Tax Alert

Related party transactions disclosures
Why consistency matters

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Imagine facing a billion-shilling transfer pricing adjustment by the Tanzania Revenue Authority (TRA), not because of the transaction not being at arm's length in substance but due to a mislabel or inconsistency in your related party disclosure note in your financial statements.

Recently we have witnessed companies facing transfer pricing penalties applied by the TRA simply due to errors in the often-overlooked financial statements note – the related party disclosures. Something as simple as an inconsistent label or mismatch in your related party disclosure note could expose your business to significant tax adjustments and penalties, even when the underlying transaction was in fact at arm's length.

This unfortunate reality comes due to the fundamental differences between the approach in preparation of financial statements and tax audits. Financial statements are typically prepared with a focus on materiality and the emphasis is on whether the financial statements, as a whole present a true and fair view with a focus on the statement of profit or loss, statement of financial position and statement of cashflows, rather than reviewing every note in detail.

As a result, some notes tend not to be updated properly on a year-on-year basis, and in the majority of instances, we tend to see this in relation to the related party notes.

The importance of related party transaction disclosures extends beyond financial reporting requirements. As the TRA continues to dedicate increased resources to the examination of related party transactions and comprehensive transfer pricing (TP) audits become the norm, it is essential for businesses to ensure consistency in their related party transaction disclosures.

Some of the most common issues that have been picked during TRA audits include the following.

- Mismatch transaction values: In several cases, the amounts disclosed in the related party transaction note do not reconcile with figures recognised in the financial statements. For example, the quantum disclosed in the related party note for management services is TZS 8 billion, but the amount in the income statement is TZS 10 billion. Another issue is the movements in related party receivables or payables not aligning with the actual transactions during the year.
- We have also seen TRA raise queries where the amounts recorded as income in one entity do not match the corresponding expense recorded in the corresponding entity, which raises a number of difficult questions.
- Another common issue relates to inconsistent transaction descriptions across different documents. We have encountered situations where a transaction is described as a "management fee" in the financial statements while it is in fact "cost reimbursement" as correctly mentioned in the transfer pricing documentation. Similarly, a transaction may be described as a purchase of goods and services in the financial statements, while being described as "support services" in the transfer of pricing documentation. While the actual words do not have to be identical, when these are significantly different between documents, this leads the TRA to question the true nature and substance of the transaction, potentially resulting in recharacterisation and tax adjustments.
- We have also observed omissions of certain related party transactions from the related party disclosure note. In some instances, transactions are reflected in the income statement but are not disclosed in the related party transaction disclosure note. From a tax audit perspective, such omissions undermine the credibility of the financial statements and weaken the taxpayer's overall defense.
- At the legal court level, we have also seen the courts rule in favor of TRA in such cases. This is because the issue often involves comparing the company's financial statements against the company's own statements. As a result, it becomes very difficult to argue that the label or classification was incorrect as the expectation is that these documents were internally reviewed and verified.

To address this, companies should ensure that related party transaction disclosures are provided with the same diligent attention as other parts of the financial statements. In practice, this includes reconciling related party disclosures to the general ledger and income statement and balance sheet, aligning transaction descriptions across financial statements, transfer pricing documentation and intercompany agreements and ensuring that all related party transactions are fully and accurately disclosed. Regular internal reviews prior to finalising financial statements, together with clear documentation of the nature and pricing of related party transactions, can significantly reduce inconsistencies and mitigate the risk of challenges during TRA audits and facing a substantial and potentially avoidable penalty.

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