

Tax Alert

The Transfer Pricing Guidelines, 2020

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Get in touch

Rishit Shah

Tax Leader

E: rishit.shah@pwc.com

T: +255 22 219 2601

Ali Dawoodbhai

Associate Director - Transfer Pricing Leader

E: ali.dawoodbhai@pwc.com

T: +255 22 219 2620

James Magesa

Manager - Transfer Pricing services

E: james.m.magesa@pwc.com

T: +255 22 219 2614

Novat Matoju

Senior Associate

E: novat.matoju@pwc.com

T: +255 22 219 2676

Omari Nina

Senior Associate

E: omari.nina@pwc.com

T: +255 22 219 2626

Bhavesh Dineshchandra

Associate

E: bhavesh.dineshchandra@pwc.com

T: +255 22 219 2675

Gloria Joseph

Associate

E: gloria.joseph@pwc.com

T: +255 22 219 2688

Background

The Transfer Pricing Guidelines 2020 ("the Guidelines") issued on 1 July 2020 provide guidance on the application of the Tax Administration (Transfer Pricing) Regulations, 2018 ("the Regulations"). Although not prescriptive, the Guidelines provide the Tanzania Revenue Authority ("TRA")'s interpretation of the Regulations.

In brief

Technical:

- Functional analysis must be substantiated with evidence on the functions performed by different parties.
- The tested party can be a foreign entity only if sufficient and verifiable information is available (for the foreign entity).
- Continuous losses require economic justification.
- Express prohibition of intercompany service fees not based on actual costs.
- Specified factors to be considered in relation to intra-group financing and intangible property.
- Commodity transactions to reference the quoted spot price of the day.

Administrative

- No extension of time for a response to a TRA request for Transfer Pricing documentation.
- Preference for the Transfer Pricing documentation to be submitted in electronic format.
- Guidance on information required regarding ownership and organisational structure.
- New time limit for notification of corresponding adjustment under a double tax treaty.

- Further clarification on procedures for Advance Pricing Arrangement ("APA") request.

Introduction

The Transfer Pricing Guidelines, 2020 ("the Guidelines") were released on 1 July 2020 by the Commissioner General in order to provide guidance on the application of the Tax Administration (Transfer Pricing) Regulations 2018 ("the Regulations") that were released on 21 November 2018.

The Guidelines include an introductory message from the Commissioner General which touches amongst other things on:

- **The challenges posed by** transfer pricing both to tax administrations and Government (in terms of tax base erosion) and to taxpayers and their advisors (in terms of double taxation and penalties).
- States that the objective of the Guidelines are to provide practical guidance and are not intended to be prescriptive nor are exhaustive regarding every transfer pricing issue that might arise. In addition, every transfer pricing arrangement will be decided on its own facts and circumstances.
- Confirms that the Guidelines:
 - » Are not intended to be a substitute to applicable laws and regulations and in case of conflict of interpretation the provision of law will prevail.
 - » Are not static, in the sense that they will be periodically reviewed and revised to keep in line with relevant changes in law and best practice.
- Articulates the aspiration that the Guidelines will lead to enhanced certainty for taxpayers.

This tax alert highlights the main areas covered by the Guidelines.

Functional Analysis, Comparability Analysis - What needs to be provided?

Evidence to support functional analysis

A functional analysis in the TP documentation has to be substantiated with evidence in respect of the functions performed and risks actually borne by different parties to a transaction. The Guidelines provide some examples of source documents that will be required:

Function	Evidence required
Procurement	<ul style="list-style-type: none">• Profile of employees engaged in procurement activities (including name, position, academic qualifications, and years of experience)• Samples of key correspondence between the associates.
Financing	<ul style="list-style-type: none">• Sources of funds of the financier• Documentation to support amounts involved in the financing arrangement and to evidence receipt of funds (for example, bank statements).
Management services	<ul style="list-style-type: none">• The service provider's employees profile• Details of any visit (such as visit dates, duration and purpose for each visit, passport copies, permits, etc.)• Key correspondence between the associates.
Sales and marketing	<ul style="list-style-type: none">• Employees' profile• Customers list and dynamics over time• Key correspondences between a person and its associate and between the associate and customers• Sample invoices• Risks connected with the performance of the sales and marketing function (such as price risk) may be demonstrated by decreased profit (gross and operating) margins expected to be reflected on the associate's financial statements.

The Guidelines also provide a framework (to summarise the functional analysis) with scores (in the scale of 1 to 5) assigned in order of the significance of each function and risk.

Choice of a tested party

Regulation 5(7) of the Regulations states that "where the most appropriate method requires selection of a tested party outside the united republic such a party shall be considered only when a person provides all relevant information of the person". In this regard, the Guidelines provide that when choosing a foreign tested party for comparability analysis:

- TRA will accept the foreign tested party only where sufficient and verifiable information (on the tested party) is provided
- Relevant information on the foreign tested party may include financial reports, employee profile, registration evidence of intangibles, organisation chart and financial data.

Comparability analysis

The Guidelines require a person to seek comparable data for transactions undertaken in the same year as the year of the person's controlled transaction. If this is not readily available then the average of the most contemporary years not exceeding three years prior to the financial year should be used.

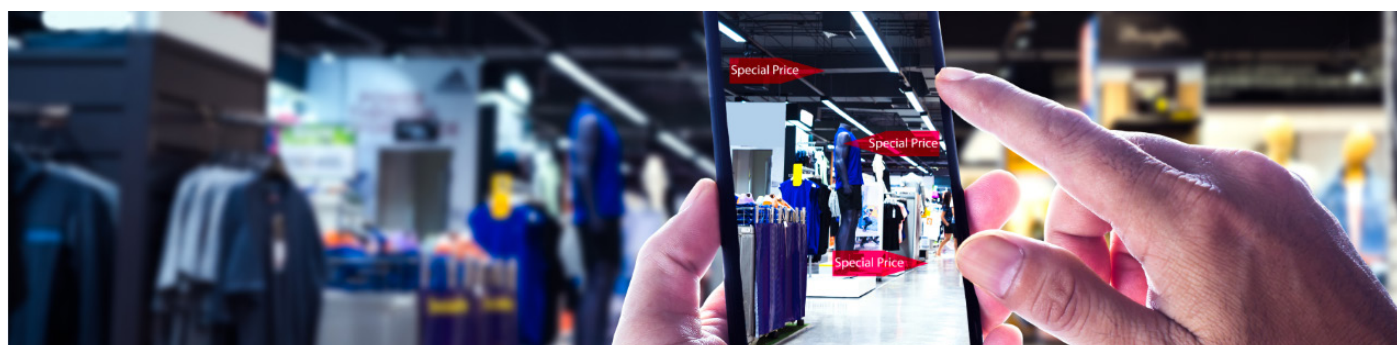
In practice, when using external benchmarks as comparables, the databases will usually have data older than two (2) years. By way of illustration, the deadline to finalise a documentation for a December 2020 year end will be June 2021, but at that time, the commonly used databases for benchmarking will not have information for 2020 and only limited information for 2019 .

This contrasts with TRA's previous practice of allowing comparable data for the previous five years, an approach that ideally would have been maintained.

Intra-group services

The Guidelines state that relevant and sufficient evidence to support the provision of intra-group services should be provided at the time of providing the TP documentation (such as reports etc).

The failure to provide the necessary evidence or the provision of only limited evidence may result in a conclusion that no services were actually rendered or that only limited services were rendered.



What special considerations or factors are taken into account?



Continuous losses as a red flag

Where a person has continuous losses, the Guidelines state that the TP documentation must explain the reasons for incurring such losses (e.g. start up losses, market penetration strategies and research and development) and the measures being taken to address the situation within reasonable time. (this requirement was not provided for in the Regulations.)

Basis of charging for intercompany services

For service charges, fees should be charged by reference to actual costs incurred and where actual costs cannot be directly determined, such costs can be recharged by use of appropriate allocation keys. The Guidelines explicitly reject intercompany service fees based on budgeted costs or a percentage of turnover.

Special considerations for intra group financing

The Regulations require a person in a controlled transaction who provides or receives intra-group financing directly (with or without consideration) to determine the arm's length interest rate for such assistance.

The Guidelines go further to list factors to be considered in determining an arm's length arrangement for financial assistance, including whether the nature and quantum of debt is justifiable (i.e. such that an independent party would have been willing to enter into a similar financial arrangement).

Recognition of Intangible Property ("IP") beyond the accounting treatment

Given the potential significant economic value of intangibles the Guidelines provide that intangibles should be considered for transfer pricing purposes, including cases where the costs of developing the intangibles (such as research and development and advertising costs) are expensed rather than capitalised in financial statements.

The Guidelines further provide that when a person who is not a legal owner of the marketing intangible undertakes any function in excess of what a comparable independent person may have done, the owner of the marketing intangible should give the person an arm's length consideration for undertaking such activities.

Ideally, the Guidelines could have provided further guidance in situations where marketing activities (i) directly benefit the local entity; and (ii) benefit both the local entity and the global brand/ IP owner.

Special considerations for commodity transactions

For commodity transactions, the arm's length price is the daily quoted spot price of the day on which the goods are shipped (as evidenced by the bill of lading or equivalent document depending on the means of transport). In our view, reference to the invoice date as the date of transaction would have been a better approach so as to reflect the economic reality of the relevant transaction and to avoid the compliance burden of performing reconciliations.

Corresponding adjustments

The Regulations recognise that a double tax treaty may give a taxpayer the right to request a corresponding adjustment consistent with an adjustment made by a foreign tax authority so as to align with the arm's length principle. However, the Guidelines seek to constrain this right by stating that any request for such a corresponding adjustment must be made within one month from the date of an adjustment or such time allowable in the existing tax treaty. In practice most of Tanzania's double tax treaties provide a time limit of either two or three years of the first notification of the action which gives rise to taxation not in accordance with the treaty; however some treaties do not expressly state a limit.

By contrast, the Guidelines are silent on assistance from TRA to the taxpayer in facilitating agreement on a corresponding adjustment in the relevant overseas jurisdiction in situations where TRA has initiated the TP adjustment.

Documentation - who is required to provide documentation, by when, and how?



Documentation requirements - threshold

The Guidelines restate the requirements of regulation 7 of the TP Regulations 2018, in relation to submission of TP documentation, namely that:

- For a person with transactions with related parties that exceed TZS 10 billion - TP documentation to be filed with the tax return.
- For those not exceeding this threshold - TP documentation to be submitted within 30 days of request by the TRA.



The Guidelines state that the TZS 10 billion threshold considers the value of all controlled transactions in a particular year of income.

Although not explicitly mentioned, the normal expectation would be that this includes revenue transactions (normally reflected in the income statement) and capital transactions (resulting in movements in the balance sheet, for example the receipt of moneys by way of a loan).

Documentation requirements - information to be provided

Regulation 7 also sets out requirements in relation to the information to be provided in the documentation, and the Guidelines provide further detail on the expectations in this regard including in relation to: ownership and organisational structure; nature of business or industry and market conditions; controlled transactions; pricing policies; other comparability information and appropriateness of documentation.

The worldwide ownership structure of a group must be portrayed. In case of a multinational company the structure must include both direct and indirect ownership including all interposed persons covering all associated persons whose dealings directly or indirectly affect the pricing of the transacted goods, services or intangibles.

As regards the operational structure, a person should clearly illustrate the way a person's business is organised regionally and/or globally in terms of business conduct (e.g. financing, procurement and logistics, HR management, technical services etc), and how intangibles (if any) are owned and/or protected.

Documentation requirements - hardcopy or electronic form

The taxpayer has the option to file the TP documentation in hardcopy or electronic form. However, TRA prefers and recommends submission in electronic form.

Extension of time to file TP documentation - alignment with the tax return basis

For persons subject to the compulsory TP documentation filing (i.e. above the TZS 10 billion threshold), the maximum extension of time to submit TP documentation (which can be granted by the Commissioner upon demonstration of a good cause) shall not exceed the extended period for filing a corporate tax return (i.e. 30 days).

However, for persons whose transactions do not exceed TZS 10 billion (hence not required to submit their TP documentation together with the tax return), no extension of time shall be granted for failure to submit the documentation within 30 days after the Commissioner's request.

Sanctions for failure to comply

Aside from reference to the penalty set out in Regulation 7(4) (currently TZS 52.5 million¹), the Guidelines² state that *"should a person fail to respond to the Commissioner's notice regarding contravention of Regulation 7 of the Regulations, the criminal measures shall be initiated"*.

Advance Pricing Agreements - a ray of hope?

General

The aim of an Advance Pricing Agreement ("APA") is to provide taxpayers with an opportunity to reach an agreement with the TRA on the mode of application of the arm's length principle to their related party transactions on a prospective basis.

Specifically the Guidelines state that *"Generally, TRA would accept an APA request if there is a genuine motive to obtain certainty in compliance with the arm's length price and the request relates to specific current or future transactions that are not hypothetical"*.

Timing

The Guidelines include the following narrative: "TRA appreciates that the usefulness of an APA to a person may be diminished if a timely agreement cannot be reached. In this regard, TRA will do its best to expedite the APA process and reach agreement. However the actual duration of the process would depend on the complexity of the issues involved in each case, and the response time of the parties involved."

Procedures to follow

The Guidelines set out procedures for a taxpayer to follow when requesting an APA from the Commissioner. These procedures include:

- Seeking a pre-filing engagement to discuss the proposed APA with TRA;
- Submission of information (business model, industry information, transactions covered, period of the APA);
- TRA initial response as to if it is willing to accept the case for the APA, and if so the necessary

¹ Being the current value of three thousand five hundred "currency points"

² Paragraph 10.9 of the TP Regulations 2020

follow up actions and expectations (including timeframe for completion);

- Where foreign tax authorities are involved (bilateral and multilateral APAs), the taxpayer should initiate similar meetings with the relevant foreign tax authorities ;
- Formal APA submission, and review and negotiation;

If agreement is reached, a meeting within 30 days of such agreement to confirm details including APA compliance and monitoring requirements.

Missed Opportunity?

Ideally, a draft of the Guidelines would have been issued for public discussions and comments (similar to the approach taken by the Organisation for Economic Co-operation and Development (“OECD”) before releasing guidelines (for example, the OECD Guidelines on Financial Transactions in February 2020 and other Guidelines in previous years). Such consultation could have ensured that the Guidelines take better account of practical compliance challenges faced by taxpayers.

On the other hand, as highlighted earlier, the introductory narrative from the Commissioner General does make clear that the Guidelines will be periodically reviewed and revised to keep in line with relevant changes in law and best practice.

Take aways

Change in TP documentation to include more details

To substantiate information in the transfer pricing documentation taxpayers need to provide more details in the functional analysis compared to the past so as to evidence that sufficient and appropriate records have been maintained.

Annual update of the TP documentation - best practice for all taxpayers with related party transactions

Although from a technical perspective the obligation to file TP documentation with the tax return is subject to a threshold (TZS 10 billion), from a practical perspective (including considering the extent of evidence required) it may be a challenge to prepare TP documentation within 30 days of a request from the Commissioner. Accordingly, and especially given the significant sanctions for failure to submit TP documentation, in practice it is important for all taxpayers

with related party transactions (irrespective of threshold) to have TP documentation prepared by the time of filing the final tax return (and indeed this is what the Regulations contemplate).

Special Considerations for Intangible Properties (“IP”)

When incurring expenses or performing any development, enhancement, maintenance, protection and exploitation (DEMPE) functions which may relate to IP owned by another company, a taxpayer needs to be compensated for such expenditures. Taxpayers need to be able to substantiate any marketing expenses they have incurred and separate “above the line” costs (i.e. those which add value to the IP) and “below the line” costs (i.e. those which directly benefit the taxpayer).

