



Transfer Pricing Regulation

Impact on Entities
Transacting Business in
Nigeria

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INTRODUCTION

The adoption of transfer pricing mechanisms into the tax systems of nations dates as far back as the early 20th Century. As of today, many countries across the globe have adopted transfer pricing laws because of its significance to revenue generation. Many related entities are able to leverage their commercial and financial relationships to achieve undue tax advantages and ultimately revenue base erosion to the host nation. The principle behind transfer pricing is to statutorily empower tax authorities to adjust the pricing of related entity transactions for tax purposes where same was not conducted in line with the principles of arm's-length dealing.

The Organization for Economic Co-operation and Development (OECD) has for several decades been in the forefront of the development of transfer pricing policies and regulations. It issued its first guideline in 1979 from which the United States and several other European countries have developed their transfer pricing regulations.

In 2012, the Federal Inland Revenue Service (FIRS) came up with the Income Tax (transfer pricing) Regulation No.1, 2012 in an attempt to plug holes in the tax leakages suffered as a result of related entity transactions in Nigeria. The regulation came into effect on the 2nd of August, 2012 and applies to all related entity businesses transacted after that date.

The main objectives of the regulation includes amongst others:

- 1. Mechanism for protection of the tax base:** provides the tools to fight artificial transactions and shifting of profits out of their jurisdiction by connected taxable persons.
- 2. Increase competition:** provides a level playing field between connected taxable persons and independent enterprises doing business within the Country.

3. **Maximise profits:** gives the Country the opportunity to have a fair share of the profit of connected taxable persons' transactions and dealings
4. **Certainty:** provide connected taxable persons with certainty of transfer pricing treatment in the Country.

WHAT IS TRANSFER PRICING?

Transfer Pricing (TP) is the price at which goods, services or intellectual property are transferred between Connected Taxable Persons. That is, a process of setting the mechanism for the transfer of goods and services (which would include intangible assets (e.g. intellectual property) and related party loans) between related entities (i.e. entities with common ownership or control, also called 'Connected Persons') in a manner that ensures fair pricing and arm's-length dealing (the basis on which transactions are contracted where parties are independent and unrelated and neither is acting under compulsion or undue influence). Simply put, related-party transactions are compared with other third-party transactions to determine the fairness or otherwise of the pricing.

For instance, Rheingold Logistics Limited, a wholly owned subsidiary of a British Corporation "Rheingold Group", provides inbound logistics services to its parent company "Rheingold Group" at a price lower than its standard service price to third party customers, the Federal Inland Revenue Service in determining the Tax liability of Rheingold Logistics Limited can apply necessary adjustments to the pricing of its services to Rheingold Group to reflect its standard service price.

Connected Taxable Persons

Connected Taxable Persons are persons referred to as business associates in any form, and two enterprises are considered to be associated where: one enterprise participates directly or indirectly in the management, control or in the capital of the other; or the same person or persons participates directly or indirectly in the management, control or in the capital of both enterprises. Connected Taxable Persons include persons referred to as:

"Associates" in the Companies and Allied Matters Act, CAP C20, LFN 2004 (as amended); and

“Persons” in Section 17(3)(b) of the PITA; Section 15(2) of the PPTA; and Sections 13(2)(d), 18(2)(b) and 22(2)(b) of CITA;

“Associated Enterprises” of the OECD Guidelines; and Article 9 of the UN and OECD Model Tax Conventions

THRUST OF THE REGULATION

Scope

The regulation applies to transactions between connected persons including sale and purchase of goods; sale, transfer, purchase or lease of tangible or intangible assets (such as use of technology and intellectual property rights); provision of services; manufacturing arrangements and any other transaction capable of impacting on the profitability or otherwise of the transacting parties.

The FIRS by including this omnibus provision: “any other transaction capable of impacting on the profitability or otherwise of the transacting parties,” has deliberately broadened the scope of the regulation such that it would apply to all connected party transactions without exception.

Application

The litmus test for the applicability of the regulation is whether transactions are between “Connected Persons”. The principal tax legislations in Nigeria (Personal Income Tax Act, Companies Income Tax Act and the Petroleum Profit Tax Act) collectively define connected persons to include “individuals and entities (including trusts, associations, partnerships, companies etc.) that share common control or participate directly or indirectly in management, control or profit of one another”. It presupposes therefore that all transactions between connected persons are subject to the provisions of the TP Regulation, to the extent that either or both of the parties are taxable persons under Nigerian Law. This extends to Group/Holding Companies, Subsidiary Companies, Head Offices and Branches, Franchise Outlets, Foreign Companies with Local subsidiaries, unrelated companies sharing similar Directors and/or Shareholders.

Compliance

All transactions between or amongst related entities – “controlled transactions” – are by the regulation required to be conducted and priced in a manner consistent with arm's-length principles. Where they fail to comply, the FIRS have statutory powers to make necessary adjustments before determining the taxable entity's tax liability in each accounting year.

The regulation prescribes the acceptable transfer pricing methods, which are consistent with the arms length principles. Taxable entities are required to apply the TP method that is most suitable in the circumstance giving consideration to the Comparability Factors – the bases for determining whether a transaction is comparable with another independent transaction conducted under similar circumstances. They include the following: Comparable Uncontrolled Pricing (CUP) method (comparison with prices of similar transaction), Resale Price method (price at which a product purchased from a related party is sold to an independent party), Cost Plus method (determining appropriate mark up of production cost to arrive at an arm's length price), Transaction Net Margin method (determining appropriate margin of profit which will be added to the base cost of the good or service to arrive at an arm's length price) and Transaction Profit Split method (a split of the total profit derived from the transaction between the related parties as would have been expected where parties are independent and unrelated). The regulation also gives the FIRS the power to prescribe other methods as it may deem fit.

Connected Taxable Persons are required to keep records (information and documents) of all controlled transactions prior to filing of tax returns in the year the transaction occurred and make such records available upon demand by the FIRS in the course of its audit procedures. However, the regulation failed to provide procedure or guidelines for the records

required to be kept. But since regulation 11 states that the regulation shall be applied in a manner consistent with the OECD TP Guidelines, it is advisable that Connected Taxable Persons strive to comply with the provisions of the guideline as it relates to records and documentation.

Where sufficient record is not kept, the Connected Taxable Person would have failed to satisfy the burden of proof that its transaction complied with arm's length principles. In this regard the FIRS may apply adjustments as it deems necessary.

Advanced Pricing Agreements

The regulation makes provision for Connected Taxable Persons to enter into forward agreements with the FIRS. Here, both parties agree to a TP methodology to be applied by the entity in pricing all its controlled transactions within the materiality threshold of ₦250, 000,000.00 (Two Hundred and Fifty Million) for an agreed period (not exceeding three years). This agreement may be made subject to such conditions as the FIRS may deem fit and may also be terminated where there is a breach, mistake/misrepresentation or a change in law.

Corresponding Adjustments

Where an adjustment is made to the tax liability of a connected taxable person, in a jurisdiction with which Nigeria has a double taxation treaty, upon application, the FIRS may permit a corresponding adjustment to the income tax liability of such person in Nigeria so as to avoid double taxation.

Legal Implication of the TP Regulation

The Regulation is made pursuant to the FIRS' powers under the Federal Inland Revenue Services (Establishment) Act, 2007. Its provisions are binding on all persons taxable under PITA, CITA and PPTA.

The penalty for contravention of the regulation may range from FIRS' outright disregard of the transaction or an adjustment of the tax liability of the related taxable entity to reflect arm's-length dealing.

The regulation equally makes room for its own internal dispute resolution mechanism. Where taxable entities are dissatisfied with an assessment or an adjustment, they may notify the FIRS which will in turn constitute a decision review panel. The complainant is required to provide sufficient documentary evidence to substantiate its claim and the Board's decision is final and binding subject only to the complainant's right to seek redress in a court of law.

CONCLUSION

Taxable entities can no longer use related entity transactions as a vehicle for tax avoidance or planning. Before contracting any business it is important for a taxable entity to determine whether or not the transaction falls within the related parties' threshold because the FIRS' powers to adjust the price at which parties contracted may lead to a cost overrun after the transaction is concluded. Transaction advisors must also ensure that transfer pricing elements are given consideration during the preliminary due diligence exercises and those entities are advised on its implication.

It is advised that all companies in Nigeria adopt a transfer pricing compliance policy. Companies within multinational groups that have adopted their global TP policies must also ensure that those policies are in line with local regulations and that all transactions be subjected to a related parties' litmus test. Where such relationships are established, parties must ensure that transactions are priced based on any of the acceptable transfer pricing mechanisms or in line with an advanced pricing agreement entered into with the FIRS.

Taxable entities may still, for commercial and other compelling reasons, desire to contract related transactions other than on an arm's-length basis; in such cases they could mitigate their risks by drafting sufficient indemnities from the other party into the transaction agreement such that where the transaction resorts in additional tax liability, it could be borne solely by the other party or allocated between the parties in a pre agreed ratio.

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