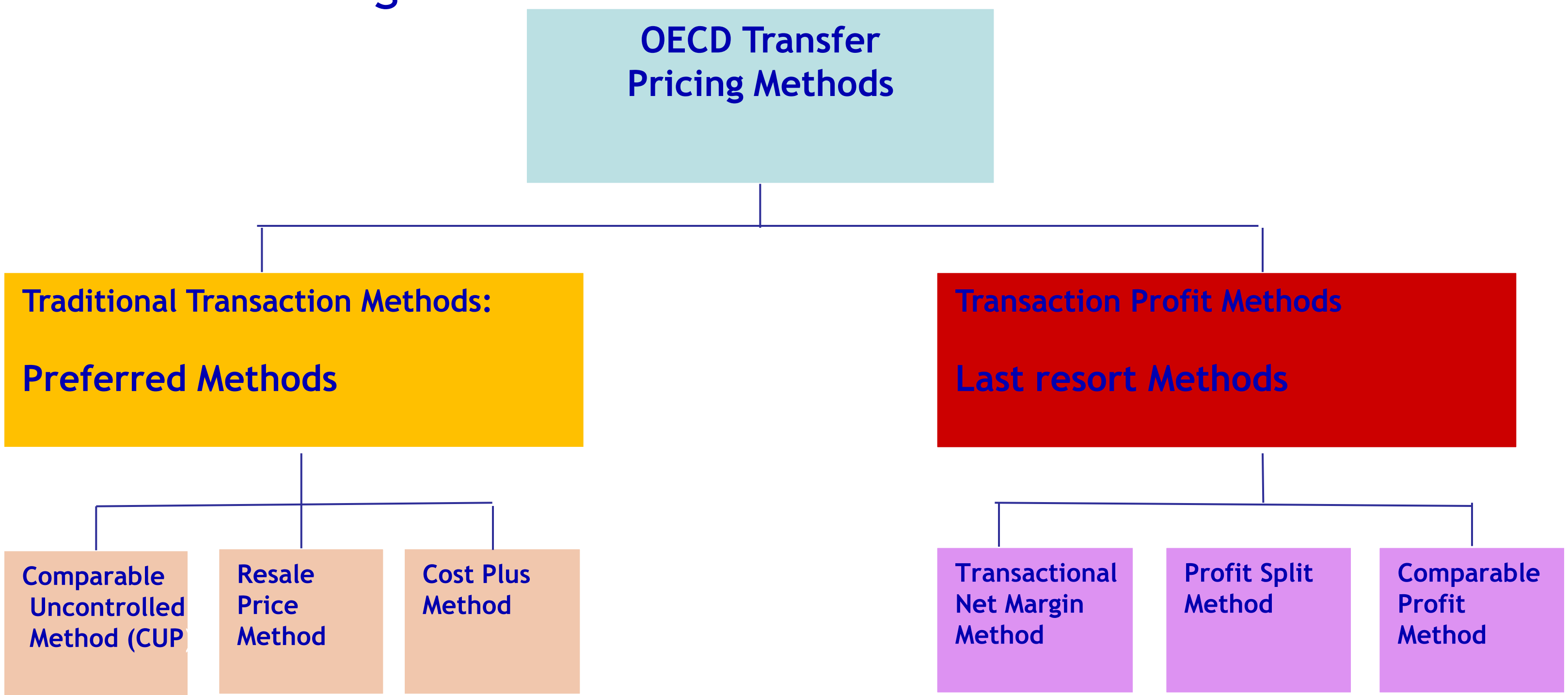
The documentation has to be kept at the disposal of the Tax Authorities for audit, once finalized the voluntary filing period of the Corporate Income Tax Return.

5. TRANSFER PRICING METHODS

5. 1 Overview

5. TRANSFER PRICING METHODS
5.1 Overview

Transfer Pricing Methods



5. TRANSFER PRICING METHODS

5. 2 Traditional Transaction Methods

5. TRANSFER PRICING METHODS
5.2 Traditional Transaction Methods

Comparable Uncontrolled Price Methods

- Comparison of the price for goods or services transferred in a controlled trans-action with the price charged for goods or services transferred in a comparable uncontrolled transaction in comparable circumstances.

5. TRANSFER PRICING METHODS
5.2 Traditional Transaction Methods

Example: Comparable Uncontrolled Price (CUP)

- A captive finance company grants a loan of US10 m at the rate of 10% to an associated company. Banks would grant the loan at a rate of 5.6 to 6%. The application of CUP is possible. A rate of 6% is acceptable at most as it is within the range of acceptable rates.

5. TRANSFER PRICING METHODS
5.2 Traditional Transaction Methods

(i) Resale Price method (RPM)

- A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin.

- What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm's length price of the original transfer of property between the associated enterprises.

5. TRANSFER PRICING METHODS
5.2 Traditional Transaction Methods

Traditional transaction methods in brief

TP - method	Determination of TP	Application areas
Resale Price Method	• Base: resale price at which the associated enterprise sells the product to an independent enterprise • Reduction by a resale price margin usual in the market which shall cover costs resulting from the functions and risks adopted and an appropriate profit mark-up	Principle: • Suited especially for companies that sells goods to affiliated companies which resell them Example: • Distribution companies

5. TRANSFER PRICING METHODS
5.2 Traditional Transaction Methods

(iii) Cost Plus Method

A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

5. TRANSFER PRICING METHODS
5.2 Traditional Transaction Methods

Traditional transaction methods in brief

TP - method	Determination of TP	Application areas
Cost plus method	• Base: costs in a controlled transaction • Addition of an appropriate cost plus mark up	**Principle:** • Suited for transactions where no market prices are available **Example:** • Goods and services being specific to the group • Services provided within a group • Semi-finished products • Long-term supply contracts

6. COMPARABILITY

6. Comparability Analysis

1. Determination of years to be covered
2. Broad-based analysis of taxpayer's circumstances
3. Review of the controlled transaction + choice of the tested party
4. Review of existing internal comparables (if any)
5. Determination of sources of information on external comparables
6. Selection of most appropriate transfer pricing method
7. Identification of potential comparables: selection + rejection
8. Comparability adjustments (where appropriate)
9. Arm's length range

5. CONCLUDING REMARKS

7. CONCLUDING REMARKS

Practical steps to mitigate TP exposure

- Develop an appropriate localized TP policy
- Leverage upon any Group transfer pricing document
- Ensure benchmarking is reviewed frequently- at least 3 years and updated
- Maintain documentation file to support transactions on an on going basis- do not wait for TP audit in order to look for documentation.
- Ensure accurate tax return disclosure of intercompany transactions (agree balances to audited financial statements)
- Maintain signed intercompany agreements
- Involve tax consultants in documentation/review as well as the tax investigation process.
- Negotiations with Revenue Authority?
- Consider Advance Pricing Agreements

THE END

mngorima@bdo.co.zw

BIOGRAPHY

Max Ngorima

Tax Director –

BDO Tax & Advisory Services (Pvt) Ltd

Expertise summary:

Cross border tax planning
Transfer pricing
Tax Investigation
Expatriate Tax Consulting
Strategy Tax Planning
International Tax

Max is a Director with BDO Tax & Advisory Services, an associate firm of BDO Zimbabwe CA (Z).

Max Ngorima has 33 years experience in taxation.

He joined BDO in 1998, after leaving the Tax Department as an Assistant Commissioner in charge of tax investigations, and also worked as a tax consultant with a private sector group of companies.

He is a member of the Tax and Legal Committee of the Institute of Chartered Accountants and also Vice President of the Institute of the Certified Tax Accountants.

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