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Tax Alert
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Tanzania's new Transfer Pricing Regulations

Highlights

- The new Tax administration (Transfer pricing) Regulations, 2018 replace the previous Regulations issued in 2014.
- Taxpayers with related party transactions of TZS 10 Billion (USD 4.35 Mil) or more must now file their transfer pricing documentation together with their tax returns.
- The hierachy of transfer pricing methods is retained, with the cost plus method designated as the method to test intra-group services. The comparable uncontrolled price (CUP) method is now the designated method to test commodity transactions.
- Restriction on use of 'tested parties'. Use of a tested party located outside of Tanzania will only be permitted if financial information on that party can be provided to the TRA.
- Transfer pricing documentation must now include actual computational workings carried out to determine the transfer prices and financial statements of the parties to the controlled transaction, including where the tested party selected is outside the country
- Penalty for non-compliance with the arm's length principle (upon audit) is now 100% of a transfer pricing adjustment, not the resultant tax. Penalties for failure to provide documentation is now 3,500 currency points (TZS 52.5 Mil or approximately USD 22,830).

Introduction

The *Tax Administration (Transfer Pricing) Regulations, 2018* ("TP Regulations 2018") are now in force, repealing the previous regulations that have been operational since February 2014. The new regulations require more detailed documentation and supporting information and impose stricter penalties for non-compliance.

We summarise below the key changes:

01. Documentation

The requirement to prepare a contemporaneous transfer pricing documentation remains in place. The new Regulations only impose a mandatory filing of such documentation for taxpayers with related party transactions of TZS 10 Billion or more. Taxpayers with related party transactions below TZS 10 Billion need not file the documentation but should still prepare them and file within 30 days of TRA's request.

Additional detail that should now be included in the transfer pricing documentation is the 'computational workings carried out in determining transfer prices.' Documentation must also include 'financial indicators, financial statements of the parties to the controlled transaction, including where the tested party has been selected outside the country".

In addition to the items specifically listed as required in a transfer pricing documentation, the Commissioner is empowered to request the taxpayer, by way of a notice, to produce, including by way of creation of a document, any other information within a specified time of the notice.

The regulations also state that "where the most appropriate method requires selection of a tested party outside Tanzania, such a party shall be considered only when a person provides all relevant information of the person". In other words, it is likely that TRA will reject a tested party if it is a foreign entity and its financial and other information is not availed to the TRA.

This proposal is in line with Base Erosion and Profit Shifting (BEPS) actions for increased transparency on the operations of MNEs. In our view, and based on practical experience, a challenge will arise where the information requested by the tax authority is excessive or not readily available in the required form. In some instances, it is difficult for resident entities to obtain the information from the non-resident related parties. This may result into testing of the local entity even where said entity is the more complex entity in the transaction.

Taxpayer should therefore carefully consider the choice of tested party taking into account the level of information that they can obtain in the case of a foreign tested party.

02. Transfer pricing methods

The Regulations maintain TRA's preference for traditional methods prior to opting for transactional methods. This is a departure from best practice that allows use of the most appropriate method for each particular tested transaction.

However, a change relates to the explicit designation of the cost-plus method as the preferred method to test intra-group services. This is in line with best practice although in many cases the application of gross margins is difficult due to differences in accounting treatment and therefore a net margin approach is applied.

03. Special method for commodity transactions

The Comparable Uncontrolled Price (CUP) method is now the designated method to test commodity transactions between related parties. The quoted price is preferred as the reference price to determine the arm's length price. The exception to this is where the the commodities are exported from the country (Tanzania) at a price that is higher than the quoted spot price, in which case the agreed price shall be considered as the transfer price.

This change is aligned to the approach adopted by various African tax administrators for commodity transactions. The impact is likely to be significant for companies dealing with commodities. This calls for a revision of the transfer pricing arrangements and consideration of the role of related parties in the supply chain.

04. Benchmarking / Comparability analysis

This is an area that has been contentious between TRA and taxpayers. The regulations make a clear attempt to minimise some aspects of these disputes as follows:

The regulations specify what the arm's length range will be, which is now between the 35th and 60th percentile for comparable sets of more than four data points and an average for data sets of four or less.

The regulations specify that where the taxpayers results fall outside the above prescribed 'arm's length range,' the results shall be adjusted to the median point of the range.

The application of median as a reference point is in line with the current trends in tax revenue audits. Additional clarification on whether approach will be applied on a yearly basis or 3 or 5 year basis would be useful.

While the specification of the arm's length range is welcome, other aspects of benchmarking that are likely to remain contentious include the choice of database, the choice of comparable companies and the adjustments that may be required to achieve comparability.

05. Powers of the Commissioner to reject taxpayers' benchmarking study

Powers have been vested on the Commissioner to reject wholly or partially the comparability analysis prepared by taxpayers and either request for resubmission or make necessary adjustments as deemed appropriate.

The commissioner must provide a reason for the above rejection or perform an alternative comparability analysis.

In our opinion, this provision will likely result in arbitrary rejection of benchmarking studies. Even though the Commissioner is required to provide reasons, our experience indicates that the revenue may rely on reasons that are not strong or provide very limited justification for rejection of benchmarking studies provided by taxpayers.

06. Intra Group Services

As stated above, the designated method to determine the arm's consideration for intra group services shall be the cost of performing the identified and rendered intra group services.

Where services are rendered jointly to various associates, and it is not possible to identify specific services provided to each entity, then allocation is to be on the basis of **reasonable allocation criteria.**

The allocation criteria shall be accepted provided it is measurable and relevant to the type of the service.

This provision indicates that indirect methods of allocation would be acceptable where services cannot be directly attributed to a specific entity (ies).

Challenges will remain in terms of the level of supporting documentation required to satisfy the revenue authority with regard to the benefits received from intra-group services.

07. Intra-Group Financing

There is a requirement to determine the arm's length interest rate for intra group financing irrespective of whether there is consideration for such financing.

08. Intangible properties

The Regulations recognise that an arm's length consideration for a transfer or licensing of intangible properties ("IP") should be charged by the seller / provider for the IP.

The regulations further require an arm's length remuneration for entities that are not owners of IPs but are involved in the development, enhancement, maintenance or protection of the IP.

The regulations state that when an intangible is transferred outside the United Republic, an appropriate compensation should be made and that it shall not attract royalty when licensed back for use in Tanzania.

This measure is in line with the BEPS actions on intangible assets. It involves identifying the entities in the group performing functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles (DEMPE) and allocating the returns based on functions performed.

09. Advance Pricing Agreements (APAs)

The regulations maintain the same five-year timeframe for envisaged APAs. In addition, there is a requirement to file annual compliance report for each income year covered in the APA on the date of filing the return of income.

The Commissioner may cancel an APA in case of 1) material failure to comply with fundamental terms of the agreement 2) material breach of one or more of the critical assumptions underlying the agreement 3) there is a change in the tax law that is materially relevant to the agreement and 4) the agreement was entered into based on misrepresentation, mistake or omission by the taxpayer.

10. Key Take aways

- There are now increased documentation requirements that taxpayers must take into account. Taxpayers whose transactions mandate compulsory filing must bear that in mind and start preparing the documentation in good time.
- Taxpayers in the commodity sector will need to revise the transfer pricing arrangements given the introduction of the sixth method that does not take into account the role of related parties in the supply chain.
- The narrower definition of the arm's length range may mean that many taxpayers may face adjustments (to the median) despite results falling within the inter-quartile range. This requirement diverges from the common OECD and UN Guidance on benchmarking
- The requirement to test interest rate irrespective of 'compensation' means that taxpayers will need to benchmark their interest-free loans as well.
- One would expect the TZS 10 Billion threshold to be stated in currency points, in line with the broader currency points usage adopted by the Tax Administration Act 2015.
- The severity of the penalties mean that taxpayers need to make sure that their documentation and benchmarking studies are up to scratch and defendable.

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