THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

CITN

Integrity & Service

HANDBOOK ON

TRANSFER PRICING DOCUMENTATION

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To build an Institute which will be a citadel for the advancement of taxation in all its ramifications

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Integrity and Service

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Service, Teamwork, Excellence, Professionalism (STEP)

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THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

FOREWORD

Members of the Organization for Economic Cooperation and Development (OECD) have set themselves to work together to eliminate, albeit reduce to the barest minimum, the impact of aggressive tax planning, base erosion and profit shifting, consumption tax, dispute resolution, exchange of information, fiscal federalism network, global relations and development, public finance, tax administration, tax and crimes, tax policy analysis and tax treaties on cross border economic activities across national boundaries. Transfer Pricing has become a central topic in International Taxation as it places a central role in these identified barriers to cross boarder economic activities.

The International Taxation Faculty of the Chartered Institute of Taxation of Nigeria has adopted the OECD guidelines and standards to produce the Handbook on Transfer Pricing Documentation to provide a working tool and basis for members of the Institute who need such knowledge to guide their practice and performance, as well as to upskill our professional members in this current area of international taxation. The Handbook provides a comprehensive overview of Transfer Pricing issues, together with technical analysis and implementation of Transfer pricing methods. The examples cited have provided additional boost to enhance understandability of the issues discussed. This handbook becomes necessary to serve as guideline for tax practitioners, tax administrators as well others who are interested in the area of Transfer Pricing in particular, and international taxation in general.

It is my sincere belief that this Handbook will help tax practitioners and administrators effectively in carrying out their various tasks and also serves as reference book for students of the Institute who want to fully understand Transfer Pricing procedures. I, therefore recommend the Handbook as unique and fit for general use and particularly for members of the Institute.

Dame Gladys Olajumoke Simplice, FCTI
14th President and Chairman of Council
Chartered Institute of Taxation of Nigeria
Lagos

August, 2020

PREFACE

International Taxation deals with the determination of taxes arising from the income and profits earned from economic activities of non – resident corporate organizations and individuals. As a specialty field of taxation, there is dearth of technical expertise to handle the varied tax issues that stem from different countries' reporting and taxation standards. Prominent among international taxations issues is Transfer Pricing, with various transfer pricing documentation rules relating to various transactions or arrangements.

Handbook on Transfer Pricing Documentation provides the Institute's attempt to bridge the knowledge gaps in dealing with transactions between related parties for tangible property, services, intangibles property and financial transaction. The handbook will serve as guiding manual to help both the tax practitioners and administrators to understand the key role of Transfer Pricing in allocation of profits from one jurisdiction to another.

Chapter one of the Handbook analysed the definition of Transfer Pricing and basic concepts associated with Transfer Pricing, sources of Transfer Pricing laws and regulations, the Nigeria Transfer Pricing Regulation 2012, 2018; Article 9 of OECD and UN model, sections 22, 17 and complying with the Arm's Length principle.

Chapter two discussed the comparability analysis which comprises of objectives of comparability analysis, comparability process, factors, identification of comparables, sources of open comparables, selection of tested party, and economic analysis.

Chapter three and four dwelt on Transfer Pricing methods and intragroup services that comprises of the methods of computing the arm's length price, types of intra-group services and arrangements, shareholders services and other services, determination of arm's length remuneration for intra-group services, identification of acceptable allocation keys, service charge computation and documentation.

Chapter five and six explained intangibles and Cost Contribution Arrangement (CCA), Transfer Pricing methods for intangibles and pre-requisite for participating in Cost Contribution Arrangements.

Chapter seven discussed Transfer Pricing review and audit/advanced pricing agreement with emphasis on pricing risk assessment and profiling, transfer pricing audit process, mutual agreement procedures, advanced pricing agreements.

Finally, Chapter eight analysed the transfer pricing documentation requirements and other contemporary issues.

It is our hope that this publication will provide a guide on dealing with Transfer Pricing issues as they confront tax practitioners, tax administrators and corporate organizations in their daily affairs. Students of Transfer Pricing in professional examinations and tertiary institutions will find this Handbook as an indispensably ally in their studies.

As Transfer Pricing issues evolve, we look forward to your feedback on the Handbook as these will provide us with the required arsenals to keep updating the Handbook in subsequent editions.

Albert Folorunsho, FCA, FCTI
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16th August 2020

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ABOUT THE INSTITUTE

The Chartered Institute of Taxation of Nigeria started on February 4, 1982 as Association of Tax Administrators and Practitioners (ATP). Thereafter, it transformed into Nigeria Institute of Taxation, which was formally launched on February 21, 1982 and statutorily recognized on May 6, 1987 as a company Limited by Guarantee.

The Institute was chartered by the Federal Government of Nigeria by the enabling Act No. 76 of 1992 (now CITN Act, CAP C10, Vol. 2, Laws of the Federation of Nigeria, 2004) and charged with the responsibility, among others, of regulating and controlling the practice of the tax profession in its entire ramifications and also determining what standards of knowledge and skills are to be attained by persons seeking to become professional Tax Practitioners or Administrators in Nigeria.

THE CHARTER OF THE INSTITUTE

The aims and objectives of the Institute as laid down in its charter (Act No. 76 of 1992), among others, are:-

- To determine what standards of knowledge and skill are to be attained by persons seeking to become registered members of the taxation profession;
- To raise, maintain and regulate the standard of taxation practice amongst its members;
- To promote professional ethics and efficiency in tax administration and practice; and
- To encourage, promote and co-ordinate research for the advancement of taxation practice and administration in Nigeria.

Under the Act, the Institute is the only professional body empowered to regulate tax practice and administration in Nigeria and only its members can practise Taxation. The Act sets out the rules as regards membership, composition and officers of Council, etc.

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ABOUT THE TAXATION FACULTIES OF THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

The Taxation Faculties of the Institute were established as specialist faculties to offer guidance, support and best advice on tax legislation to members of the Institute as well as to facilitate tax education and training to tax practitioners, tax administrators, accountants, legal practitioners and company secretaries through seminars, symposiums, online webinars and conferences. The Taxation Faculties serve as the think tank to the Council of the Institute on tax policy matters and help to raise the profile of the taxation profession in Nigeria, by providing a platform for stronger advocacy and engagement with regulators, policy makers and taxmen. It also provides avenues for further development of high-quality tax services under the Institute.

The Faculties serve to drive the technical, advocacy and liaison functions of the Institute. The CITN Tax Faculties are coordinated by the Committee of Deans of Faculties, headed by a Coordinating Dean. Membership of the Faculties are draw from experienced tax administrators and practitioners, legal practitioners and other distinguished professionals as determined by the Governing Council of the Institute.

Five Faculties have been established in this light:
1. Direct Taxation Faculty
2. Indirect Taxation Faculty
3. Tax Policy and Administration Faculty
4. Extractive Industry Taxation Faculty
5. International Taxation Faculty

The International Taxation Faculty (ITF) of the Chartered Institute of Taxation of Nigeria addresses taxation issues relating to business activities across international borders, as well as international taxation laws and policies. Tax implications of bilateral, regional and global agreements and treaties affect Nigeria, including Transfer Pricing regulations and issues, are among the specific terms of reference for the Faculty. Handbook on

Transfer Pricing Documentation is one of the outputs of the International Taxation Faculty in the 2019/2020 Presidential Year of the Institute.

The members of International Taxation Faculty (ITF) who contributed to the successful writing of this Transfer Pricing Handbook are given below:

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Albert has been involved in all aspects of taxation practice including International Tax Advisory, Transfer Pricing Planning and Implementation, and Oil & Gas Taxation Management. He has also handled several Insolvency assignments for financial institutions including; Debt Recovery, Liquidation and Receivership Management and has over 28 years of professional experience in Taxation, Insolvency Practice and Management Consulting He co-founded Pedabo Associates Limited in 1998 and is presently the Managing Consultant of the firm.

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Sandra is a graduate of Accounting and was the best graduating student in her set. She holds a master's degree in Business Administration, an Advanced Diploma in International Tax as well as an Advanced Diploma in Transfer Pricing from Thomas Jefferson School of Law United States.

She is a fellow of both the Chartered Institute of Taxation of Nigeria (CITN) and Institute of Chartered Accountants of Nigeria (ICAN), and the Secretary of the Society of Women in Taxation (SWIT) Lagos Chapter. She is the founder of Insightful Ladies Forum; a platform which aims to empower young girls and ladies into leadership. She is the chairperson for Professional Women's Network (PWN), Lagos.

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'Yomi is currently a Tax Specialist offering specialized tax strategy and planning services to the Oando Group.

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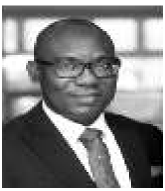
In her spare time, she mentors junior tax practitioners and tutors students aspiring to become chartered professionals of the Chartered Institute of Taxation of Nigeria (CITN). She is also an avid reader, lover of theatre and travels, and an incurable epicure.



Victor Adegite (Deceased) was a senior manager in Tax and Transfer Pricing with KPMG Nigeria. He is a chartered accountant and tax practitioner with over 13 years of relevant tax experience working in multinational companies on various assignments, such as transfer pricing (advisory compliance and audit), tax and regulatory compliance, corporate mergers and acquisitions.

Victor's professional experience spanned across industries such as oil & gas, financial services, agriculture & agro-allied, construction & engineering, manufacturing, IT/business outsourcing, pharmaceuticals and maritime. He worked on several global TP documentation projects (BEPS Action 13). He also worked on several international transfer pricing planning and documentation assignments from countries such as Egypt, India, Italy, South Africa and the United States etc.

Victor was a member of the International Tax Faculty and Transfer Pricing Committee of the Chartered Institute of Taxation of Nigeria (CITN). He was an associate of CITN and the Institute of Chartered Accountants of Nigeria (ICAN), and a member of the International Fiscal Association (IFA).

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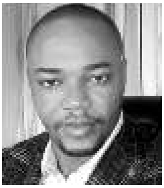

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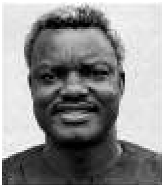

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He serves the Institute as a member of the International Taxation Faculty in the 2019-2020 Presidential Year.

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CHAPTER ONE

INTRODUCTION TO TRANSFER PRICING

1.1 Definition of Transfer Pricing

Transfer Pricing (TP) can be defined as the setting of appropriate prices for transactions between associated enterprises (related party transactions) to ensure that the pricing is consistent with the arm's length principle. TP has been defined by several authors and bodies as follows:

Organisation for Economic Cooperation and Development (OECD)

"Transfer pricing refers to the pricing of transactions between related parties for tangible property, services, intangible property, and financial transaction."

United Nations

"Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices for transactions between associated enterprises for the transfer of property or services."

While TP in itself is not unlawful, transfer mispricing is frowned at by the tax authorities as it is seen to be acrimonious and illegal. Transfer mispricing is an abusive process of setting non-arm's length prices for transactions between associated enterprises.

TP has since become one of the most important issues in international tax to Multinational Enterprises (MNEs) Group and tax administrations, as it determines the taxable income allocated to different jurisdictions and eventually the taxes paid to tax administrations.

In the past, TP application has been left in the hands of practitioners. However, the remarkable global economic crises in recent past have shed light on the risk of TP application jeopardizing the arm's length principle and impacting on the economies of the world.

In view of this, tax administrators became appreciative of the key role of TP in allocation of profits from one jurisdiction to another. The belief is that TP is one of the potent strategies which can be adopted by MNEs Group to reduce their global tax rate by shifting profits from a high tax jurisdiction to a low tax jurisdiction.

1.2 The Importance of Transfer Pricing

It has become important for MNEs and tax administrations to understand the subject of TP, given its multiple implications. In recent times, TP has gained significant popularity among tax administrations and MNEs for reasons such as globalization through advancement in technology, specialization among associated enterprises in MNEs leading to centralization of services in some countries, business restructurings e.g. mergers and acquisitions resulting in transfers of items from one entity to another. Highlighted below are some other reasons why TP has gained significant prominence:

1.2.1 **It affects amounts paid as taxes -** With the current economic globalization and consequent increase in cross border transactions among MNEs, TP is the overarching concept determining allocation of profits among the MNEs group and tax collection by governments in different jurisdictions.

1.2.2 **It encourages profit shifting to jurisdictions with favourable tax rates -** Cross border transactions are usually between associated enterprises located in jurisdictions with different corporate tax rates. As such, there are incentives for MNEs Group to shift profits from high tax jurisdictions to low tax jurisdictions in order to reduce the effective tax rate of the group.

Accordingly, tax administrations in high tax jurisdictions subject transactions with associated enterprises paying taxes in low tax jurisdictions to greater scrutiny.

1.2.3 **Results in tax exposure and possible double taxation from TP disputes -** It is a general knowledge that TP is not an exact science hence the need for MNEs to have adequate and sufficient documentation to support the arm's length nature of their pricing. In the event that tax administrations are not satisfied that intra group transactions of MNEs have been priced in accordance with the arm's length principle, they may resort to imposition of TP adjustments and calculation of additional taxes to be paid by the MNEs entities. In some cases, the additional taxes from TP adjustments are so huge that MNEs can be tremendously affected if caught unawares.

Occasionally where cross-border transactions are between associated enterprises located in two different countries without a double taxation treaty, imposition of TP adjustment by tax administrations presents a risk of double taxation where two jurisdictions involved are claiming tax rights on the same profits.

1.2.4 **It presents MNEs with opportunities for business optimization -** The in-depth understanding of MNEs businesses and their industries in performing TP analysis alerts organization to possible areas for business efficiency and optimization. Furthermore, the TP analysis assists to identify business restructuring opportunities.

1.2.5 **Addresses possible disputes between tax administration and customs authority –** In many jurisdictions, it helps define the responsibilities of different government authorities regarding the evaluation of transfer prices of goods and properties declared for tax and customs purposes.

To this end, transfer prices declared by companies to tax administration in respect of goods and properties may not be accepted by the custom authorities. In essence there may be different valuation basis for the same item for tax or custom purposes.

1.3 SOURCES OF TRANSFER PRICING LAW AND REGULATIONS

1.3.1 The Global Overview

The role of MNEs in world trade has tremendously increased over the last 20 years on the basis of their contribution to world trade The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs given that the taxation of MNEs cannot be viewed in isolation of individual countries' tax regimes, but must be addressed in a broad international context.

These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment (PE) that is part of an MNE group that should be taken into account within a jurisdiction, particularly where the MNE group's operations are highly integrated.

One of the most difficult issues that has arisen is the establishment of appropriate transfer prices for tax purposes. Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to its associated enterprises. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions.

The history of TP can be traced back to the treaties concluded by the United Kingdom, United States and France in the first half of the last century. The United States can be said to haveone of the oldest TP regimes in the world and was the first country to adopt a comprehensive TP legislation in 1968.

In order to minimize the risk of such double taxation, an international consensus is required on how to establish for tax purposes, transfer prices on cross-border transactions. In 1995, the OECD Transfer Pricing Guidelines (OECD TPG) was published and it represents a consensus among OECD Member countries.

The TP Regulations enacted in many jurisdictions are modeled after the OECD TPG and also the United Nations Practical Manual on Transfer Pricing (“UN TP Manual”) on the basis that they follow the arm's length principle as described in Article 9 of the OECD Model Tax Convention.

The arm's length principle dates back to the League of Nations Model Tax Conventions and was formulated for the first time in Article 6 of the draft Convention on Allocation of Profit and Property on International Enterprises in1936. These conventions shaped the worldwide consensus in the earlier part of the 1900s. The principle was first mentioned in Article 9 of the OECD Model Tax Convention in the year 1963 and in Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries in 1980 (Marlies de Ruiter, 2012)

The OECD TPG and UN TP Manual assist MNEs and tax administrations to evaluate the arm's length nature of transfer prices set for related party transactions and provide an element of consistency among countries in the application of such rules. The first OECD TPG, released in 1995 had undergone various revisions over the years. The latest version of the OECD TPG is the 2017 edition, which incorporates the OECD Base Erosion and Profit Shifting (BEPS) recommendations on TP transfer . The OECD TPG has been adopted by most tax authorities (including the FIRS), either wholesale or with some level of customization to address local issues.

1.3.2 African Overview

In Africa recently, the scrutiny of the tax footprints of MNEs have been on the rise. The TP policies of African nations are influenced by three major international players. These are the OECD, UN and African Tax Administration Forum (ATAF). The framework created by these players has the arm's length principle as the foundation of their TP policies and establishment of the TP regimes in Africa has been the focus of these international tax players.

African countries have different TP regimes which guide business transactions in the respective countries. However, the development of TP in Africa has been faced with a number of challenges especially in developing countries. These include inadequate comparable transactions, low level of knowledge and resources, and few tax treaty networks amongst others.

1.4 INCOME TAX (TRANSFER PRICING) REGULATIONS 2012

The establishment of the TP regime took a long time to berth in Nigeria. The foremost Nigeria's TP Regulations (the Regulations) were released in 2012 with a commencement date of 2 August 2012 and was applicable to basis periods commencing after 2 August 2012.

The Regulations emphasized the application of arm's length principle in setting transfer prices and applies to both domestic and cross border related party transactions. The Regulations gave effect to the relevant provisions of the Companies Income Tax Act (CITA), Personal Income Tax Act (PITA),andthe Petroleum Profits Tax Act (PPTA).

Prior to its introduction, the Nigerian domestic tax laws merely provided general anti-avoidance rules that related party transactions must be conducted at arm's length without detailed guidelines on the application of the arm's length principle. Accordingly, the Regulations were introduced to provide guidance on the application of the arm's length principle.

The Regulations sought to reduce the risk of economic double taxation, provide the Federal Inland Revenue Service (FIRS) with the tools to fight artificial transactions, and, provide multinational enterprises with certainty of TP treatment among other objectives. The Regulations which were released to give effect to the general anti-avoidance provisions under various tax laws set out guidelines on related-party transactions. Both domestic and cross-border transactions between associated enterprises are subject to the provisions of the Regulations.

The Regulations were repealed in 2018 upon the enactment of the Income Tax (Transfer Pricing) Regulations of 2018.

1.5 INCOME TAX (TRANSFER PRICING) REGULATIONS 2018

In furtherance of the powers conferred on the FIRS by Section 61 of the Federal Inland Revenue Service Establishment Act 2007, the Income Tax (Transfer Pricing) Regulations 2018 (TP Regulations) was issued to replace the Regulations of 2012. The commencement date for the TP Regulations was 12 March 2018 and remains currently in force. The TP Regulations incorporate some of the recommendations of the OECD TPG of 2017 as well as provisions contained in the ATAF Suggested Approach to drafting TP legislation. It applies to both domestic and foreign related party transactions.

Unlike its 2012 predecessor, the TP Regulations give effect to the Capital Gains Tax Act (CGTA), Value Added Tax Act (VATA) as well as the CITA, PITA and the PPTA. The objectives of the TP Regulations, include amongst others, reducing the risk of double taxation, ensuring appropriate taxable basis corresponding to the economic activities of taxable persons and their related entities, and providing certainty of transfer pricing treatment.

The TP Regulations apply to transactions between connected taxable persons and require that the taxable profits resulting from such transactions are consistent with the arm's length principle. The transactions to which the TP Regulations apply include but are not limited to:

a) Sale and purchase of goods and services
b) Sale, purchase or lease of tangible assets
c) Transfer, purchase, license or use of intangible assets
d) Provision of services
e) Lending or borrowing of money
f) Manufacturing arrangements
g) Any transactions which may affect the profit or loss of the company, pertaining to transactions referred to in (a) – (f) above.

For the purposes of applying the TP Regulations, a PE and its Head Office are deemed as separate connected entities, and any transaction between the parties or between either and other persons is considered to be a controlled transaction.

1.5.1 Legal Framework for Transfer Pricing

The legal and statutory framework for transfer pricing regulations in Nigeria are:

a) The Income Tax (Transfer Pricing) Regulations 2018;
b) The Companies Income Tax Act Cap C21 LFN 2004 (as amended);
c) The Personal Income Tax Act Cap P8 LFN 2004 (as amended);
d) Petroleum Profit Tax Act Cap P13, LFN 2004 (as amended);
e) Capital Gains Tax Act Cap C1, LFN 2004
f) Value Added Tax Act Cap V1, LFN 2004
g) The Finance Act 2019; and
h) Article 9 of the Nigerian Double Tax Treaties

1.5.2 Main Provisions of the Nigerian Transfer Pricing Regulations

1.5.2.1 Commencement Date

The commencement date of the TP Regulations is 12 March

2018.Upon its issuance, the FIRS granted relevant taxpayers up to 31 December 2018 to fulfil all pending obligations pertaining to the filing of TP Declaration, disclosing controlled transactions, submission of TP Documentation and so on. Although laws do not generally have a retrospective application, the TP Regulations allow for an exception. Regulation 26 (2) of the TP Regulations provides that any act done pursuant to the revoked Regulations of 2012is to be treated as though it were done under the TP Regulations of 2018, to the extent that it is not inconsistent with any provisions of the latter.

It should be noted that the TP Regulations are to be applied contemporaneously i.e. the transactions should be documented as at the time of conducting those transactions.

1.5.2.2 Purpose

The TP Regulations give effect to the provisions of:

a) Section 17 of Personal Income Tax Act, Cap P8 LFN 2004;
b) Sections 22& 27 (1) of Companies Income Tax Act, Cap C21 LFN 2004 (as amended);
c) Section 15 of Petroleum Profits Tax Act, Cap P13 LFN 2004 (as amended);
d) Section 23 of the Capital Gains Tax Act Cap C1 LFN 2004.

1.5.2.3 Objectives

The objectives of the Nigerian TP Regulations are to:

a) ensure that Nigeria is able to tax on an appropriate basis corresponding to the economic activities deployed by taxable persons in Nigeria, with associated enterprises;
b) provide the Nigerian authorities with the tools to fight tax evasion through over or under-pricing of controlled transactions between associated enterprises;
c) reduce the risk of economic double taxation;

d) provide a level playing field between multinational enterprises and independent enterprises doing business within Nigeria; and
e) provide taxable persons with certainty of transfer pricing treatment in Nigeria.

1.5.2.4 Transfer Pricing Compliance Requirements in Nigeria.

Each entity within the scope of the Nigerian TP Regulations will need to fulfill the following requirements:

a) Prepare contemporaneous TP documentation.
b) Completion and filing of TP Declaration (one-off requirement for as long as there are no material changes in information contained therein).
c) TP Disclosure Form (annual requirement) as part of the annual TP returns.
d) Prepare TP Policy documents (Group and Domestic) and file these along with the first TP returns.

The above requirements are explained in more detail in chapter 6.

1.6 ARTICLE 9 OF OECD AND UN MODEL

The Article 9 of OECD Model Tax Convention, and UN Model Convention deal with transactions with associated enterprises and they form the basis for most bilateral treaties for avoiding double taxation. Article 9 of the OECD, and UN Models recommend the arm's length standard for pricing of transactions between connected taxable persons(OECD, 2017).

This Article states the following points:

- *Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the* *management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*

- *Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.*

1.7 SECTIONS 22, 17, 15 OF CITA, PITA, AND PPTA

Sections 22, 15 and 17 of CITA, PPTA and PITA respectively address artificial transactions and empowers the tax authorities to adjust any related-party transaction(s) which is artificial (i.e. not at arm's length) and reduces taxable income in Nigeria.

These sections of the laws state that:

> *"Where the Board is of opinion that any disposition is not in fact given effect to or that any transaction which reduces or would reduce the amount of any tax payable is artificial or fictitious, it may disregard any such disposition or direct that such adjustments shall be made as respects liability to tax as it considers appropriate so as to counteract the reduction of liability to tax affected, or reduction which would otherwise be affected, by the transaction and any company concerned shall be assessable accordingly"*.

Up until the release of the TP Regulations, there have been ambiguities on the basis of adjustments by the tax authorities, as there was no guidance or framework for enforcing the anti-avoidance provisions. The TP Regulations were introduced to provide guidance on the application of the general anti-avoidance provisions.

1.8 CONNECTED PERSONS AND ASSOCIATED ENTERPRISES

Connected persons generally include individuals and entities who share common control, management or shareholders. They also include individuals and entities who participate directly or indirectly in the management, control or capital of one another.

Generally speaking, enterprises are associated where the same persons participate directly or independently in the management, control or capital of both enterprises, i.e. both enterprises are under common control.

In the context of TP, connected persons are associated enterprises to which TP laws and regulations may apply.

1.9 COMPLYING WITH THE ARM'S LENGTH PRINCIPLE

An arm's length transaction is often characterized as a transaction in which the buyers and sellers of a product act independently and though they have no affiliation to each other. In a situation where trading/provision of services occurs between independent parties, it is usually expected that the pricing is done at market price. The underlying concept of the arm's length principle is that such transactions are the product of pure negotiation on open market competitive terms.

The arm's length principle is the international standard agreed by OECD Member countries to be used for determining transfer prices for tax purposes. The principle stipulates that where conditions are made between or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would have accrued to one of the associated enterprises, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

According to the TP Regulations, the arm's length principle means that the conditions of a controlled transaction should not differ from the conditions that would have applied between independent persons in comparable transactions carried out under comparable circumstances.

1.10 TRANSFER PRICING CYCLE REGIME

The TP life cycle consists of five phases, which include planning, implementation, monitoring, documentation, and communication to regulatory bodies and tax authorities. The first two phases are the cornerstone of TP, however, the other three are crucial components of the TP cycle.

The first phase of the cycle is planning which involves the creation of policies to guide the establishment of transfer prices for related party transactions. As such, the TP policy is created in this phase with the involvement of various stakeholders in the group to ensure the alignment of TP strategy with objectives of the business and also manage their risk exposures.

Following the creation of the TP policy, steps ought to be taken to ensure the group's accounting systems generate the result intended by the TPpolicy. This is the implementation phase where rules are established to ensure the policy is implemented consistently throughout the organization. Contracts could be prepared and the terms of the agreement should be enforced and followed by the business.

The monitoring phase focuses on the implementation of the policies as there is need to ensure that transfer prices result in the desired arm's-length outcome. This is where comparisons are made between budgeted results and actual results, substance of intercompany agreements and form of the intercompany transaction, etc. Efficient monitoring should result in significant efficiencies in tax compliance costs and reduction in risks of transfer pricing audit adjustments.

Documentation is the phase in which intercompany transactions are tested to determine the arm's length pricing of related party transactions i.e. to determine whether the related party transactions are conducted at arm's length. The importance of documentation has increased in recent years as the number of countries (including Nigeria) requiring TP documentation have grown rapidly. The Nigeria TP Regulations require that companies prepare TP documentation contemporaneously and that it be made available upon request. Companies operating in countries that adhere to the OECD's guidance on TP documentation and country by country reporting must file their transfer pricing documentation within one year from the fiscal year end, assuming they do not meet the small and medium enterprise exception.

The communication to regulatory bodies and tax authorities involves complying with compliance requirements as mandated by the tax authorities. In Nigeria, this entails filing of transfer pricing forms (TP declaration and disclosure forms in Nigeria) annually and submission of compliance documentation upon request.

CHAPTER TWO

COMPARABILITY ANALYSIS

2.1 Introduction

Comparability Analysis is carried out to ascertain the arm's length price/remuneration that is chargeable on transactions between connected persons/related parties.

Comparability analysis is a pre-requisite in the application of all TP methodologies that conform to the arm's length principle. This involves comparing conditions in a controlled transaction with those in uncontrolled transactions between independent parties. Transactions are deemed comparable if there are no material differences between the transactions being compared or, reasonably accurate adjustments can be made to eliminate any material differences in the transactions.

In a comparability analysis, focus is usually directed at circumstances surrounding the commercial and financial relations between associated enterprises, the processes involved, the economic performance such as profits and margins, and factors that influence the economic performance. Comparability must also be considered when dealing with products that are sophisticated or high-tech such as computer software or involve services such as consultancy or engineering.

The OECD TPG provides that transactions are comparable where none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.Application of the TP method requires a comparison of the conditions under which transactions between associated enterprises are carried out with conditions found in one or more comparable transactions between unrelated parties.

2.2 Why Comparability Analysis?

It has been emphasized that comparability analysis is central to the application of the arm's length principle. It is therefore pertinent to understand why it plays a pivotal role and why it is impracticable to conduct a TP analysis without a comparability analysis. Some of the reasons include:

a. It provides a mechanism for understanding the key economically significant characteristics of the taxpayer's-controlled transaction. This provides a foundation for selecting and applying the most appropriate transfer pricing method.
b. It helps in understanding the respective roles of the parties to the controlled transaction. This is generally performed through an examination of five comparability factors which will be discussed later.
c. It provides a mechanism for identifying reasonably reliable comparable transactions to reference in testing arm's length pricing.

2.3 COMPARABILITY PROCESS

The two major guidelines recognized by the Nigerian Transfer Pricing Regulations (OECD Transfer Pricing Guidelines and the

United Nations Practical Manual on Transfer Pricing for Developing Countries) state a step by step guide to be followed in conducting a comparability analysis. It is recommended to follow these steps, as the process is considered an accepted good practice to ensure that the resultant comparables chosen are relevant for further analyses to be undertaken. Following the steps will also provide needed cover for TPaudits.

The steps highlighted by the OECD Guidelines are stated below:

a. Determination of the years to be covered.
b. Broad – Based Analysis of the taxpayer's circumstances.
c. Understanding the controlled transaction(s) (Functions, Assets and Risk (FAR) Analysis).
d. Review of existing internal comparables, if available.
e. Determination of external comparables, where applicable.
f. Selection of the most appropriate TP method.
g. Identification of suitable comparables.
h. Making Comparability adjustments, where appropriate.
i. Interpretation and use of data collected& determination of arm's length price.

The steps highlighted by the UN Guidelines are stated below:

a. Understanding the economically significant characteristics of the industry taxpayer's business and controlled transactions;
b. Examination of comparability factors of the controlled transaction;
c. Selecting the tested party(ies) (if applicable);
d. Identifying potentially comparable transactions — internal and external;
e. If there is no internal comparables, check for external comparables;
f. Comparability adjustments where appropriate;

g. Selection of the most appropriate transfer pricing method;
h. Determination of an arm's length price or profit (or range or prices or profits); and
i. Documentation of comparability analysis and monitoring.

Though the steps stated by the two Guidelines are different they require similar actions to be taken.

2.4 COMPARABILITY FACTORS

In selecting comparable companies, five factors are considered for similarity or adjustments of the controlled transaction. They include:

2.4.1 Characteristics of Property or Services

Property, whether tangible or intangible, as well as services, may have differing characteristics which may lead to a difference in their values in the open market. Therefore, these differences must be accounted for and considered in any comparability analysis of controlled and uncontrolled transactions.

Similarity in product characteristics is more relevant when comparing prices rather than profit margins between controlled and uncontrolled transactions. Comparison of product characteristics is used to a greater extent in the application of the Comparable Uncontrolled Price (CUP) method than any other method.

Characteristics that are compared should include:
a. In the case of tangible property, the physical features, quality, availability, and the volume of supply of property;
b. In the provision of services, the nature and extent of services; and
c. In the case of intangible property, the form of transaction, type of property, and the anticipated benefits from its use.

2.4.2 Functional Analysis

Functional analysis which entails the identification of functions performed, assets employed and risks assumed with respect to the controlled transactions is carried out in determining the comparability of transactions by independent and related entities. In conducting a functional analysis, it is important to identify and compare the economically significant activities and the responsibilities undertaken by the independent and the associated enterprises. An economically significant activity is one which materially affects the price charged in a transaction and/or the profits earned from that transaction.

Fixing of remuneration for transactions is affected by the functions performed by the parties to the transactions, including assets used and risk assumed. Hence, there is the need to assess the functional comparability between the parties to the controlled transaction and the parties to the uncontrolled transaction, including:

a. Identifying and comparing the key valuable assets, and who owns and utilises them.
b. Comparing risk assumed as there can be expected to be a link between the risk assumed and the expected returns.
c. The risks associated with the functions performed e.g. a full-fledged manufacturer will perform more functions than a contract manufacturer.
d. Does the assumption of risk accord with economic substance and the ability to control and manage the risk in practice?

Some of the functions that are usually examined in a transaction include product design, manufacturing, marketing, advertising, intra-group services and research and development (R&D). In comparing such functions, assets employed (e.g. plant and machinery) as well as the nature of such assets (e.g. age and market value), and the use of intangibles must also be considered. The type of risks to consider include market risks, financial risks including exchange rate risks and the risks associated with the success or failure of R&D that the MNE undertakes.

A functional analysis by itself does not determine the arm's length result of a controlled transaction but instead should form the basis for identifying comparables.

2.4.3 Contractual Terms of the Transaction

An analysis of contractual terms should form part of the functional analysis. Allocation of responsibilities, risks, and benefits between enterprises are normally defined in a contract agreement. The terms and conditions that may influence the price or margin include credit or payment terms, the volume of sales or purchases, the terms of warranties, delivery terms etc.

Comparability should take into account how the conduct of associated parties conforms to the terms of a contract; just as how the terms and conditions previously mentioned would influence transactions made between independent enterprises. In making this observation, it should be noted that independent parties will more likely hold one another to the contractual terms than related parties.

2.4.4 Economic Circumstances

Economic circumstances that may affect prices charged or profits earned in controlled and uncontrolled transactions include the geographic location of the market; the size of the market; the availability of substitute goods and services; the extent of government intervention e.g. whether goods compared are price controlled, the timing of the transactions, and availability of substitutes.

2.4.5 Business Strategies

Business strategies that are relevant in determining comparability include market penetration, market expansion, and market maintenance strategies. In a comparability analysis, it may be necessary to see whether independent enterprises in the taxpayers' circumstances would have adopted these strategies and if so, what rewards would have been expected.

It is pertinent that the business strategy being pursued should be supported by logical economic rationale and appropriately documented.

2.5 IDENTIFICATION OF COMPARABLES

2.5.1 Types of Comparables

The following are the types of comparables acceptable in an analysis:

a. **Internal Comparable:** where the price of a controlled transaction is determined by the price of the items transferred between one party to the controlled transaction and an independent enterprise in a comparable uncontrolled transaction.

b. **External Comparable:** where the price of a controlled transaction is determined by the price of the items transferred between two independent enterprises none of which is party to the controlled transaction, in a comparable uncontrolled transaction.

2.5.2 Secret versus Open Comparables

Open comparables generally refers to publicly available information. The information is available to both the taxpayers and the TP officers. Secret comparables refers to data that is not in the public domain.

A secret comparable generally refers to the use of information or data about a taxpayer by the tax authorities to form the basis of TP scrutiny of another taxpayer, who is often not given access to that information as it may reveal confidential information about a competitor's operations.

Concern is often expressed by enterprises over aspects of data collection by tax authorities and its confidentiality. The fact is that tax authorities are privy to, as they need to be, very sensitive and highly confidential information about taxpayers, such as data relating to margins, profitability and business contracts. Confidence in the tax system means that this information needs to be treated very sensitively, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies and so forth. Secret comparables must be made available to the taxpayer whenever it is used by the TP officer in benchmarking analysis. However, OECD favours the use of publicly available information.

Data not available in public domain can also be used for the purpose of comparability analysis. However, if such information is used by the tax authority in arriving at a taxpayer's TP position, it should be made available to the taxpayer.

In the recent case of **Genisys Integrating Systems (India) Pvt. Ltd,** the Tribunal ruled that;

"… if any information is sought to be used against the Taxpayer, then such information has to be furnished to the taxpayer and the Taxpayer's objections have to be considered by the TP Officer before coming to a conclusion".

2.5.3 Foreign vs. Domestic Comparable

Foreign comparables are data derived from foreign countries while domestic comparables refer to data derived from Nigeria. Generally, domestic comparables are preferred to foreign comparables because they arguably require lesser adjustments. However, foreign comparables are more reliable because of the dearth of available and organized database on domestic comparables.

2.5.4 Things to consider while searching for comparables

a. Availability of financial data
b. Industry Selection
c. No Government-owned Company
d. Size of Operation

2.5.5 Factors to consider when choosing comparables

a. Volume of transactions with related parties
b. Level of Profit or Loss
c. Volume of transactions with related parties
d. Companies growth level
e. Level of Inventory
f. Marketing Expenses

2.6 SOURCES OF OPEN COMPARABLES

Lack of information is one of the major impediments to TP Regulations in developing countries. However, the OECD Guidelines allow for use of information and comparables from other tax jurisdictions.

Some entities have developed database software to store information on different companies across Europe and America; the information in the database can be used as comparables. Some of the available database software available are:

a. Orbis;
b. Amadeus;
c. KTMine;
d. Deal Scan;

e. Altman-Zee;
f. Royalty Range;
g. Thomson Reuters One Source; etc.

2.7 SELECTION OF TESTED PARTY

Paragraph 2.3.3.1 of the UN's Practical Manual on Transfer Pricing for Developing Countries provides that:

"When applying the Cost Plus Method, Resale Price Method or Transactional Net Margin Method, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested"

For purposes of this section, the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. In most cases the tested party is the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it and sufficient data on comparable is furnished to the tax administration and vice versa in order for the latter to be able to verify the selection and application of the TP method.

The choice of the tested party should be consistent with the functional analysis of the controlled transaction. Attributes of controlled transaction(s) will influence the selection of the tested party (where needed).

Furthermore, Regulation 5(2) of the TP Regulations provides that the most appropriate TP method shall be used taking into account the:

a. Respective strengths and weaknesses of the transfer pricing method in the circumstances of the case;
b. Appropriateness of a transfer pricing method having regard to the nature of the uncontrolled transaction determined, in particular, through an analysis of the functions performed, assets employed and risks assumed by each person that is a party to the controlled transaction;
c. Availability of reliable information needed to apply the transfer pricing method; and
d. Degree of comparability between controlled and uncontrolled transactions, including the reliability of adjustments, if any, that may be required to eliminate any differences between comparable transactions.

2.8 ECONOMIC ANALYSIS

2.8.1 Selection of Most Appropriate Method

Once the TP method is selected, it is applied to arrive at the correct arm's length price or profit (or range of prices or profits). The most appropriate method takes cognizance of:

a. Nature and class of transaction.
b. Functional analysis, including analysis of risks assumed and assets employed.
c. Degree of comparability between the controlled and uncontrolled transactions.
d. Extent of which reliable and accurate adjustments can be made to account for differences, if any.
e. Availability, coverage and reliability of necessary application of methods.

f. Nature, extent and reliability of assumptions required to be made in application of the method.

2.8.2 Statistical Analysis

Statistical analysis is used to determine the arm's length price/profit range to be applied on uncontrolled transactions. Various statistical analysis can be carried out to arrive at an arm's length price range. The common statistical analysis used include:

a. Interquartile Range
b. Averaging/Arithmetic Mean
c. Least Square Regression Analysis
d. Credit Risk Analysis

There are various statistical softwares that facilitate the derivation of the statistics especially when faced with numerous comparables including Altman Z-score, Edgarstat, TP Catalyst, etc.

2.8.3 Arm's Length Price

TP is often more of an art than a science and it is usual to derive a range of equally reliable arm's length prices or margins. If the range derived is very wide, there may be a need to check analysis and reconfirm the regularity of the processes used paying attention to extreme figures and determining if the comparables they pertain to are relevant.

2.8.4 Comparability Adjustment

Lack of local comparables is often addressed by using suitable comparables from other jurisdictions. Yet, when such comparables come from countries with significantly different economic conditions than the country of the tested party, some adjustments to account for these differences are called for. For instance, using an

American company as a comparable for a Nigerian company must take into account differences in economic conditions, the margins that companies earn in different geographies, and the need for appropriate adjustments.

If information from the local market is not available, an uncontrolled comparable derived from a different geographical market may be considered if it can be determined that:

a. There are no material differences between the two markets that would affect the price or profit of the transaction; or
b. Reasonably reliable adjustments can be made to account for such material differences between the two markets.

The taxpayer should adjust the differences (if any) between the uncontrolled transaction and the controlled transaction.

2.9 CONCLUSION

Comparability analysis is about choosing a suitable uncontrolled transaction for the purpose of establishing the arm's length price for a controlled transaction.

In arriving at the arm's length price, the under-listed factors are very crucial:
a. The characteristics of the products and services;
b. Functional Analysis;
c. Contractual terms;
d. Economic circumstances; and
e. Business strategy pursued.

An arm's length price is choosing from a range i.e. between the lower quartile and the upper-quartile. Adjustment is sometimes required due to the difference in the comparable.

CHAPTER THREE

TRANSFER PRICING METHODS

3.1 INTRODUCTION

The transfer price is the actual price charged in a transaction. However, where the transaction is between associated enterprises, there is a rebuttable presumption in law that the price fixed is at variance from the arm's length price.

Transfer prices refer to the price including terms and conditions which associated enterprises agree for their controlled transactions. Examples of such transactions are the provision of management services, supply of goods, and provision of loans.

TP is the setting of the price for goods and services sold between controlled or relatedentities within an enterprise. For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent company to the subsidiary is the transfer price.

The Arm's Length Price (ALP) is what would have been the price if the transactions were between two unrelated parties similarly placed as the related parties, in so far as nature of product, conditions and terms and conditions of the transactions are concerned.

Article 9 of the OECD Model Tax Convention laid the foundation for the arm's length principle. It stipulates that:

a. The relationship between the transacting parties should not affect the price at which the transaction is entered.
b. The transactions should be valued as if they had been carried out between unrelated parties; each acting in his own interest.

The following statements further explained the ALP:

a. The ALP mechanism is to disregard the apparent consideration recorded in the books of account and substitute it with the consideration which would have been agreed upon if the entities had been independent of each other.
b. When transfer prices of related parties adhere to the ALP, they reflect comparability to the pricing that independent commercial entities in similar situations would transact at and hence, there will be no distortion in the profits and tax liabilities.
c. ALP is founded on the premise that where market forces drive the terms and conditions agreed in an independent party transaction, the pricing of the transaction would reflect the true economic value of the contributions made by each entity in that transaction.
d. The ALP also means that if two related parties derive profits at levels above or below the comparable market level solely by reason of the special relationship between them, the profits will be deemed as non-arm's length. In such a case, the tax authorities that adopt the arm's length principle can make necessary adjustments to the taxable profits of the related parties in their jurisdictions so as to reflect the true value that would otherwise be derived on an arm's length basis.
e. The statutory objective is to prevent the avoidance of tax resulting from price distortions which can arise in the context of

> non-arm's length relationships by reason of the community of interest shared by related parties. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective.

It must be noted that the ALP does not require that, price must allot reasonable profit to the associated enterprises. It is also not relevant whether ALP at the hands of recipient is also ALP at the hands of the payer.

3.2 TYPES OF METHODS

There are two general categories of TP methods – the Traditional Transaction Methods and the Transactional Profit Methods. The former consists of the Comparable Uncontrolled Price (CUP), Resale Price, and Cost-Plus Methods; while the latter consists of the Transactional Net Margin and Profit Split Methods.

According to Regulation 5 of the TP Regulations, one of the following TP methods is to be applied in determining whether transactions between related entities are conducted at arm's length:

a. The Comparable Uncontrolled Price (CUP).
b. The Resale Price Method
c. The Cost-Plus Method
d. The Transactional Net Margin Method; or
e. The Transactional Profit Split Method (TNMM)
f. Any other method as may be prescribed by Regulations made by FIRS from time to time.

The taxpayer is expected to choose the most suitable method based on the circumstances of each transaction conducted with a related party, taking into account the type of transaction, functional analysis, comparability factors, availability of comparable transactions and the likelihood of making adjustments. These methods are now considered separately.

3.3 THE COMPARABLE UNCONTROLLED PRICE (CUP) METHOD

The CUP method compares the price charged for properties or services transferred in a related party transaction to the price charged for properties or services transferred in an independent transaction in comparable circumstances. It is the most direct method as it compares the price or value of the transactions. The price is the financial indicator of the CUP method. However, it requires a relatively high level of comparability to produce reliable results.

The CUP method involves the following steps:

a. Identify the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction or a number of such transactions.
b. Adjust such price for differences, if any:
   i. Between the controlled transaction and the comparable uncontrolled transaction; and
   ii. Between the enterprises entering into such transactions, adjustment will only be required if these could materially affect the price in open market
c. The adjusted price, represents the ALP i.e.:

Take the price of comparable transaction	XXX
Add/(Deduct) Adjustments in respect of material differences between comparable transactions and inter-transaction.	XX/(XX)
Add/(Deduct) Adjustments for material differences between the enterprises	XX/(XX)
ALP	XXX

3.3.1 Internal and External CUP

There are two types of comparison:

a. **Internal CUP –** This is where the price of the controlled transaction is compared to the price charged in an uncontrolled comparable transaction between one of the enterprises to the transaction and an independent enterprise.

b. **External CUP –** This is where the price of the controlled transaction is compared to the price of an uncontrolled comparable transaction between third party enterprises.

The use of the internal CUP method, where available, is preferred to the external CUP method as, all other things being equal, the circumstances of the controlled transaction are likely to mirror more closely those of the uncontrolled transaction.

3.3.2 Applying the CUP Method

The following are pre-requisites for application of the CUP method:

a. There are no differences in the transactions being compared that would materially affect the price.
b. A reasonably accurate adjustment can be done to account for material differences between the controlled and uncontrolled transactions.
c. All comparability factors should be considered and the most important being similarity of products, contract terms and economic/ market conditions.

Examples of situations in which it is most appropriate to apply the CUP method include:

i. Financial transactions such as the interest rate charged on an inter-company borrowing between associated enterprises.
ii. Sale of commodities traded in an open market.

iii. Royalties charged on licensed intangible properties e.g. trademark, design, copyright.

For CUP method to be applicable, it requires high degree of comparability along the following dimensions:

i. Quality of product or services
ii. Contractual terms - Scope and terms of warranties, sale or purchase volumes, credit terms, terms of delivery, insurance and transportation
iii. Level of market – wholesale or retail
iv. Geographical market in which the transaction takes place
v. Date of transaction
vi. Intangible property associated with the sale
vii. Foreign currency receipts
viii. Risk incurred

3.3.3 Other Points on CUP method

a. All reasonable adjustments required should be made to the prices charged in the uncontrolled transaction.
b. No adjustment should be made to the controlled price.
c. Adjustments should be made only for differences that would materially affect the price in the open market.
d. Individually immaterial differences may be collectively significant and should be adjusted.
e. CUP method is preferable over all other methods in cases where it is possible to locate comparable uncontrolled transactions.
f. An uncontrolled transaction is comparable to a controlled transaction if:
i. None of the differences between the transactions being compared or between the enterprises undertaking those transaction could materially affect the price in the open market.
g. Reasonable accurate adjustment can be made to eliminate the material effect of such differences.

ILLUSTRATION

ABC Limited is a manufacturer of compact disc (CD) writers and its customers include, amongst others, Y Limited and M Limited. ABC Limited during the year supplied 10,000 units of its product to Y Limited at a price of N1950/unit and 1500 units of the same to Z Limited at a price of N2600/unit. Sales of the same product have also been made to various other customers (M Limited being a prominent customer). A quantity of 1000 unit have been sold to M limited at N3000/unit.

ABC Limited and Y Limited are associated enterprises within the meaning of the regulations on TP in Nigeria and Y Limited was incorporated in UK. The nature of transaction of ABC Limited, with Y Limited and M Limited are comparable, subject to the following differences:

a. While the sales to Y Limited are FOB, sales to M Limited are CIF. The freight and insurance paid by Y Limited for each unit is N600.00
b. As Y Limited places orders in large volumes, ABC Limited offers a corporate discount worth N10 each for every CD Writer sold to Y Limited. Further, ABC Limited has also offered a quantity discount of N50 per unit to Y Limited.
c. The sales to Y Limited are made with a credit facility of one month, whereas the sales to M Limited have always been on cash and carry basis. The cost of credit may be taken at 1% per month.
d. The sales to M Limited are backed by a free warranty for 6 months after sales whereas no such warranty is offered to Y Limited. The estimated cost of warranty extension may be taken as N400.00

SUGGESTED SOLUTION

Analysis

a. M Limited is an independent enterprise.

b. Transaction between ABC Limited and Y Limited is an international transaction as Y Limited is a non-resident and associated enterprise of ABC Limited.

c. The comparable uncontrolled transaction is the transaction between ABC Limited and M Limited.

d. In using the CUP method, one starts from the price charged in the comparable uncontrolled transaction. In this case study, one has to start with the price charged by ABC Limited to M Limited.

e. The price charged to M Limited will have to be increased by the value of credit offered to Y Limited which is at the rate of 1% per month (i.e. 12% PA). If similar credit were offered to M Limited, the price to M Limited would have been higher after factoring in the cost of the credit period.

f. The price charged to M Limited, will have to be reduced by the following:

   i. N600 representing the freight and insurance paid by Y Limited by reason of which price charged to M Limited has been more by the same amount.

   ii. N400 per unit representing the estimated cost of warranty execution for a period of six months on the basis of a technical analysis and past experience. If the same were not offered to M Limited, the price to M Limited would have been lower, without factoring in this cost.

   iii. N10 representing the cost of each CD offered to Y Limited but not to M Limited.

   iv. N50 represents a quantity discount offered to Y Limited but not to M Limited. Due to the discount, the effective price charged to M Limited is more to that extent.

Calculation of ALP and Adjustments to Total Income under the CUP method.

Price charged to Y Limited (FOB)		N1950 per unit
Quantity		10, 000 units
Sales (at actual sales price)		N19,500,000
		N
Price charged to M Limited (independent enterprise) CIF		
	(A)	3000.00
Add:		
a. One month credit @1% per month to Y Limited	(B)	30.00
Less:		
a. Freight/insurance paid by Y Limited		600.00
b. Warranty given to M Limited not to Y Limited		400.00
c. Value of free gift to Y Limited not to M Limited		10.00
d. Quantity discount to Y Limited not to M Limited		50.00
	(C)	1060.00
Arm's length price (A+B-C)		1970.00
Adjusted Sales @ ALP (1970 x 10000)	19,700,000.00	
Increased Income (19,700,000 – 19,500,000)	200,000.00	

3.4 THE RESALE PRICE METHOD (RPM)

This method is used for determining the ALP only when goods purchased from an associated enterprise are resold to unrelated parties and there is little value addition involved. This method involves working back from the resale price received from unrelated parties to arrive at an arm's length price for the purchases made from associated enterprise. The financial indicator of the RPM is the resale margin. If the purchase price (transfer price) exceeds the arm's length price arrived at by the work back, the excess is disallowed in assessment.

RPM involves the following steps:

a. Identify the price at which the property/services purchased or obtained from associated enterprises are resold/provided to an unrelated party.

b. Deduct the normal gross profit margin. That is, the margin that the enterprise would earn if the same/similar product or service was purchased or obtained from an unrelated party and resold to an unrelated party.

c. Deduct the expenses incurred in connection with purchase of property/obtaining of services from the above.

d. Make adjustments for differences between the uncontrolled transaction and the transaction between the enterprises involved. To merit adjustment, these differences should be such as would materially affect the gross margin in the open market.

e. The adjusted price above shall be the ALP.

f. If the price charged is more or less, substitute the arm's length price and adjust returned income accordingly.

The resale price margin should be calculated by reference to the margin obtainable in similar internal or external uncontrolled transactions. The appropriate resale profit margin should increase with increased assets, functions and risks. If the reseller incurs significant amount of marketing expenditure for the promotion of a trademark that is owned by an associated enterprise and risks its own resources in these activities, the reseller would be entitled to a commensurately higher return than an agent.

3.4.1 Applying the Resale Price Method

The RPM is applied as follows:

Resale price charged to unrelated enterprise in resale of property purchased/service obtained from an associated entity (AE)	XXX
Less Normal gross profit margin on same/similar property or service in comparable uncontrolled transaction	XXX

Less: Expenses in connection with purchase of property/Service	XXX
Add/Less: Adjustments for opening and closing stocks of goods purchased from AEs	XXX
Add/Less: Functional/other differences between the transfers/ enterprises.	XXX
ALP	XXX

The sum-up:

a. The resale price is the price from the distributor to the customer. The TP price is the price to the customer less applicable gross margin earned by the distribution.

b. The applicable gross margin is based on the gross profit margin realized in comparable uncontrolled transactions, subtracting the appropriate gross profit from the applicable resale price.

c. The RPM assumes that the reseller has not added substantial value to the tangible goods by physically altering the goods before resale.

d. Adjustments for differences between controlled and uncontrolled transactions should be made when material differences between controlled and uncontrolled transactions would affect gross margin. These adjustments should be made to the gross profit margin earned from the uncontrolled transactions. The following adjustments may be particularly relevant to the RPM:

   i. Inventory - inventory levels and turnover rate may have to be adjusted; business and other risks may also have to be adjusted.

   ii. Contractual terms: Examples – warranties provided, sales/purchase volumes, credit terms and transport terms.

   iii. Sales, Marketing, Advertising programmes and services such as promotional programmes and rebates.

iv. The level of the market – Wholesales or retails.
iv. Foreign currency risk.

3.5 COST PLUS METHOD (CPM)

The CPM combines the costs incurred to produce the property with the gross profit mark-up from the costs. The amount charged in a controlled transaction is compared with the comparable uncontrolled transaction in evaluating whether the gross profit mark-up is at arm's length. The financial indicator of the CPM is the mark-up on costs.

The CPM involves the following:

a. Determine the direct and indirect costs incurred by the enterprise in respect of property transferred/services provided to AE.
b. Add normal gross profit mark-up. This will be the gross profit arising from transfer of same or similar property or services by the enterprise in a comparable uncontrolled transaction. Both internal and external comparable may be used.
c. The normal GP mark-up to be used will be adjusted for functional and other differences between the international transaction and the comparable or between the enterprises involved in both transactions.
d. The sum arrived at after the adjustments is the Arm's length price.

3.5.1 Other Issues on Cost Plus Method

i. The CPM is most useful where semi-finished goods are sold between related parties or where the related party transaction involves provision of services.
ii. The CPM is adopted in situations where comparable transactions are of functional similarity with that of controlled

transaction. Therefore, FAR analysis is critical in identifying functionally similar comparable transactions.

iii. The application of CPM has to be on transaction basis rather than on global basis.

The following should be noted about the application of CPM:

a. Suitable where semi-finished goods are sold between associated enterprises
b. Applicable to joint facility agreement between associated enterprises and where the controlled transaction involves the provision of services.
c. Applicable to long-term buy-and-supply arrangements.
e. Where accounting practices differ in the controlled transaction and the uncontrolled transaction, appropriate adjustments should be made to the data used to ensure that the same type of costs are used in each case to ensure accounting consistency for instance:
    - The gross profit mark-ups must be measured consistently between the related entities and the independent enterprise.
    - Differences in the treatment of costs that affect gross profit mark-ups.
    - It may be necessary to take into account certain operating expenses in order to achieve consistency and comparability.

ILLUSTRATION

X limited is a Nigerian Company. The shareholding structure of X Limited is as follows:

Shareholders	Name	Status	% holding
Y Limited	Foreign Company		30
Z Limited	Nigerian Company		30
Financial Institution	Nigerian Company		10
Public			30

X Limited develops software and does both onsite and offsite consultancy for various customers who include Y Limited and M Limited.

X Limited, during the year billed Y Limited for 100 man-hours at the rate of N2,000 per man-hour. The total cost (direct and indirect) for executing the work amounted to N175,000. However, X Limited billed M Limited, a third party, at the rate of N3000 per man-hour for the similar level of manpower and earned a gross profit of 50% and its costs.

The nature of transactions of X Limited with Y limited and with M Limited are comparable subject to the following differences:

i. While X Limited derives technology support from Y limited, there is no such support from M Limited.
ii. As Y Limited gives businesses in large volumes, X Limited offered to Y Limited a quantity discount.
iii. In the case of rendering service to Y Limited, X Limited neither runs any risk nor incurs any marketing costs. On the other hand, in the case of rendering service to M Limited, X Limited has to assume all the risks and costs associated with the marketing function.
iv. X Limited offered one month's credit to Y Limited.

SUGGESTED SOLUTION

a. X Limited and Y Limited are associated enterprises within the definition of the TP Regulations. Z Limited is also an AE.
b. M Limited is an independent enterprise.
c. Transaction between X Limited and Y Limited is international transaction as Y Limited is a non-resident and AE of X Limited.
d. Comparable uncontrolled transaction – transaction between X Limited and M Limited.

e. In the CPM, one starts with the gross profit mark-up which the enterprise earned in a comparable uncontrolled transaction. That is; the transaction between X Limited and M Limited.

f. The Gross profit mark-up needs to be decreased by the following:
   i. Value of technology support received by Y Limited is taken to be 20% of normal gross profits.
   ii. For bulk orders placed, quantity discount is taken to be 10% of usual gross profits.
   iii. Marketing risk associated with services rendered to customers other than Y Limited – may be 10% of normal gross profit.

g. Impact of credit period should be considered.

h. After the adjustment, the resultant gross profit mark-up is the arm's length gross profit mark-up.

i. This arm's length gross profit mark-up has to be applied on the costs to arrive at the arm's length income of X Limited from Y Limited.

j. The impact of cost of credit may be taken at 12% of normal gross profits.

Determination of the ALP under CPM

Man-hour rate charged to Y Limited	N2,000 per hour
Man hours 100 man hours	
Income from Billings (Actual)	(A) N200,000
Direct and Indirect Cost	N175,000
Price charged to M	N3,000
Gross profit mark-up in case of M Limited	50%
Less:	
1. Technology Support from Y Limited (20% of 50%)	10%
2. Quantity discount to Y Limited not to M Limited (10% of 50%)	5%

3. Risk factor non-existent with Y Limited (10% of 50%)	5%
Sub-Total	20%
Add:	
1. Cost of credit to Y Limited	1.5%
Sub-Total	1.5%
Arm's length gross profit mark-up on cost	31.5%
Arm's length income (B) [(175,000 x 31.5%) + 175,000]	N230,125
Increase Income (B-A)	N30,125

3.6 PROFIT SPLIT METHOD (PSM)

The PSM identifies the aggregate profit to be split for the associated entities from controlled transaction(s) and then splits those profits between them on an economically valid basis that approximates the division of profits that would have been made at arm's length between independent enterprises. The TP Regulations describe the method as one in which the division of profit and loss achieved in a controlled transaction is compared with the division of profit and loss that would be achieved in a comparable uncontrolled transaction. Thus, the financial indicator of the PSM is the division of profit and loss.

The method involves:

a. Ascertaining the combined net profit of the associated enterprises arising from an international transaction;
b. Split/allocate this net profit to all the associated enterprises involved on the basis of their respective contributions to earning the profit; and
c. Use the profit apportioned to arrive at arm's length price.

3.6.1 Approaches to Profit Split Method

There are two alternative approaches to the PSM as follows:

3.6.1.1 Contribution Approach – Single stroke method

a. Determine the combined net profit of the associated enterprises arising from the international transaction in which they are involved.

b. Evaluate the relative contribution made by each of them to earning the combined net profit. This evaluation is done based on the following factors:
   i. Function performed
   ii. Assets employed / to be employed
   iii. Risk assumed by each enterprise
   iv. How such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.

c. Split the combined net profit amongst the enterprises in proportion to their relative contribution as per the evaluation.

d. Use the profit apportioned to arrive at the arm's length price.

3.6.1.2 Residual Analysis – Two stage allocation approach

Steps (a) and (b) will be same as the contribution approach explained above.

c. Partially allocate the combined net profit in the first instance to each enterprise as to provide it with a basis return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved in similar transactions by independent enterprises.

d. The residual profit may then be split among the enterprises as indicated for the contribution approach.

e. The aggregate of net profit arrived at by two stage allocation will be taken as its net profit from the international transaction.

3.6.2 Applying the Profit Split Method

a. The PSM is particularly useful when transactions are so highly inter-related that they cannot be evaluated separately or where the existence of unique intangible assets makes it difficult to find exact comparable.

b. Generally, the profit to be split is the operating profit, sometimes, it may be appropriate to carry out a split of the gross profit and then deduct the expenses incurred by or attributable to each relevant party.

c. PSM may be the most appropriate method where both parties to a transaction make unique and valuable contribution to the transaction.

d. In determining the combined profit to be split, the following guidelines were provided by OECD:

   i. The profit should be those arising from the controlled transaction under review.

   ii. The transactions to be covered and the level of aggregation must be determined.

   iii. The parties to the transaction must be identified and the profit to be split.

   iv. The amount of the parties involved must be put on a common basis as to accounting practice and currency.

   v. Accounting standards should be selected in advance of applying the method.

3.6.3 Allocation Keys to be Used For PSM

The division of continued profit under the PSM can be achieved using one or more allocation keys based on the following:

a. Asset/ Capital – Operating assets, fixed assets, intangible assets and capital employed

b. Costs- Spending/ investment in key areas such as R&D, engineering, marketing

c. Incremental subs

d. Head count

e. Time spent by certain group of employees

f. Number of servers, data storage, floor areas

3.7 TRANSACTION NET MARGIN METHOD (TNMM)

The TNMM examines the net profit margin relative to an appropriate base such as Sales, Costs or Assets that an enterprise realises from a controlled transaction that it is appropriate to aggregate and compares this with the result achieved by independent enterprises on a similar transaction. The TNMM involves the following steps:

a. Compute the net margin realised by an enterprise from an international transaction with an associated enterprise. The computation may be in relation to costs incurred or sales effected or assets employed or any other relevant base. Some of the ratios for determining net margin profit level indicator(PLI) are:
   - i. NP before tax to sales
   - ii. Cash profit to sales
   - iii. Net profit before interest and tax (EBIT)/Sales
   - iv. Operating cost to operating revenue
   - v. Net profit before interest and tax to Assets
   - vi. Net profit before tax to shareholder funds
   - vii. Ratio of gross profit to operating expenses also known as Berry Ratio.

b. The net profit margin realised by an enterprise or by an unrelated enterprise from comparable uncontrolled transaction(s) is computed having regard to the same base.

c. The net profit margin is adjusted for differences between the transactions/enterprises involved if the differences could materially affect the amount of the net profit margin in the open market.

d. The adjusted net margin is taken into account to compute the arm's length price.

e. In computing the PLI, only income and expenditure which have direct nexus with the transaction should be considered.

f. It has been held that interest income, rent, dividend, foreign exchange fluctuations and profit on sale of assets do not form part of operating income as they don't relate to the operations of the company.

g. Multiple year data should be considered for the TNMM for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take account the effects on profits of product life cycles and short term economic conditions.

3.7.1 Applying the TNMM

a. Functional Analysis

A functional analysis of the tested party of the independent enterprise, as the case may be, is required to determine whether the transactions are comparable and the adjustments required to be made to obtain reliable results. The FAR analysis will cover functional profile, assets and risks assumed of controlled and uncontrolled transactions.

b. Most Appropriate Method and PLI

The selection of the most appropriate method and PLI depends upon the FAR and the available data of the comparables. The method and the PLI used should not lead to manifestly absurd results, so as to put one of the parties to the transactions of abnormally higher profitability than the other party at significant loss.

If a particular PLI results in abnormal results, then one should move onto choosing a method and PLI which provides rational results.

c. Adjusting the NPM

The Net Profit Margin identified must be adjusted to take into account the transaction level and enterprise level differences (if any). Differences should be those that could materially affect the net profit margin in the open market.

The adjusted net profit margin is taken into account to arrive at the arm's length prices in relation to the international transaction.

The following are examples of enterprise level and transaction level differences that may be adjusted for:

- **Enterprise level**

i. Working capital – stockholding, debtors and creditors

ii. Cost of capital – manner of funding such as equity, preference, debenture and inter-corporate loans.

iii. Assets employed - take operating margin on operating cost before depreciation as profit level indicator to ensure that such difference do not affect net profit

iv. Assured or risk bearing business.

- Transaction Level
  - i. Free gifts
  - ii. Extended warranty
  - iii. Marketing Risks
  - iv. Pricing ex-shop or FOB Destination
  - v. Quantity discount

3.7.2 Strengths and Weaknesses

a. Strengths of TNMM
   - i. Net profit indicators are less affected by transaction differences.
   - ii. It is more tolerant to functional difference.
   - iii. Differences in functions performed may lead to difference in Gross margin but still end up with similar net margin.

iv. The use of net margin eliminates the problem of classification of expenses to operating and direct costs.

b. Weaknesses of TNMM

i. Net profit indicator of a taxpayer can be influenced by some factors that would either not have effect or less substantial or direct effect on price or gross margins.

ii. Information on uncontrolled transaction may not be available at the time of the controlled transaction.

iii. It may be difficult to ascertain revenue and operating expenses related to the controlled transaction to establish the net profit indicator.

iv. It may be difficult to determine an appropriate corresponding adjustment, where it is not possible to work back to a transfer price.

3.7.3 Comparability Standard

a. A comparability analysis must be performed in all cases in order to select and apply the most appropriate TP method.

b. Comparables are those independent enterprises, a high degree of similarity is required in a number of aspects of the associated enterprises involved.

c. The reliability of the necessary adjustments will affect the reliability of the analysis.

d. The use of range may to some extent manipulate the level of accuracy, but may not account for situations where a taxpayer's profit are increased or reduced by a factor unique to that tax payer.

e. The TNMM may afford a practical solution to otherwise insoluble TP problems if it is used sensibly and with appropriate adjustments to account for differences.

f. The net profit indicator must be measured consistently between the AE and independent enterprise. Differences in the treatment of operating and non-operating expenses must be accounted for in order to achieve reliable comparability.

3.7.4 Determination of Net Profit

a. Only items that directly or indirectly relate to the controlled transaction and are of operating value should be taken into account in determining the net profit indicator for TNMM.

b. Costs and revenues that are not related to the controlled transaction should be excluded where immaterial.

c. It is inappropriate to apply TNMM on a company under one basis if the company engages in a variety of different controlled transactions.

d. Non-operating items such as interest income and expenses, and income taxes should be excluded.

e. Exceptional and non-recurring items should generally be excluded.

3.7.5 Weighting the Net Profit

a. The denominator selected should be consistent with the comparability analysis of the controlled transaction.

b. The denominator should be focused on the relevant indicator(s) of the value of the function performed by the tested party to the transaction under review taking account of its assets used and risk assumed. Example, full costs or operating expense may be appropriate base for a service or manufacturing activity.

c. The denominator should be reasonably independent from controlled transaction; otherwise there would be no objective starting point.

d. The denominator should be one that is capable of being measured in a reliable and consistent manner at the level of the taxpayer's controlled transactions and the comparable uncontrolled transaction.

e. Where the net profit is weighted to costs, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overhead of the business.

f. Whether and to what extent it is acceptable at arm's length to treat a significant portion of the tax payer's costs as pass through costs to which no profit element is attributed (i.e. as costs which are potentially excludable from the denominator of the net profit indicator) depends on the extent to which an independent party in comparable circumstances would appear not to earn a mark-up on part of the costs it incurs. The response should be based on comparability analysis.

3.7.6 Use of Berry Ratio

a. Berry ratio is defined as the ratio of gross profit to operating expenses.

b. Interest and extraneous income are generally excluded from the gross profit denominator.

c. Depreciation and amortization may not be included in operating expenses.

d. For berry ratio to be appropriate test of remuneration for controlled transaction, it is necessary that the value of the functions performed in the controlled transaction (taking account of assets used and risk assumed) is proportional to the operating expenses, the value of the functions performed in controlled transaction is not materially affected by the value of the product distributed and the taxpayer doesn't perform, in the controlled transactions, any significant function that should be remunerated using another financial indicator.

e. Berry ratio can be useful for intermediary activities where a tax payer purchases goods from an associated enterprise and sells them to another associated enterprise.

3.8 OTHER METHODS

Examples of Other Methods which may be acceptable to the FIRS are:

a. Arm's length valuation of intangible by income method or capitalisation method (discounted cash flow method)
b. Valuation of unlisted shares which are transferred
c. Bona fide offers/bid

3.8.1 Most Appropriate Method (MAM)

In selecting the MAM, the following factors shall be taken into consideration:

a. The nature and class of the associated transaction.
b. The class/ classes of associated enterprises entering into the transaction and the functions performed by them, taking into account assets employed or to be employed and risks involved.
c. The availability, coverage and reliability of data necessary for the application of method.
d. The degree of comparability between international transaction and between the enterprises involved.
e. The extent to which the accurate adjustments for differences can be made to uncontrolled transaction comparable; and
f. The nature, extent and reliability of the assumption involved in the method.

The preferred method should be one best suited to the facts and circumstances of each transaction and must provide the most reliable measure of the arm's length price.

CHAPTER FOUR

INTRAGROUP SERVICES

4.1 INTRODUCTION

Multinational Enterprise (MNE) groups around the world require diversity of services for its entire group operations. These services could be administrative, technical, financial or commercial in nature. These services could also be related to management, coordination and control functions for the entire group. In general, such services will be performed centrally – usually at the level of the ultimate parent company – and charged to the other group members that require these services in order to be fully operational.

Independent companies across the world in need of certain similar services might obtain these services from a service provider that specializes in the provision of these types of services. Also, in some instances, this company might perform the services by itself.

On the other hand, a member of an MNE group in need of such a service may obtain it directly or indirectly from independent companies, or from one or more related companies which are part of the same MNE group (i.e. intra-group). If a company obtains such services from a related party, under certain conditions (provided below) these will be considered as intra-group services. Some common intra-group services provided to and/or received by companies in an MNE group are provided below:

a. Legal services
b. Accounting services
c. Central auditing services
d. Financial advice
e. Human resource management
f. IT service

Note that the list above is non-exhaustive and other services can qualify as intra-group services.

Intra-group service activities may vary considerably among MNE groups, as does the extent to which those activities provide a benefit, or expected benefit, to one or more group members. Each case is dependent upon its own specific facts and circumstances and the arrangements within the group.

Regulation 6 of the TP Regulations as well as Paragraph 7.5 of the OECD TPGprovide for the treatment of intra-group services which identifies two main issues that must be considered in the analysis of transfer pricing for intra-group services:

a. Whether the intra-group service has indeed been provided; and
b. The intra-group charge for such a service for tax purposes should be in accordance with the arm's length principle.

Benefits Test

In determining the first issue, Paragraph 7.6 of the OECD TPG provides that the answer is dependent on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering if an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by another independent enterprise or would have performed the activity in-house for itself. Thus, if the activity is not one for which an independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered. This is referred to as the 'benefits test'.

Duplication

Services performed by one group member to another which the recipient performs for itself, or receives from a third party, do not qualify s intragroup services as they are a mere duplication of services which already exist in the group entity. However, there are exceptions where duplication of services is only temporary or where the duplication is undertaken to reduce the risk of a wrong business decision. In this case, an examination of the information provided by the taxpayer may determine that the intra-group services are different, additional, or complementary to the activities already performed in-house or by an independent third party. The benefits test may subsequently be applied to the non-duplicative elements of the intra-group services.

For example, Subsidiary Co, a company resident in Country A, is part of an MNE group (the group). The group's business is growing primary produce and distributing it in local markets. The parent company is Parent Co in Country B. Parent Co oversees treasury functions for the group. Parent Co's treasury function ensures that there is adequate finance for the group and monitors the debt and equity levels on its books and those of its subsidiaries. Subsidiary Co maintains its own treasury function and manages its finances on an independent basis. It manages its treasury operations and ensures that it has finance available either in-house or externally. A functional analysis indicates that Subsidiary Co carries on its own treasury functions in order to ensure that it has adequate debt capital to finance its operations. In this situation duplication arises as Subsidiary Co is performing treasury functions necessary for its operations and Parent Co is performing the same treasury functions for Subsidiary Co. Accordingly, Parent Co's treasury activities are duplicated activities that fail the benefit test. Under the arm's length principle, Parent Co cannot charge a service fee to Subsidiary Co for the treasury functions being performed, unless it may be proven that the particular services provided by Parent Co to its subsidiary are different or complementary to the existing services provided by Subsidiary Co on its own.

Incidental Benefits

In cases where an intra-group service performed by a group member relates only to some group members but incidentally provides benefits to other group members, the OECD TPG refers to these benefits as incidental. The service may constitute an intra-group service to the group members who are direct beneficiaries of same. On the other hand, the other group members who enjoy the incidental benefits would not be treated as receiving an intra-group service since the service would not be one for which an independent enterprise would be willing to pay.

Centralized Services

There may be other services rendered within the group which relate to the entire group, and are referred to as centralized services.

The services are usually administrative and may include planning, coordination, and budgetary control; financial services such as supervision of cash flows and solvency, capital increases, and refinancing; assistance in the fields of production, buying, distribution and marketing; and services in staff matters such as recruitment and training. These centralized services qualify as intra-group services since independent enterprises would be most likely to pay for same or perform in-house.

For example, an MNE group carries on an airline business in 5 countries (Countries A, B, C, D and E) with the parent of the group located in Country A. Customers of the airline in these countries are provided with the option of calling staff by telephone to book travel and receive advice where necessary. The MNE group decides to create a centralized call centre for the MNE group to exploit economies of scale. The low cost of telecommunications and the ability to share business information among group members allows for the centralized call centre to be located in any country in which the MNE group operates. The call centre can operate on a 24-hour basis in providing call services to all time zones in which the MNE group carries on business. The MNE group concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advantage of both economies of scale and low costs. The call centre services provided by the subsidiary in Country E to the parent company and other group members satisfy the benefit test. Without the call centre the group members would either have to establish their own call centres or engage an independent party to provide call centre services on their behalf.

4.2 SHAREHOLDER SERVICES AND OTHER SERVICES

4.2.1 Shareholders Services

These services as defined in Chapter 7of the OECD TPGare services a group member, usually the parent company or a regional holding company, performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder. Such services do not qualify as intra-group services as the group entities usually do not require the services and as such comparable independent enterprises would not be willing to pay and any charge connected thereto may not be justified. Rather, the costs incurred in performing these services should be borne and allocated at the level of the shareholder.

The TP Regulations further elucidate on the treatment of shareholder activities. Regulation 6(2) of the TP Regulations provide that a service charge made to a connected person solely as a result of the shareholder's ownership interests in another member of the group, is not to deemed to be consistent with the arm's length principle.

Examples of such costs incurred or activities performed in this regard include:

a. Costs or activities relating to the juridical structure of the parent company itself such as meetings of shareholders of the parent company, issuing of shares in the parent company, stock exchange listing of the parent company and costs of the parent company's supervisory board;
b. Costs or activities relating to reporting requirementsof the parent company including the consolidation of reports, costs relating to the parent company's audit of the subsidiary's accounts carried out exclusively in the interest of the parent company, and costs relating to the preparation of consolidated financial statements of the MNE;
c. Costs or activities relating to raising funds for the acquisition of its participations, unless such participations are directly or indirectly acquired by the entity to whom the service charge is made and the acquisition benefits or is expected to benefit the entity; and
d. Costs relating to compliance of the parent company which has no effect on the charged entity with the relevant tax laws.

For example, Controller Co is a resident of Country A and it is the parent company of an MNE group. Controller Co is listed on the stock exchange in Country A, and it is required by the stock exchange and securities regulators to report its financial position periodically. The reporting requirements include the group's consolidated profit and loss statements and balance sheet prepared in accordance with International Financial Reporting Standards (IFRS). Subsidiary Co is a subsidiary company resident in Country B and maintains its own accounting function to support the operation of its business. Subsidiary Co is required under the domestic law of Country B to prepare its accounts in accordance with IFRS and to annually file statutory financial statements. Subsidiary Co's chief financial officer provides certain reports and financial statements to Controller Co for inclusion in the group's consolidated financial statements.

The incorporation of this material into Controller Co's consolidated financial statements are actions that Controller Co carries out as a shareholder of Subsidiary Co. Thus, Controller Co cannot impose a service charge on Subsidiary Co for reviewing and incorporating its financial statements into the group's consolidated financial statements that Controller Co is required to file, as these activities do not provide Subsidiary Co with a benefit. These activities are exclusively attributed to the obligations imposed on Controller Co as a listed company. If Subsidiary Co incurs costs in preparing financial statements required for the group's consolidated financial statements that exceed what is necessary to meet the financial reporting requirements in Country B, Controller Co should compensate Subsidiary Co on an arm's length basis for the additional activities.

4.2.2 On call services

These are services which occur when the specific need for them arises. For instance, a parent company may be on stand-by to provide managerial or technical services to any member of the group upon request. In providing the service, the parent company may require to make staff and equipment available for the use of the entity for which a charge applies. The test for determining whether an intra-group service exists, is if an independent enterprise in comparable circumstances would incur charges to ensure the availability of the on-call services where the need arises. In addition, the benefits conferred on the entity by the on-call arrangements should be considered, possibly by examining the extent to which the services have been used over a period rather than solely for the year in which a charge is to be made, before determining that an intra-group service is being provided.

4.2.3 Low Value-Adding Intra-Group Services

These are services performed by one or more members of an MNE group on behalf of one or more other group members which:

a. are of a supportive nature,
b. are not part of the core business of the MNE group, that is, not contributing to economically significant activities of the group,
c. do not require the use of unique and valuable intangibles, and
d. do not involve the assumption of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

Examples of services which may qualify as Low Value Added Services (LVAS) include:

a. Human resource activities e.g. staffing & recruitment, training & employee development, remuneration services, etc.
b. Accounting and audit
c. IT services where they do not form part of the principal activity of the group
d. Legal services
e. Activities relating to tax obligations e.g. tax advisory, preparation of tax returns
f. General administrative/clerical services

The OECD proposes a simplified methodology to determine an arm's length charge for LVAS which contains five steps:

a. Determination of the costs incurred
b. Allocation of low value-adding service costs
c. Profit mark-up
d. Total charge for low value-adding services
e. A simplified benefit tests

4.3 DETERMINATION OF ARM'S LENGTH RENUMERATION FOR INTRA-GROUP SERVICES

It is pertinent that the amount charged for an intra-group service is in accordance with the arm's length principle. This means that the intra-group charges for services should be that which would have been adopted between independent enterprises in comparable circumstances.
This can either be done through the direct-charge method (preferred) or indirect-charge method (most used).

4.4 DIRECT-CHARGE METHOD

The direct-charge method is used where connected persons are charged by the group for specific services provided. This method offers great value to tax administrations as it allows the service performed and the basis for the payment to be clearly identified. Consequently, the direct-charge method eases the determination of whether the charge is consistent with the arm's length principle. This is the preferred method by the OECD to determine an arm's-length price for intra-group services. However, this method may be difficult to apply in practice, and recourse is sought in the indirect-charge method which is used quite often.

4.5 INDIRECT-CHARGE METHOD

Here, groups use cost allocation and apportionment methods, which involve some degree of estimation or approximation, as a basis for calculating an arm's length charge. Any indirect-charge method should be sensitive to the commercial features of the individual case, contain safeguards against manipulation, follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.

The allocation might be based on turnover, or staff employed, or some other basis. Whether the allocation method is appropriate depends on the nature and usage of the service. For instance, the usage or provision of payroll services may be more related to the number of staff than to turnover, while the allocation of the stand-by costs of priority computer back-up could be allocated in proportion to relative expenditure on computer equipment by the group members.

4.6 TRANSFER PRICING METHOD

The generally preferred method to determine the arm's length price of intra-group services is the CUP method where there is a comparable service provided between independent enterprises or by the associated enterprise providing the services to an independent enterprise in comparable circumstances. For instance, where accounting, auditing, or legal services are being provided to related as well as unrelated companies, these transactions become comparable. Where the CUP method may not be employed due to lack of comparables, thecost-plus method is the next preferable method.

To determine the arm's length charge for LVAS, a profit mark-up is to be applied on the costs of providing the services. The recommended mark-up, per paragraph 7.61 of the OECD TPG, is 5% of the relevant cost and as such, no benchmarking analysis is required for this category of services.

4.7 DOCUMENTATION

Paragraph 7.64 of the OECD TPG recommends that where intra-group services are provided between connected persons, the following information and documentation are to be provided to the tax authorities of entities making and receiving payments for low value adding intra-group services: .

a. A description of the categories of low value-adding intra-group services provided; the identity of the beneficiaries; the reasons justifying that each category of services constitute low value-adding intra-group services; the rationale for the provision of services within the context of the business of the MNE; and a description of the benefits or expected benefits of each category of services;

b. Written contracts or agreements for the provision of these services and any modifications thereto;

c. Documentation and calculations showing the determination of the cost, and of the mark-up applied thereon; and

d. Calculations showing the allocation of costs.

CHAPTER FIVE

INTANGIBLES

5.1 INTRODUCTION

Transfer of Intangibles is one of the key areas tax authorities are becoming sensitive to when examining arrangements between related parties. This is to ascertain if there are any transfer or development of intangibles, where compensations are based on the value created by the group members through functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles, and whether the provisions of the arm's length principles have been applied or not.

5.2 DEFINITION

IAS 38 defines intangible assets as identifiable non-monetary assets without physical substance but with the embodiment of economic value. They cannot be seen or touched but have economic benefits that flow into the entity. Hence for an item to meet the definition of intangible asset, such asset must be identifiable, entity must have control over the asset and there must be existence of future economic benefit from such asset.

Intangibles as defined by the OECD for TP purpose is something which is not a physical asset or financial asset (e.g. cash, or equity instrument), capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Intangibles are created through costly and expensive research and development activities and cost are recovered through product sales, service contracts and license agreements. Examples of intangibles are goodwill, patents, copyrights, franchise, computer software, customers list, customers' relationship etc.

5.3 CATEGORIES OF INTANGIBLES

a. **Marketing Intangibles:** These are intangibles created to aid the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Such as trademarks, trade names, brand names, customer lists, customer relationships, and proprietary market and customer data.

b. **Trade Intangibles:** These are commercial assets other than marketing intangibles, created through costly and expensive research and development activities. The developer generally tries to recover his expenditures on those activities and obtain return thereon through product sales, service contracts and license agreements. Trade intangibles include:

   a. Technical Know-how and Trade secrets
   b. Patent
   c. Franchises and Licenses
   d. Rights under contracts
   e. Business Process and System Procedures
   f. Copyrights etc.

There are also unique and value intangibles which are not comparable to intangibles used in potentially comparable transactions, and whose use in business operation, such as manufacturing, is expected to generate future economic benefits which would ordinarily not have been generated in its absence.

5.4 OWNERSHIP OF INTANGIBLES

In transfer pricing, determining the ownership of an intangible is crucial since allocation of the returns derived from the exploitation of intangibles depends largely on the forms and basis of ownership.

5.4.1 Legal Ownership

This is the recognized owner under the law. This occurs where the intangible is registered with the relevant authority and thus, is legally protected. Generally, the registered owner of an intangible has the legal and commercial right to use the intangible, as well as to prevent other from using it. This right may be granted for specific period of time and/or geographic area. An example of an intangible which may be legally owned is the right in a patent with a lifespan of twenty (20) years.

However, if there is no legally recognized owner under the law, then the member of the MNE group that controls decisions concerning the exploitation of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner.

It must be noted that any legal ownership without contribution to the valuation creation of the intangible is not entitled to the income derived from the exploitation of the intangible, as the attribution of returns depends on the functions an entity performed, the assets used and the risks assumed, that is, the economic ownership. This is equally applicable to any entities that assumed no risks according to the principle of Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE).

However, the returns on the intangibles may initially accrue to the legal owner by virtue of owner's right to exploit the intangible.

5.4.2 Economic Ownership

This is based on business and economic activities attached to the functions performed, assets used and risks assumed in the development, enhancement, maintenance, protectionand exploitation (DEMPE) of intangibles. A member of a group licensed to use an intangible becomes an economic owner if that member has the responsibility to perform the important value creating functions of DEMPE of the intangible.

Where the legal owner has contracted the functions performed in relation to the DEMPE of the intangible to other members of the group, creating an economic owner, then the legal owner has a responsibility to compensate the members of the group for their respective contribution at an arm's length price.

However, a legal owner of an intangible is entitled to all returns attributable to the intangible only in substance where it:

a. Performs and controls all of the important functions related to the development, enhancement, maintenance and protection of the intangibles;
b. Controls other functions outsourced to independent enterprises or associated enterprises and compensates those functions on an arm's length basis;
c. Provides all assets necessary to the development, enhancement, maintenance, and protection of the intangibles; and
d. Bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible."

5.5 FUNCTIONS, ASSETS AND RISKS (FAR) ANALYSIS FOR INTANGIBLES

The intangible related functions are;

a. **Development:** These are activities involving coming up with ideas for brands, products and services. It involves having a strategy in place for the creation of the brand, product or service.

b. **Enhancement:** Working towards improving aspects of the intangible.

c. **Maintenance:** Carrying out activities to ensure that the intangible performs well and does not deteriorate in value.

d. **Protection:** Performing activities to protect the intangible from infringement.

e. **Exploitation:** Using the intangible for the purpose it is intended to generate profit.

The intangibles are the assets used and this could require the skills or technical know-how of people involved.

The determination of the risks assumed is dependent on which entity or entities have the purported risk appetite and will be responsible for the consequences if the risk materializes.

5.6 TYPES OF TRANSACTIONS

For the purposes of TP, there are two types of transactions where the identification and examination of intangibles would be relevant:

a. Transactions involving transfers of intangibles or rights in intangibles, e.g. a sale of a license to an associated enterprise or a right to use an intangible; and

b. Transactions involving the use of intangibles in connection with the sale of goods or the provision of services, e.g. transaction involving the manufacture of goods

In these transactions, it is essential that the comparability analysis considers the unique features of the intangibles, especially where the CUP method is employed. Some of the features to be considered are exclusivity, duration of legal protection, geographic scope, useful life, expected benefits, right to further develop etc. The selection of most appropriate TP method is dependent on the nature of the relevant intangibles and the availability of comparable uncontrolled transactions and intangibles.

5.7 TRANSFER PRICING METHODS FOR INTANGIBLES

Identification of legal ownership and compensation of functions performed, asset used and risk assumed by members of the group, provides the analytical framework for identifying the arm's length prices used for intangible transactions.

The most appropriate methods in transaction involving intangibles are the Comparable Uncontrolled Price (CUP) method and the Transactional Profit Split Method (TPSM).

5.7.1 Comparable Uncontrolled Price Method

This method evaluates whether the amount charged for a controlled transfer of intangible property was at arm's length by reference to amount charged in a comparable uncontrolled transaction.

Where reliable comparable uncontrolled transactions can be identified, and a CUP method is used to determine the arm's length rule with the transfer of intangibles, consideration must be given to the comparability of the intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions.

In conducting a comparability analysis, the following factors must be considered;

a. The stage of development of the intangible in the market.
b. The terms of the transfer.
c. The rights to receive update or modification of the intangible.
d. The uniqueness of the property and the period for which the property remains unique.
e. Time periods, including the duration of the license, contract or other agreement.
f. The economic and product liability risks to be assumed by the transferee.
g. The relationship between the transferee and the transferor.
h. The functions to be performed by the transferor and the transferee, including ancillary or subsiding services.

However, given the unique nature of some intangibles, finding a comparable for the use of CUP method can prove difficult especially where there is no recent acquisition of a similar intangible by an unrelated party or an available market for such comparison. In situations like this, the profit split method is the most applicable method.

5.7.2 Transactional Profit Split Method (TPSM)

This method identifies and compare the combined profit to be allocated between associated entities for the use of an intangible, to the relative value contributed by each controlled party on a basis that reflect the division of profit that would have been anticipated in an agreement made at arm's length.

In evaluating the reliability of TPSM, the following must be considered:

a. The availability of reliable and adequate data regarding combined profits;

b. Appropriately allocable expenses: and
c. The reliability of factors used to divide combined income.

Therefore, a full functional analysis to determine the functions performed, assets used and risk assumed by each member must be carried out.

Where a TPSM is based on projected revenue and expenses, the reliability of the projection is dependent on the accuracy of the projection of future cash-flows/income on which the valuation is based.

5.7.3 Other Methods

Where the traditional TP methods prove unproductive for the purpose of determining the arm's length price of transfer of intangibles between connected entities, other unconventional methods may be utilized. These other methods include:

1. Valuation Method– Discounted Cash Flow Method

In determining the arm's length price for intangibles transferred between associated enterprises, valuation method using income based discounted cash flow derived from the exploitation of the intangible being valued can be applied.

In applying this method, the following assumptions should be properly considered:

a. Realistic and reliable financial projections
b. Growth rates
c. Discount rates
d. The useful life of intangibles
e. Tax effects of the transaction

Applying this method can be volatile, as a small change in one or more assumption can lead to large differences in the intangible value the model produces

2. Value Contribution Approach Method (VCAM)

It allows the group entity's Profit to be allocated across the Value Chain based on how Value Creation Contributions have been made to the group profit, having regard to the functions and risks undertaken by Nigerian local enterprises. It is most essential when comparability information is extremely unavailable.

5.7.4 The Rule under the Nigerian TP Regulations

As a departure from the OECD recommendations in this regard, the TP Regulations provide that in controlled transactions involving exploitation of rights on an intangible, the tax deductible payments for the transfer of rights therein is capped at 5% of earnings before interest, tax, depreciation and amortization (EBITDA). However, based on the provision of Regulation 19 of the TP Regulations, the domestic tax laws (that is, the TP Regulations) shall prevail where any inconsistencies exist between itself and any other applicable law.

5.7.5 Hard to value Intangibles

The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises:

(i) no reliable comparables exist, and

(ii) at the time the transactions were entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

For such intangibles, information asymmetry between taxpayer and tax administrations, including what information the taxpayer took into account in determining the pricing of the transaction, may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined.

In dealing with the potential controversy regarding the arm's length pricing of HTVIs, the tax administration can consider actual outcomes as presumptive evidence about the appropriateness of the anticipated pricing arrangements. The actual outcomes provide information on the determination of the valuation at the time of the transaction.

CHAPTER SIX

COST CONTRIBUTION ARRANGEMENT (CCA)

6.1 INTRODUCTION

Cost Contribution Arrangements (CCA) are contractual arrangements among associated enterprises within a group in which the participants share certain costs and risks in return for each participant having a proportionate interest in the expected outcomes arising from the arrangements. CCAs may be used for a wide range of purposes such as acquiring or creating intangible assets, and providing intra-group services.

An important feature of the CCA is the sharing of contributions. To satisfy the arm's length principle, a participant's share of contributions must be proportionate to the expected benefits under the CCA. This is necessary to mitigate against profit shifting amongst connected entities in a group. CCAs may be contracted between dependent or independent parties.

It is a necessary precondition that parties to the CCA have a reasonable expectation of benefit. Thus, an entity whose only responsibility is to perform the subject activity of the CCA, would not be considered a participant but rather a service provider.

6.2 TYPES OF CCAs

There are majorly two types of CCA:

6.2.1 Development CCA

This is established for the joint development, production or the obtaining of tangible and/or, intangibles assets. This form of arrangement is expected to create ongoing and future benefits for participants and is associated with significant risks which relate to the uncertainty of distant benefits.

Under this CCA, each participant receives a right in the developed asset and such right often take the form of separate rights to exploit the intangible asset. The separate rights may be an actual legal ownership or only one of the participants is the legal owner while the other participants have certain rights to use or exploit the asset. A participant's right to exploit its interest is free of obligation to pay royalties or other consideration in addition to its contributions except where the expected benefits are not proportional to the contribution.

6.2.2 Service CCA

This is established for sharing in the costs and benefits of obtaining services and offers more certain, current and less risky benefits. A service CCA sets out the services that each participant of the arrangement is entitled to receive and it offers a streamlined net payment based on aggregated benefits and costs associated with intra-group services received and rendered by each participant.

Some of the advantages of using a CCA include:

a. Provides for economies of scale and corporate efficiency for commonly required services;

b. Lowers proportional cost compared to individual in-house service;

c. Reduces duplication of functions within MNE groups; and
d. Shared risks among the participants to the CCA.

Some of these services which may be the subject of a CCA include management, technical, marketing, and legal services etc.

6.3 FEATURES OF CCAs

A standard CCA should have the following features:

a. Must have at least two participants;
b. The sharing of costs between the participants is based on anticipated benefits;
c. Participants should have a reasonable expectation of benefitting from taking part in the arrangement;
d. The details of the arrangement must bedocumented;
e. The form of the CCA and the economic substance are consistent; and
f. Arrangements exist for the departure of participants (buy-out) from the CCA and the entry of new participants to the CCA (buy-in).

6.4 PRE-REQUISITE FOR PARTICIPATING IN A CCA

For any party to be a participant in a CCA, the following conditions must be met:

6.4.1 Mutual Benefit

Participants must expect to benefit from the output of the CCA, for example by being able to exploit the rights acquired or services developed in their own businesses.

6.4.2 Control

Participants must have the functional capacity to exercise control over the risks taken in the CCA. They must be capable of making the decision to take on the initial financial risk of participation in the

CCA, and must have the ongoing decision-making capacity to decide on whether or how to respond to the risks associated with the CCA. They must also have a clearly defined interest in the output of the CCA.

6.4.3 Value

The value of the contributions made by CCA participants must be in proportion to their reasonably anticipated benefits from the CCA.

6.5 CCA AND THE ARM'S LENGTH PRINCIPLE

To determine if a CCA measures with the arm's length rule, it is important to measure the value of each participant contribution to the arrangement. Under the arm's length rule, the value of each participant's contribution should be consistent with the value that independent enterprises in comparable circumstances would have assigned to that contribution.

6.5.1 Participant's Contribution Adjustments

When the consideration or cost received/contributed by a participant is inadequate, and that received or contributed by another participant is excessive; the arm's length principle requires an adjustment often through a balancing payment. This does not constitute a royalty for the use of the intangible but generally treated as a cost to the payer for contributing less and a reimbursable to the recipient for contributing more.

6.5.2 CCA Entry, Withdrawal or Termination

Whenever there is a new entrant to an existing or active CCA, the sum payable for pre-existing benefits by the new participant (buy-in payment) is based on the arm's length value of the interest in the intangibles and/or tangible assets the new entrant obtains, with consideration of the overall expected benefits to be received under the CCA. Similarly, when a participant leaves an arrangement (buy-out) and transfers his right, such transfer is compensated in line with the arm's length principle. However, upon termination of any CCA, each participant receives a beneficial interest in the results of the CCA activity consistent with its proportionate share of contribution.

Conclusion

The rule of substance over form is paramount in testing the applicability of CCAs by revenue authorities. Therefore, the terms of a CCA must substantially conform to the commercial reality arising from the application of the arrangement. The CCA may be disregarded by the revenue authorities if the terms/form of the CCA differs from the commercial substance/reality.

CHAPTER SEVEN

TRANSFER PRICING REVIEW AND AUDIT/ ADVANCED PRICING AGREEMENTS

7.1 INTRODUCTION

Transfer Pricing (TP) documentation requirements enhance transparency for tax administrations and provide information useful for TP risk assessment. TP risk assessment involves review of the taxpayer's tax and accounting records as well as related party disclosures to identify high risk taxpayers.

7.2 TRANSFER PRICING RISK ASSESSMENT AND PROFILING

Tax administrators normally select cases for TP audits based on effective risk identification and assessment using system-based data analytic methods. The selection may also be routine based on criteria such as industry, sector groupings, locations etc.

In performing a TP review, the tax authorities will typically give greater attention to companies having:

a. Transactions with related entities in countries with lower effective/ marginal tax rates;
b. Transactions with centralized supply chain/procurement entities in tax jurisdictions with low tax rates;
c. Transactions with related parties in jurisdictions with aggressive/ strict transfer pricing rules;

d. Poor performance and consistent losses (in comparison with industry standards as well as in relation to Group performance);
e. A large volume of sales or purchases from a related party compared to total transaction volume;
f. Excessive debt or interest expense, intragroup services, management fees, royalty for transfer or use of intangibles, etc.; and
g. Poor or non-existent TP documentation

In conducting TP risk assessment for intercompany transactions, a critical analysis of the filed corporate tax and transfer pricing returns of related entities within the same tax jurisdiction is conducted. Other documents that serve as sources of information for the tax authorities include:

a. Taxpayer's tax returns/disclosures and audit records of previous years
b. Publicly available information regarding the taxpayer including newspaper articles, information on website etc.
c. Site visits and meetings with company personnel
d. Customs data
e. Exchange of information under tax treaties
f. Country-by-Country reports filed in other jurisdictions

Typically, this review is carried out unbeknownst to the taxpayer. If the tax authority determines from its review that a taxpayer has significant potential TP risk, such a taxpayer will be selected for a full-scale TP audit.

7.3 TRANSFER PRICING AUDIT PROCESS

The TP audit process in Nigeria will often follow the order described below:

a. **Information and Document Request (IDR):** At this stage, the International Tax Division of the Federal Inland Revenue

Service (FIRS) sends an information request list to the taxpayer. Information requested will usually include financial and non-financial information such as specific ledger downloads, trial balance, financial statements of other related parties, tax computations, specific queries on related party transaction and transactions with third parties, information on the Group and Company's businesses, mapping of related party transaction to the trial balance, financial statements, tax computations etc.

b. **Presentation by Taxpayer:** The FIRS may request (by means of a formal letter) the taxpayer to make a presentation on the business model and operations of the Company. The aim is to enable the FIRS understand the taxpayer's business operations. This presentation is usually done at the FIRS' office.

c. **Field visit:** For taxpayers involved in manufacturing or drilling operations, the FIRS would request to visit the factories or work sites to inspect the production line/rig yard with a view to observing the production/work processes as well as confirm facts that may have been provided by the taxpayer. They may also take a tour of the taxpayer's administrative offices for physical verification of some assets.

d. **Functional Analysis Interview:** At this stage, the FIRS carries out fact gathering interviews with key company officials. The interview sessions are usually recorded and the transcripts printed for the interviewees to sign. Facts documented by the FIRS at this stage will form the basis for their assertions and audit report.

e. **Document Review:** Review of relevant documents (invoices, ledgers, agreements, etc.) provided. At this stage, they may also request additional documents and explanations from the taxpayer on various tax, accounting, operational and management issues.

f. **TP Audit Report:** The FIRS' TP audit team performs its TP analysis based on the facts gathered during the field phase of the audit to determine the appropriate price/return for the related party transaction. The FIRS will propose TP adjustments to some of or all the taxpayer's controlled transactions if they determine that the “appropriate” price/return differs from actual price/return.

   All their assertions and positions are articulated in an audit report issued to the taxpayer. The report usually comes with a date by which the taxpayer is expected to respond to the issues raised and provide additional documents where required.

g. **TP Audit Assessment / Reconciliation:** The FIRS will usually meet with the taxpayer to resolve any outstanding issues and address the taxpayer's concerns. The outcome of such meetings will determine the final TP adjustments to be made and any additional tax liabilities assessed.

h. **TP Dispute Resolution:** In a situation where the taxpayer disagrees with the adjustments by the FIRS, the taxpayer may approach the Tax Appeal Tribunal or a Court of competent jurisdiction.

7.4 MUTUAL AGREEMENT PROCEDURES

The Federal Inland Revenue Service (FIRS) issued the Mutual Agreement Procedure (MAP) Guidelines in Nigeria on 21 February 2019. The MAP Guidelines is aimed at providing guidance and clarity on the procedures for accessing MAP as a means of dispute resolution, pursuant to the Double Taxation Agreement between Nigeria and each of its Treaty Partners.

The MAP is a means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. The MAP guidelines specify that a taxpayer that is a resident in Nigeria is eligible to apply for MAP, if it considers that the actions of either or both Nigeria and the treaty partner's tax authorities result or will result in a taxation that is not in accordance with the provisions of the income tax treaty, regardless of the remedies provided by Nigerian domestic law. Subject to the provisions of the relevant tax treaty, a non-resident person can also make an application under the MAP guidelines. A MAP application can be made in respect of matters relating to:

a. Transfer pricing
b. Dual residence status
c. Withholding tax
d. Permanent establishment
e. Characterisation or classification of income

7.5 ADVANCED PRICING AGREEMENTS

A taxpayer with related party transactions may request the FIRS to enter into an Advance Pricing Agreement (APA) with it. The purpose of an APA is to establish an appropriate set of criteria for determining whether the taxpayer has complied with the arm's length principle for certain future controlled transactions undertaken over a fixed period. Under the Nigerian TP Regulations, an APA can last for three years.

A taxpayer seeking to enter an APA is required to furnish the request with the following:

- *Description of the taxpayer's activities including:*
    a. a detailed description of the controlled transactions to be included within the scope of the APA,

b. an analysis of functions to be performed, assets to be employed and risks to be assumed by the parties to the covered transactions, and

c. the proposed duration of the APA

- *A proposal by the taxable person for the determination of the transfer prices for the transactions to be covered by the APA.*

- *Identification of any other country or countries that the person wishes to participate in the Advanced Pricing Agreement.*

Any other relevant information that the Service may require to complete its analysis of the Advance Pricing Agreement request.

CHAPTER EIGHT

TRANSFER PRICING DOCUMENTATION REQUIREMENTS AND OTHER CONTEMPORARY ISSUES

8.1 INTRODUCTION

In a bid to align Nigeria's Transfer Pricing (TP) Regulations with the Organization for Economic Co-operation and Development's (OECD) Transfer Pricing Guidelines, 2017 (OECD TP guidelines), Nigeria's Federal Inland Revenue Service (FIRS) issued revised TP Regulations which revoked the existing TP regulations introduced in 2012. The Income Tax (Transfer Pricing) Regulations, 2018 (the new Regulations or the Regulations) was introduced in June 2018 and is effective for basis period commencing after 12 March 2018. The TP documentation requirements in the new Regulations are quite different from those in the revoked TP Regulations as they adopt the recommendations in one of the Action points of the Base Erosion and Profit Shifting (BEPS) Project championed by the OECD and the G20 nations. Action 13 of the BEPS Project advocates a three-tiered, standardised approach to transfer pricing documentation.

This chapter examines in detail, the three-tier documentation requirements as embodied in Nigeria's new TP Regulations and other contemporary issues arising therefrom.

8.2 DOCUMENTATION REQUIREMENTS

Regulation 16 of the Regulations requires connected persons to record, in writing or on any other electronic device or medium, sufficient information or data with an analysis of such information and data to verify that the pricing of controlled transactions i.e. transactions between connected persons/entities are consistent with the arm's length principle.

Regulation 16(5) of the Regulations provides for contemporaneous TP documentation. This means that the basis of pricing related party transactions must be in place prior to or at the time of undertaking the transactions.

TP documentation should be developed, maintained and submitted upon request in order to demonstrate that pricing of controlled transactions was done in accordance with the Arm's Length Principle. The onus to prepare TP documentation lies with the taxpayers who are required to evaluate their compliance with the TP Regulations prior to filing tax returns. To achieve this, taxpayers are expected to adopt a three-tiered documentation structure as follows:

1. Master File
2. Local File
3. Country-by-Country (CbC) Report

Each of the above stated documentation requirements are explained below:

8.2.1 Master File

Generally, the master file provides a high-level view of the Multinational Enterprise (MNE) Group's TPpractices in their global economic, legal, financial and tax context. Thus, the master file should provide an overview of the MNE group's business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to enable tax administrations determine the presence of significant transfer pricing risk. The OECD suggest five (5)categories of information that should be included in the master file, the master file should include information covering amongst others:

Category	Information Required
Organizational Structure	▪ Legal ownership structure chart ▪ Geographies of each jurisdiction
Description of the MNE's business	▪ Profit drivers for the business ▪ Overview of the supply chain for the five largest products/services (or any products/ services that account for over 5% of global turnover) ▪ Important service arrangement (excluding R & D) including locations, capabilities, cost allocations and pricing ▪ Main geographical market ▪ Brief functional analysis showing principal contribution to value creation ▪ Details of important business restructuring, acquisitions and divestures during the year
Intangibles	▪ Description of strategy for developing, owning and exploiting intangibles ▪ Location of principal R & D facilities and management ▪ List of important intangibles showing legal ownership ▪ List of intangibles – related intragroup agreements, such as cost contribution agreements, license research service agreements ▪ Related transfer pricing policies

	▪ Details of intragroup transfer of intangibles during the year
Intercompany Financial Activities	▪ Overall explanation of how the group is financed (including financing arrangements with third parties) ▪ Group financing companies and their locations ▪ Transfer pricing policies with respect to related party financing arrangement
Financial and Tax Position	▪ Annual consolidated financial statements ▪ List and brief description of unilateral advance pricing agreements (APAs) and other tax rulings relating to allocation of income among countries.

Source: *OECD BEPS Action 13: 2015 Final Report*

The breath of information required in the Master File is intended to provide a "blueprint" of the operations of an MNE.

8.2.2 Local File

The Local File provides more detailed information relating to specific intercompany transactions. The Local File refers specifically to controlled transactions of the local taxpayer with associated enterprises. The information provided by the Local File, in addition to that of the master file, helps to meet the objectives of demonstrating that the taxpayer has complied with the arm's length principle in the pricing of its related-party transactions. The OECD suggested that the local file contains the following:

Categories	Information Required
Overview of the Local Entity	▪ Management structure and local organisational chart ▪ Description of business and business strategy ▪ Key competitors

Controlled Transactions	▪ Description of the transactions and context ▪ Amount of intragroup payments and receipts ▪ Identification of related parties and relationship ▪ Copy of material intercompany agreements ▪ Comparability and functional analysis of taxpayer and related party ▪ Selection of most appropriate transfer pricing method and reason for selection ▪ Important assumptions made in applying the selected method ▪ Reason for performing a multi-year analysis ▪ Description of selected comparable uncontrolled transactions, if any, financial indicators for independent enterprises used in the transfer pricing analysis and search strategy ▪ Explanation of any comparability adjustments performed ▪ Rationale for concluding on arm's length pricing ▪ Summary of financial information used ▪ Copy of existing APAs or other tax rulings related to the transactions (where local entity is not a party).
Financial Information	▪ Local audited financial statements if available, else existing unaudited statements ▪ Reconciliation between financial data used in applying the transfer pricing method to the financial statements ▪ Summary of financial data for comparables and source

Source: *OECD BEPS Action 13: 2015 Final Report*

The Nigerian TP Regulations provides for inclusion of value chain analysis in the local file. The information to be included in the value chain analysis includes: (a) Flows of business, goods and materials, and capitals within the group, including design, development, manufacturing, marketing, sales, delivery, billing and payment, consumption, after-sale service, recycling, other processes related to goods, services or other relevant underlying targets of the controlled transactions and all the parties involved.

(b) Annual financial statements of each of the parties involved in the controlled transactions for the relevant accounting year.
(c) Measurement and attribution of value creation contributed by location specific factors.
(d) Allocation policies and actual allocation results of the group's profits in the global value chain.

8.2.3 Country-by-Country Report (CbCR)

CBCR is the third tier of the transfer pricing documentation as provided in both the OECD BEPS Action 13 as well as the Nigerian TP Regulations. The CbCR provides aggregated information by tax jurisdiction, showing MNE's allocation of income, income tax paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates.

MNEs are required to file the CbCR annually to provide information on each tax jurisdiction in which they do business, the amount of revenue, profit before income tax and income tax paid or payable. MNEs are also to report their number of employees, stated capital, retained earnings and tangible assets in each jurisdiction. MNEs must identify each entity within the Group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in. These pieces of information will assist the tax administration in carrying out high-level transfer pricing risk assessment.

The following are the criteria for determining a company that should prepare and submit annual CbCR Returns to the FIRS in any year of assessment:

a. Any Nigerian Company who is a member of an MNE Group that has a total group revenue of one hundred and sixty billion Naira (? 160 billion or EUR750 million) and above during the Accounting Year immediately preceding the year of assessment (as reflected in the Group's Consolidated Financial Statements for that preceding Accounting Year or, as may be otherwise ascertained); and

b. It is the Parent Company of the MNE Group ("Ultimate Parent Entity") or designated by the MNE Group to file on behalf of the Group ("Surrogate Parent Entity") or has obligation for local filing of country-by-country report in Nigeria (i.e. there is no other entity filing a country-by-country report that contains the financial information of the Nigerian entity, that will be made available to the Service).

The first filing obligation for a CbCR in Nigeria commences in respect of fiscal years commencing on or after 1 January 2018. The CbCR must be submitted within 12 months after the end of each accounting period to which the report relates. Therefore, for 2019 fiscal year (January to December 2019), the CbCR for the group is expected to be filed on or before December 2020.

Also, Nigerian resident members of an MNE Groups are required to notify the FIRS of the identity and tax jurisdiction of the entity that will be responsible for filing the CbCR where the Group have a consolidated revenue of EUR750 million or N160 billion. The notification is to be done not later than the last day of the reporting year end of the entity.

8.3 OTHER CONTEMPORARY ISSUES

1. **Annual TP returns:** As done under the now revoked Regulations, taxpayers are still expected to file an annual disclosure form and declaration form (if the need arise) with the tax authority. The disclosure form basically contains details of controlled transactions with connected persons during the assessment period, while the declaration form provides detailed information of the taxpayer, its owners and directors, its related parties and nature of relationship with all connected persons.

2. **Timeline for Submission of Transfer Pricing Documentation:** In the case of a company having controlled transactions of N300m or more, transfer pricing documentation shall be furnished within twenty-one (21) days of the receipt of FIRS' notice requesting for the submission of the TP documentation. While in the case of a company having controlled transactions of less than N300million, it shall be furnished within ninety (90) days of the receipt of FIRS' notice requesting for the submission of the TP documentation.

3. **Administrative penalties for non-compliance within stipulated period:** In ensuring strict compliance with the requirements of the Regulations, the FIRS introduced various administrative penalties to defaulting taxpayers. These are summarised as follows:

S/n	Type of TP Default	Penalty
a.	Failure to provide Transfer Pricing documentation within the stipulated period	Higher of ? 10 million or 1% of the total value of all controlled transactions plus ? 10,000 for every day in which the failure continues
b.	Failure to file CbCR returns within the statutory deadline	? 10million and ? 1million for every month in which the failure continues.
c.	Filing incorrect or false CbCR	? 10million
d.	Failure to notify the FIRS of the entity that will file the CbCR within the statutory period	? 5 million and ? 10,000 for every day in which the failure continues.
e.	Failure to submit TP Declaration Form within statutory period	? 10 million plus ? 10,000 for every day in which the failure continues.
f.	Failure to submit updated TP Declaration Form (within six months of the end of accounting year in which the event occurred).	? 25,000 for every day in which the failure continues
g.	Failure to submit TP disclosure form with the stipulated period.	Higher of ? 10 million or 1% of value of undisclosed controlled transactions plus ? 10,000 for every day in which the failure continues
h.	Failure to appropriately disclose related party transaction	Higher of ? 10 million or 1% of value of omitted controlled transactions plus ? 10,000 for every day in which the failure continues
i.	Incorrect disclosure of controlled transactions	Higher of ? 10 million or 1% of the value of the incorrectly disclosed controlled transactions

4. **The Language of Transfer Pricing Documentation:** The official language of the TP documentation is English language.

5. **Update of Transfer Pricing Documentation:** The Transfer Pricing Documentation should be reviewed and updated annually in order to determine whether functional and economic analyses are still accurate and relevant; and to confirm the validity of the applied transfer pricing methodology.

6. **Materiality:** A taxpayer whose total value of controlled transactions between the connected persons is less than three hundred million naira (N300 million) may choose not to maintain contemporaneous documentation. However, upon request by the tax authority, the taxpayer is expected to prepare the relevant documentation and submitted to the tax authority not later than ninety (90) days from the date of receipt of a notice.

7. **Documentation requirement for procurement transactions:** Where a related party procures goods or services from a third party on behalf of a connected person, the connected person is required to maintain invoices, contracts etc. issued by the third party as part of the annual TP documentation.

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ABOUT THE BOOK

The Handbook on Transfer Pricing Documentation was put together by members of International Taxation Faculty as approved by the Governing Council of the Institute. Transfer pricing has a lot of legal complexities which allows related parties to price goods, services, intangible assets, loans and other transactions between them. Transfer pricing rules and regulations are established in different countries to ensure that related parties' pricing decisions are reasonable and fair. The Handbook on Transfer Pricing would serve as reference material to members of the Institute who service clients and regulators involved in cross border related transactions, accounting and reporting, as well as complying with relevant regulatory requirements in Nigeria.

The handbook is recommended for Multinational organisations, business entrepreneurs, Tax consultants and Practitioners, Administrators, and Taxpayers. This handbook is a valuable material that will impact your businesses, make you relevant in the ever dynamic and changing taxation environment.

ABOUT THE INSTITUTE

The Chartered Institute of Taxation of Nigeria was established on February 4, 1982, as the Association of Tax Administrators and Practitioners (ATP). Thereafter, it transformed into Nigeria Institute of Taxation, which was formally launched on February 21, 1982, and statutorily recognized on May 6, 1987, as a company limited by Guarantee.

The Institute became chartered by the Federal Government of Nigeria by the enabling Act No. 76 of 1992 (now CITN Act, CAP C10, Laws of the Federation of Nigeria, 2004) and was charged with the responsibility, among others regulating and controlling the practice of tax profession in its entire ramifications and determining what standards of knowledge and skills are to be attained by persons seeking to become professional Tax Practitioners and administrators.