Transfer pricing full disclosure and transparency requirements – what is adequate?

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Regulation 6(1) of the Nigeria’s Income Tax (Transfer Pricing) Regulations No. 1 2012 (“TP Regulation”) places a mandatory obligation on taxpayers having related party transactions to “…record, in writing or on any other electronic device or medium, sufficient information or data with an analysis to verify that the pricing of controlled transactions is consistent with the arm’s length principle…”

Based on the Transfer Pricing (TP) guidelines of the Organization for Economic Co-operation and Development (“OECD”) adopted in the TP regulation, an affirmative proof of compliance with the arm’s length principle can only be made using any of the following acceptable TP methods:

i. Comparable Uncontrolled Price (“CUP”) method
ii. Resale Price Method (“RPM”) method
iii. Cost Plus Method (“CP”) method
iv. Transactional Net Margin Method (“TNMM”) method
v. Transactional Profit Split Method (“TPS”) method

The process of selecting and applying the TP methods requires extensive review of the various factors that affected the taxpayers’ pricing arrangement and the related party transactions under consideration. This includes business, operational, economic factors, etc. The process of carrying out this review and its results are required to be contained in the taxpayers’ TP documentation reports.

The degree of complexity of the information and analysis contained in the TP documentation report is expected to mirror the complexity and volume of the transactions being reviewed, and it is required to be adequate to enable Federal Inland Revenue (FIRS) verify the consistency of the transactions with the arm’s length principle.

Incidentally, the TP Regulation does not stipulate the minimum level and/or specific information and analysis that are required to be contained in the TP documentation reports for the adequacy test to be considered met by the taxpayer. Also, FIRS has not released any practice notes or guidelines on its expectations in this regard. Does this then imply some element of subjectivity?

FIRS has recently been requesting taxpayers to provide TP documentation reports that contain a long list of exhaustive information. The general view is that this approach by FIRS is grossly inadequate as the information which are being requested do not reflect the peculiar circumstances of the affected taxpayers and consequently, this leaves room for potential disputes between both parties. Furthermore, there is a major concern by taxpayers regarding the extent that FIRS would go in enforcing compliance with these long list of requirements in view of the related compliance costs and burdens on the taxpayers. Given that the TP regulation has not indicated a materiality threshold for related party transactions (and understandably so) that are to be included in TP documentation reports, taxpayers would be wondering if FIRS will require every related party transaction to be included in the TP Documentation, regardless of the amount.

While it is arguable that it may not be feasible or practicable to stipulate a one-size-fits-all set of requirements for taxpayers for preparing TP documentation, there is no doubt that FIRS needs to stipulate a minimum set of requirements or guidelines in order to reduce the incidence of potential disputes with taxpayers purely on documentation requests. Presenting the TP documentation report in a standardized format would also enable FIRS to cut to the chase without much stress by focusing on the crux of the matter.

The difficulty of prescribing adequate TP documentation requirements is not peculiar to the Nigerian TP rules. Several guidelines have been issued by various international organizations in order to overcome this challenge. These include:

i. TP Documentation Guidelines of the Organization for Economic Co-operation and Development
ii. TP Documentation Package of Pacific Association of Tax Administrators
iii. TP Documentation Model of the International Chamber of Commerce

There are several common themes that can be found in above documentation models. They all require information on the organizational structure and ownership linkages of the taxpayer and its group, its operating business environment, factors affecting its prices and income, its related party transactions, as well as the analysis that was performed in selecting the most appropriate TP method and how the selected TP method was applied.

It is necessary for taxpayers to always bear in mind that the whole essence of preparing TP documentation reports is to enable them to discharge the burden of proof that the TP Regulation laid on them. This involves proving that their related party transactions comply with the arm’s length principle. Thus, it is expected that taxpayers involved in related party transactions would ensure high level of transparency and completeness in their disclosure of information pertaining to such related party transactions.

The expectation is that as FIRS and taxpayers mature in the process of complying with the TP Regulations as well as testing of the compliance levels, FIRS reviews and audits, the currently unwieldy laundry list of documentary requests will become more refined, direct and specific.

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