TANZANIA REVENUE AUTHORITY

TRANSFER PRICING GUIDELINES

PREFACE

The Transfer pricing guideline (hereinafter referred to as the guidelines) has been drafted as a practical guide and is not intended to be a prescriptive or an exhaustive discussion of every transfer pricing issue that might arise. Each transfer pricing arrangement case will be decided on its own factors and circumstances, taking into account the taxpayers' business strategies and commercial judgment. These Guidelines will be periodically reviewed and revised on an ongoing basis.

Contents

1.0 INTRODUCTION

Transfer pricing of goods, services and intangible properties are intercompany pricing arrangements between associated parties in their transactions. When independent parties deal with each other, independent market forces shape the commercial pricing of goods, services and intangibles transacted between them. However, business transactions between associates may not always reflect the dynamics of market forces. These Transfer Pricing Guidelines (hereinafter referred to as the Guidelines) are largely based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines and the United Nations (UN) Practical Manual on Transfer Pricing for Developing Countries, (hereinafter referred to as OECD/UN Guidelines). TRA abides by this arm's length principle and believes that this is the most appropriate standard to determine transfer prices of related parties. Although some parts of the Guidelines have been adopted directly from the OECD /UN Guidelines, there may be areas which differ to ensure adherence to the Income Tax Act Cap.332 as well as domestic circumstances. In this regard, the Guidelines may be reviewed from time to time. Examples used in the Guidelines are for demonstrative purposes only. Thus, in dealing with actual cases, the facts and circumstances of each case must be considered before deciding on the applicability of any of the methods recommended in the Guidelines.

2.0 OBJECTIVE OF THE GUIDELINES

The objective of these guidelines is to provide taxpayers with guidance about the procedures to be followed in the determination of arm's length prices and provide consistency in administration of the Income Tax Act, Cap.332 and its regulations taking into consideration the Tanzania business environment. These guidelines are therefore expected to provide a general over view as well as a practical guidance on issues and factors to be considered in arriving at an acceptable arm's length price. These include among others:-

- The rationale for adoption of arm's length principle.
- The framework on which application of the acceptable transfer prancing method is based.
- The general principles of comparability which form the foundation of transfer pricing analysis.
- Documentation by taxpayers which should be prepared and maintained in support of their determination of the arm's length price.
- Treatment of intra group transactions.

- The underlying principle adopted in these guidelines has their basis on our own tax statutes and the OECD/UN guidelines.

3.0 SCOPE

3.1 The Guidelines are applicable on controlled transactions for the acquisition or supply of property or services between associated persons, where at least one person is assessable or chargeable to tax in the United Republic of Tanzania.

3.2 The guidelines are applicable to Taxpayers involved in domestic controlled transactions where the prices between associated parties are inconsistent with the arm's length standard.

3.3 The Guidelines shall also apply to transactions between persons who are both assessable and chargeable to tax in the United Republic of Tanzania.

3.4 The Guidelines are also applicable by analogy, in relation to transactions between a permanent establishment (PE) and its head office or other related branches. For the purpose of the Guidelines, the PE will be treated as a (hypothetically) distinct and separate enterprise from its head office or other related branches

4.0 DEFINITIONS AND TERMINOLOGIES

The words used in these guidelines shall have the following meanings:-
"**associate**" in relation to a person means another person where the relationship between the two is:-

(a) that of an individual and a relative of the individual, unless the Commissioner is satisfied that it is not reasonable to expect that either individual will act in accordance with the intentions of the other;

(b) that of partners in the same partnership, unless the Commissioner is satisfied that it is not reasonable to expect that either person will act in accordance with the intentions of the other;

(c) that of an entity and-

(i). a person who-

(aa) either alone or together with an associate or associates under another application of this definitions; and

(bb) whether directly or though one of more interposed entities, controls or may benefit from 50 percent or more of the nights to income or capital or voting power of the entity; or

(ii). Under another application of this definitions, is associate of a person to whom subparagraph (i) applies; or

(d). In any case not covered by paragraphs (a) to (c), such that one may reasonably be expected to act, other than as employee, in accordance with the intentions of the other;

"**arrangement**" includes an action, agreement, course of conduct, dealing, promise, transaction, understanding or undertaking whether express or implied, whether or not enforceable by legal proceedings and whether unilateral or involving more than one person;
"**trust**" means an arrangement under which a trustee holds assets but excludes a partnership and corporation;
"**trustee**"-

(a) means an individual or body corporate holding assets in a fiduciary capacity for the benefit of identifiable persons or for some object permitted by law and whether or not the assets are held alone or jointly with other persons or the individual or body corporate is appointed or constituted trustee by personal acts, by will be order or declaration of a court or by other operations of the law; and

(b) includes
  (i) any executor, administrator, tutor or curator;
  (ii) any liquidator, receiver, trustee in bankruptcy or judicial manager;
  (iii) any person having the administration or control of assets subject to a usufruct, *fideicommissum* or other limited interest;
  (iv) any person who manages the assets of an incapacitated individual; and
  (v) any person who manages assets under a private foundation or other similar arrangements.

"**Multinational Enterprise (MNE)"** refers to any commonly owned group with members in more than one country. The term "members" refer to constituted parts of that multinationals, each having a separate legal existence.
"**controlled foreign trust**" and "**controlled foreign corporation**" means a non-resident trust or corporation in which a resident person owns a membership interest, whether directly or indirectly through one or more interposed non-resident entities, and where-

(a) the person is associated with the trust or corporation; or
(b) there exist between one and four other resident persons which, if associated with the person, would cause the person to be associated with the trust or corporation;

"**controlled transactions**" transactions between two enterprises that are associated enterprises with respect to each other;
"**uncontrolled transactions**" transactions between enterprises that are independent with respect to each other.

5.0 POSITION OF THE LAW

5.1 The Income Tax Act, Cap.332

Section 33 of the Act is intended to counter transfer pricing practices which may have adverse tax implications for the Tanzania's fiscus. The measures to combat transfer pricing schemes are in essence contained in section 33 (1) which states that "in any arrangement between persons who are associates the persons shall quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have arisen for them if the arrangement had been conducted at arm's length".
Section 33 (2) empowers the Commissioner to make adjustments
Consistent where a person has failed to comply with the provisions of sub-section (1)

In so doing the Commissioner may:-

(a) Re- characterize the sources and type of any income, loss amount or payment; or
(b) Apportion and allocate expenditure including that referred to in section 71 (2) incurred by one person in conducting a business to the person and the associate based on the comparative turnover of the businesses. Here it should be noted that the Commissioner may either act on (a), (b) or both.

5.2 Income Tax Regulation, 2004.

Regulation 6 of the Income tax regulations, 2004 empowers the Commissioner to prepare transfer pricing guidelines.
Regulation 33 of the Income tax regulations 2004 empowers the Commissioner to enter into agreement with person as to the manner in which an arm's length price shall be determined.

6.0 THE ARM'S LENGTH PRINCIPLE

6.1 Meaning

The arm's length principle which is an internationally accepted and preferred basis for determining the transfer price of a transaction between associated persons, will be the basis adopted by the Tanzania Revenue Authority. According to the arm's length principle, a transfer price is acceptable if all transactions between associated parties are conducted at arm's length price. Arm's length price is the price which would have been

determined if such transactions were made between independent entities under the same or similar circumstances.

The arm's length principle is stated in paragraph 1 of Article 9 of the Organization for Economic Cooperation and Development (OECD) Transfer Pricing guidelines as follows:-

> *"(where) conditions are made or imposed between two (associated) enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those condition have not so accrued, may be included in the profits of that enterprise and taxed accordingly*".

6.2 Application

In essence, the application of the arm's length principle:

(i) treats associated persons not dealing at arm's length as if they operate as separate entities rather than as inseparable parts of a single unified business; and

(ii) is generally based on a comparison of:

a. prices, margins, division of profits or other indicators of controlled transactions; with

b. prices, margins, division of profits or other indicators of uncontrolled transactions.

7.0 DETERMINATION OF ARM'S LENGTH PRICE

The determination of an arm's length price involves the following steps:-

7.1 Analysis of transactions and functions

Functional analysis is an understanding of the related party transactions, business operations, functions performed, assets employed and risks assumed to determine the characterization of the taxpayer's business.

7.1.1 Details of functions performed, Risks Assumed and Assets Employed.

A functional analysis is a crucial process in determining an arm's length price as it forms the basis for identifying comparables. It involves the determination of how functions, assets (including intangible property) and risks in a business are divided up between parties involved in the transactions under review. Thus, a functional analysis serves three important purposes:

(i) to provide an overview of the organization and its business operations;

(ii) to identify the functions performed, risks assumed and assets employed by both the associated and independent persons, and
(iii) to assess important and economically significant functions, risks and assets undertaken by both the associated and independent persons.

(a) Functions Performed

Functions are activities performed by each person in business transactions such as procurement, marketing, distribution and sales. The principal functions performed by the associated person under examination should be identified first. Any increase in economically significant functions performed should be compensated by an increase in profitability of the person.

Usually, when various functions are performed by a group of independent persons, the party that provides the most effort and, more particularly, the rare or unique functions would earn the most profit. For example, a distributor performing additional marketing and advertising function is expected to have a higher return from the activity than if it did not undertake these functions.

It is thus relevant to consider the relative importance of each function in a functional analysis. The sheer number of functions performed by a particular member of a multinational group does not necessarily mean that it should derive the greater share of the profit. A party performing the most, or more, economically significant functions of the group's operations, albeit fewer functions relative to the other associated person, should be entitled to the greater share of the profit.

(b) Assets Employed

In comparing functions performed, it is also important to identify and consider the assets (tangible and intangible) that are employed, or are to be employed, in a transaction. This includes the analysis of the type of assets used (e.g. plant and equipment and valuable intangibles) and the nature of the assets used (e.g. the age, market value, location, and property right protections available).

i. **Tangible assets employed**

Tangible assets such as property, plant and equipment are usually expected to earn long-term returns that commensurate with the business risks assumed. Profitability of a company should rightfully increase with the increase in the amount, as well as the degree, of specificity of assets employed. Quantifying these amounts whenever possible helps to determine the level of risks borne and the level of profit a company should expect.

ii. **Intangible assets employed**

Intangible assets are also expected to generate returns for the owners by way of sales or licensing. It is thus essential to identify the parties to whom the returns generated are attributable.

(c) Risks Assumed

Evaluation of risks assumed is crucial in determining arm's length prices with the economic assumption that the higher the risks assumed, the higher the expected return. Controlled and uncontrolled transactions are not comparable if there are significant differences in the risks assumed, for which appropriate adjustments cannot be made.

(i) Types of risks include:

- Operational risk (including risks for manufacturing liability, systems failure, reliability of suppliers, inventory and carrying costs, environmental and other regulatory risks);

- Market risk (including industrial risks, country political risks, reliability of customers and fluctuation in demand and prices);

- Product risk (including product liability risk, warranty risk / costs and contract enforceability);

- Business risks related to ownership of assets or facilities;

- Financial risk (including currency, commodity, interest rate and funding risks);

- Credit and debt collection risks (including delay or default in payment of trade receivables, default on guaranties, loans and other receivables); and

- Risks of the success or failure of investments in research and development.

(ii) Allocation of risks

The allocation of risks between associated persons should be based on functions performed. A functional analysis helps identify important risks, as well as differentiate between the party which bears and controls the risks in the legal contractual terms and the party which bears the risks based on the economic substance of the transaction.

In an open market the assumption is that, an increased risk will be compensated by an increase in the expected return. However, this does not always mean that the actual return must necessarily also be higher, as it also depends on the degree to which the risk is actually realized.

(iii) Consistency of risk allocation with economic substance

Allocation of risks must also be consistent with the economic substance of a transaction. The best evidence, in determining whether a purported allocation of risks is consistent with the economic substance of a transaction, is in the parties' conduct.
An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in an arm's length transaction. In an arm's length dealing, it generally makes more commercial sense for one party to be allocated a greater share of those risks over which they have relatively more control and from which they can insulate themselves less costly than the other party.

7.2 Characterization of business

Characterization is an important element in the steps towards determining the arm's length price of a controlled transaction. The most common characterizations, based on the nature of activity as well as the complexity of the operations, are:

(i) Manufacturing: full-fledged, licensed, contract or toll;

(ii) Distribution: full-fledged, limited risk;

(iii) Service provider

7.3 Identification of comparable transactions

As part of the exercise of establishing an arm's length price, it is important to decide the level at which transactions are compared. The level of transaction is determined based on what is being used to compare, whether:

(i) To compare a single transaction (e.g. the sale price and terms of sale of particular product);
(ii) To compare a bundle of transactions;
(iii) To compare results at gross margin level;
(iv) To compare results at net margin level; or
(v) To compare results by reference to some other measures, such as return on capital, ratio of costs to gross margin, etc.

The most appropriate comparables should be selected in adherence to the five factors of comparability discussed in paragraph 10 below.

7.4 Tested Party

The determination of a controlled transactions leads to the determination of the tested party. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found. In the Tanzanian scenario, the TRA gives priority to the availability of sufficient and verifiable information on both tested party and comparables. As such, TRA does not accept foreign tested parties where information is neither sufficient nor verifiable.

7.5 Selection and application of Transfer Pricing Methodologies (TPM)

The Transfer Pricing Regulations have prescribed for specific methods to be used in arriving at the arm's length price as discussed in section 11 of the Guidelines.

7.6 Profit Level Indicator (PLI)

In applying the TPM, due consideration must also be given to the choice of PLI which measures the relationship between profits and sales, costs incurred or assets employed. The use of an appropriate PLI ensures greater accuracy in determining the arm's length price of a controlled transaction. PLI is presented in the form of a ratio i.e. financial ratios or return on capital employed. Just as in the selection of transfer pricing methods, the choice of an appropriate PLI depends on several factors, including:

(i) Characterization of the business;
(ii) Availability of reliable comparable data; and

(iii) The extent to which the PLI is likely to produce a reliable measure of arm's length profit.

Some of the more commonly used PLI include:

(i) Return on costs: cost plus margin and net cost plus margin.
(ii) Return on sales: gross margin and operating margin.
(iii) Return on capital employed: return on operating assets.

8.0 COMPARABILITY ANALYSIS

In applying the transfer pricing methods that conform to the arm's length principle, comparability analysis is an important pre-requisite. This involves comparing conditions in a controlled transaction with the condition in transactions between independent enterprises.

8.1 Controlled and Uncontrolled Transaction

Controlled transaction in a comparability analysis is the transaction that has been identified as the transaction where pricing may not be arm's length. An uncontrolled transaction may be:

(a) a transaction between the tested party and an independent party conducted under terms and circumstances similar to the controlled transaction (internal comparable); or
(b) a transaction between two independent parties under similar terms and circumstances (external comparable).

8.2 Factors of Comparability

Basically, there are five factors governing comparability of uncontrolled transaction against controlled. Uncontrolled transaction is deemed comparable with that of a controlled transaction if the following five factors are sufficiently similar in both situations:

(a) Characteristics of the property or services;
(b) Functions performed, assets employed and risks assumed by the respective persons;
(c) Contractual terms;
(d) Economic circumstances; and
(e) Business strategies.

8.3 Conditions of Comparability

For the purpose of comparability, the following conditions must be met where there are differences between an uncontrolled transaction and a controlled transaction:

(a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the margins in an open market; or

(b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

9.0 FACTORS DETERMINING COMPARABILITY

9.1 Characteristics of Property or Services

Characteristics similarity of a product or service is of essence when comparing prices rather than profit margins between controlled and uncontrolled transactions. Comparison of product or service characteristics is used to a greater extent in the application of the Comparable Uncontrolled Price (CUP) method than any other method. Characteristics that are compared should include:

(i) in the case of tangible property: the physical features, quality and the volume of supply of property;

(ii) in the provision of services: the nature and extent of services; and

(iii) in the case of intangible property: the form of transaction (e.g. licensing or sale); type of property (e.g. patent, trademark or know how); the duration and degree of protection; and the anticipated benefits from the use of property.

9.2 Details of functions performed, Risks Assumed and Assets Employed. (Refer paragraph 8.1.1 above for details)

9.3 Contractual terms

In determining the comparability of a controlled and uncontrolled transaction contractual terms are relevant as they may influence the price or margin of a transaction. Allocation of responsibilities, risks and benefits between enterprises are normally defined in a contract agreement. Any

differences between the contractual terms of the transactions being examined would need to be adjusted in determining an arm's length price for the controlled transaction. The terms and conditions in a contract may include:

(i) The form of consideration charged or paid;

(ii) Sales or purchase volume;

(iii) The scope and terms of warranties provided;

(iv) Rights to updates, revisions or modifications;

(v) The duration of relevant licenses, contracts or other agreements, and termination or renegotiation rights;

(vi) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(vii) Terms of credit and payment.

9.4 Economic Circumstances

Different economic circumstances may influence variations in arm's length prices. Factors that may affect the price or margin of a transaction include:

(i) The geographic location of the market;

(ii) The size of the market;

(iii) The extent of competition in the markets;

(iv) The level of supply and demand in the market as a whole and in particular regions;

(v) Customer purchasing power;

(vi) Cost of production including the costs of land, labour and capital, and transport costs;

(vii) The level of the market (e.g. retail or wholesale);

(viii) The date and time of transactions;

(ix) The availability of substitute goods and services; and

(x) The extent of government intervention e.g. whether goods compared are price controlled.

9.5 Business Strategies

Business strategies must also be observed in determining comparability for transfer pricing purpose. The strategies adopted by an enterprise influence the price charged for a product. In a comparability analysis, it is necessary to evaluate whether an independent person in the same circumstances as that of a controlled person would have adopted similar

strategies and if so, what rewards would have been expected. Business strategies that are relevant in determining comparability include innovation and new product development, degree of diversification, market penetration schemes, distribution channel selection, market level and location.

10.0 ACCEPTABLE METHODS OF DETERMINING AN ARM'S LENGTH PRICE

In determining arm's length transfer prices, there are several acceptable transfer pricing methods. All the acceptable methods attempt to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle.

Of the several acceptable transfer pricing methods, five are recommended by the OECD/UN and are adopted by many countries. From a practical point of view no one method is suitable in every possible situation and the applicability of any particular method depends on the facts and circumstances of the case, the mix of evidence available, and the relative reliability of other methods under consideration.

The following methods are recommended in determining the arm's length price:-

(a) The Comparable Uncontrolled Price (CUP) method
(b) The Resale Price Method (RP method)
(c) Cost Plus Method
(d) Transactional Net Margin Method (TNMM) method)
(e) The Profit Split Method

The first three methods are commonly known as "Traditional Transactional Methods". Although the taxpayer is given the right to choose any method, the emphasis should be on arriving at an arm's length price. It is advised that methods (d) and (e), commonly referred to as "Transactional Profit Methods", be used only when traditional transactional methods cannot be reliably applied or exceptionally cannot be applied at all. This will depend heavily on the availability of comparable data. The method that requires the fewest adjustments and provides the most reliable measure of an arm's length result is preferred by the TRA as this will reduce the scope and nature of future disputes. Therefore, in deciding the most appropriate method, the following must be considered:

(i) The nature of the controlled transaction, determined by conducting a functional analysis,

(ii) The degree of actual comparability when making comparisons with transactions between independent parties;

(iii) The completeness and accuracy of data in respect of the uncontrolled transaction;

(iv) The reliability of any assumptions made; and

(v) The degree to which the adjustments are affected if the data is inaccurate or the assumptions are incorrect.

Where both the Traditional Transactional Method and Transactional Profit Method cannot be applied at all, the Commissioner General may allow the application of other methods provided the prices arrived at is in accordance with the arm's length principle.

10.1 The Comparable Uncontrolled Price (CUP) Method.

The CUP method is the most direct way of ascertaining an arm's length price. It compares the price charged for a property or services transferred in a controlled transaction to the price charged for a property or services transferred in a comparable uncontrolled transaction, in comparable circumstances. A difference between the two prices may be an indication that the conditions of the commercial and financial relations of the associated persons are not arm's length, and that the price in the uncontrolled transaction may need to substitute for the price in the controlled transaction.
An MNE using the CUP method to determine its transfer price must first identify all the differences between its product and that of an independent person. The MNE must then determine whether these differences have a material effect on the price, and adjust the price of products sold by the independent person to reflect these differences to arrive at an arm's length price.

Example
A Tanzania enterprise "A", manufactures crocodile leather shoes and travel bags. The shoes are sold to a French subsidiary "B" which sells the shoes to unconnected exclusive boutiques. The credit terms to "B" are 90 days. Also sells the shoes to two independent distributors "C" and "D" in France. The credit terms to the independent parties are 30 days. "C" sells the shoes directly to end-users and "D" sells the shoes to expensive shoes shops in Oxford and Bond Street in London. "A" also sells the travel bags to an independent distributor in France.

Possible application of CUP
The travel bags sold to the independent distributor in France will not constitute a CUP because the product is not similar to shoes and the price is not comparable. The shoes sold to "C" would also not quality as a CUP because the level of the market is different. "B" is at a higher level in the distribution chain than C and it is unlikely to be possible to quantify this difference and make reliable adjustments. The shoes sold to "D" may be a valid CUP if the Paris and London markets are comparable. It will however, be necessary to adjust the price for the difference in credit terms.

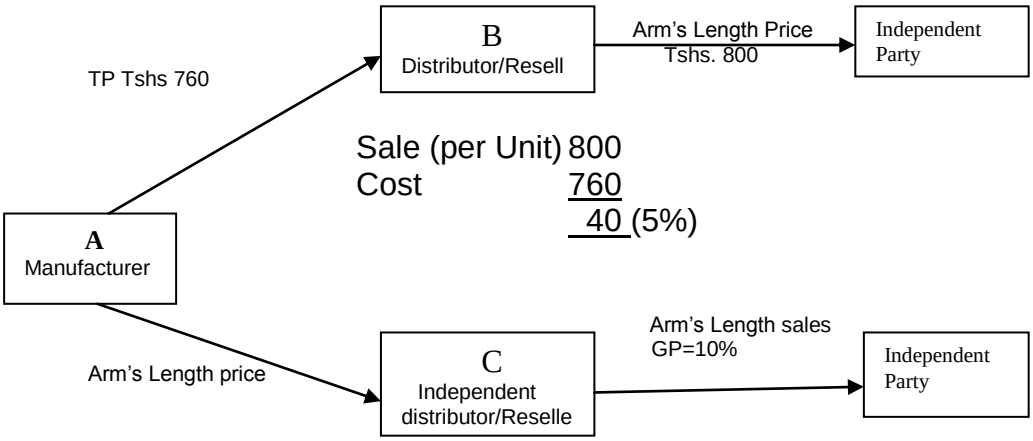
10.2 Resale Price Method (RPM)

The Resale Price Method generally is most appropriate where the final transaction is made to an independent distributor. The starting point in the resale price method is the price at which a product that has been purchased from an associated enterprise is then resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing an amount from which the reseller would seek to cover its selling and other operating expenses and in the light of functions performed (taking into account assets used and risks assumed), make an appropriate profit between associated enterprises is obtained after subtracting that gross margin, and adjusting for other costs associated with the purchase of the product (e.g. custom duties). A typical adjustment may be represented as follows:

Arm's Length Price = Resale price-(Resale price x Resale Price Margin)
Where:
* Resale Price Margin = $\frac{\text{Sales price-Purchase Price}}{\text{Sales Price}}$

** Resale price margin must be comparable to margins earned by other independent enterprises performing similar functions, bearing similar risks and employing similar assets.

Example
Taxpayer **B, a distributor,** is a Tanzanian subsidiary of multinational **A**, which is located overseas. **B** distributes high quality product manufactured by **A**. **A** also sells similar product of a lower quality to an independent distributor **C** in Tanzania. The cost of product purchased from **A** by **B** is Tshs.760 per unit. **B** resells the product to independent party for Tshs.800. A functional analysis shows that B and C perform similar functions. The gross profit ratio of **C** was found to be 10%.



In this example, it is noted that there are product (quality) differences when comparing the controlled and uncontrolled transactions. However, since the focus of comparison is on margins the differences are not as material as they would have been if the basis of comparison were on prices. Furthermore, **B** and **C** carry out similar functions (**C** being another reseller in the same market), thus the resale price margin of 10% will be used as a basis to determine the arm's length price for the original purchase by **B** from **A**.
Arm's length price of product purchased (in Tshs) = 800 – (800 X 10%)
= Tshs. **720**

10.3 The Cost Plus Method

The cost plus method requires estimation of an arm's length consideration, by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark-up should provide for an appropriate profit to the supplier, in the light of the functions performed, assets used and risks assumed. This method is best suited to situations where:

(a) Services are provided
(b) Semi-finished goods are sold between related parties,
(c) Related persons have concluded joint facility agreements or long-term buy-supply arrangements

The mark-up should ideally be determined with reference to the mark-up earned by the same supplier in uncontrolled transactions. If this is not possible, the mark-up should be determined by using the mark-up earned in comparable transactions by an independent supplier performing comparable functions, bearing similar risks and employing similar assets to those of the taxpayer.

An uncontrolled transaction is comparable to a controlled transaction for purposes of the costs plus method if one of two conditions is met.

(i) none of the difference between the transaction being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market: or
(ii) reasonably accurate adjustment can be made to eliminate the material effects of such differences.

Fewer adjustments are needed for product comparability than under the CUP and the same comparability principles as discussed under the resale price method will apply to the cost plus method.

Example
B, a Tanzania holding company, is responsible for the development of all the software to be used by its subsidiaries in Namibia and Botswana. It was clear from the beginning that there was a market for this kind of services in Africa. **B** also provides these services to other customers throughout Africa. The software and hardware required by each customer are unique and differ from the software developed and hardware supplied to the subsidiaries, but the functions and processes to provide these services are comparable. An analysis of the income and costs in respect of the services provided to the independent customers indicates that costs are recovered and gross profit of between 22 and 25 per cent is achieved. **B** should therefore charge its subsidiaries at cost plus between 22 and 25 per cent for the performance of the information technology function.

10.4 Transactional Net Margin method (TNMM)
The TNMM examines the net profit margin that a taxpayer realized from a controlled transaction relative to an appropriate base, for example cost, sales or assets. This ration is referred to as a profit level indicator. The profit level indicator of the tested party is compared to the profit level indicator(s) of comparable independent parties.

Although the TNMM is classified as a transactional profit method, it is more closely aligned to the CP and RP method than to the profit split method. TNMM focuses on the functions performed by an enterprise in the same way as the Cost Plus and Resale Plus methods do. However the difference is that the TNMM compares net profit rather than gross profit. The TNMM is, however, considered less reliable than the traditional transaction methods.

This is because the net margins which are used in the TNMM are very sensitive to the relative cost structures of the entities being compared, as they include operating efficient distributorship than the independent firm, the application of the TNMM would result in a lower net profit being determined for the distributorship than if the RP method were used. Thus,

unless an adjustment could be made to reflect the relative efficiency of the firms being compared, use of the TNMM would not provide reliable result.

In order to maximize the reliability of the TNMM, the member of the multinational and the independent firm being compared would need to be structurally similar. In practice, firms are structurally unique and comparisons of indicators between firms will tend to be less reliable than comparisons made at the gross margin level. For these reasons the TNMM along with the profit split method are considered to be methods of last resort in international practice.

This observation does not preclude the TNMM from being used. It must be recognized that reliable information on gross margins may be difficult, if not impossible to obtain. Thus information constraints may dictate the TNMM as the only practical approach in many cases.

The related party (Tested party) whose profit level will be compared to the profit level of the independent parties will usually be the party for which reliable data on the most closely comparable transactions can be identified. It is usually the enterprise that is the least complex and that does not own valuable intangible property.

Example
CCP is a manufacturer of dehydrated food. Its products are distributed to its subsidiaries through Europe. CCP does not sell to independent distributors at all and no comparables could be located that would allow the application of the CUP, cost plus or resale price methods. The only remaining method is thus the TNMM

Research on comparable independent companies resulted in the determination of an arm's length range of 15 to 18 per cent. This percentage is determined by expressing operating profit as a percentage of the turnover. After adjustments were made for differences between CCP and the comparable independent companies in respect of stock holding and debtor's days outstanding, the range of arm's length margins is 17.5 to 19 per cent.
The transfer price for the sale of the dehydrated food from CCP to its subsidiaries should thus be set at a level that will result in operating profit as a percentage of turnovers of between 17.5 and 19 per cent.

10.5 The Profit Split Method
The profit spilt method is usually applied where transactions are so integrated that they cannot be evaluated separately. Under similar circumstances, independent enterprises may decide to set up a form of partnership and agree to some form of profit spilt.

The first step in the profit spilt method is to identify the combined profit to be split between the associated parties in a controlled transaction. In

general combined operating profit is used, ensuring that both income and expenses of the multinational are attributed to the relevant associated person consistently.

That profit is then split between the parties according to an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Two alternative approaches to the profit spilt method are as outlined below:

(a) Residual Profit Split Approach
(b) Contribution Analysis Approach

Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction. The combined profit is then allocated as follows:-

(i) Under the residual profit split approach, each of the parties to the transaction is assigned a portion of profit according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.
(ii) Under the contribution analysis approach, it is generally the combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party's combined gross profit.

However, these approaches are not necessary exhaustive or mutually exclusive. There may be other alternative ways to split a profit to achieve a reliable arm's length result.

In some circumstance, it may be appropriate to split gross profits (as opposed to operating profits) between the associated parties and then deduct the operating expenses incurred by or attributable to each relevant enterprise. An example is a multinational engaged in highly, integrated word-wide trading operations involving various types of property. It may be possible to determine the enterprises in which expenses are incurred or attributed, but not to accurately determine the particular trading activities to which those expenses relate. In such case it may be appropriate to spilt the gross profit from each trading activity and then deduct from the resulting overall gross profit the operating expenses incurred by or attributable to each enterprise.

The allocation of gross profit should be consistent with the location of activities and risks. Care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the activities performed and risk assumed by the relevant entities.

10.5.1 Residual Profit Spilt Analysis

The residual profit split approach first provides both the parties to the transaction with a basic return, based on what independent firm would obtain for performing similar functions and undertaking similar risks. Applying other transfer pricing methods, such as a cost plus method or a resale price method, could also achieve this.

The residual profit remaining after the first stage division would be allocated among the parties, in accordance with the way in which this residual would have been divided between independent enterprises. Facts and circumstances that could influence the profit allocation in the second stage include the parties' contributions of intangible property and relative bargaining positions.

This requires a judgment about what factors contribute to the residual profit, and their relative contribution. For example, it may be determined that the process development and the marketing are the only relevant contributors to the residual profit and that each contributes 50 per cent to that profit. A 50-50 split of the residual profit between the manufacturer and the retailer would then be justified.

10.5.2 Contribution Analysis Approach

Under this approach, combined profits would be divided between associated persons based on the relative value of functions (i.e. contribution) performed by each of the associated persons participating in a controlled transaction. To determine the relative value of contribution, it may be necessary to focus on the nature and degree of each party's contribution of differing types (e.g. provision of services, capital invested) and assign a percentage based on the relative comparison and external market data.

Unlike the residual approach, basic returns are not allocated to each party to the transaction before the profit split is made. Generally, the profit to be combined and divided is the operating profit. Where allocation of expenses to controlled transactions is impossible, a split of gross profits may be considered, after which expenses attributable to the relevant enterprises will be deducted accordingly.

However, it is difficult to determine the relative value of contribution that each of the participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. Thus, the approach requires careful judgment and the criteria should always include what adds value to the transaction and how economically important were the functions carried out by each party in earning the profits.

The division of combined profits under the transactional profit split method is achievable by the use of allocation keys. The choice of allocation keys by which profits are split largely depends on the facts and circumstances

that surround a case. An allocation key can be in the form of a figure (e.g. a percentage) or a variable (e.g. specific expenses). Some of the more common types of allocation keys are:

Asset-based: useful where the controlled transaction demonstrates strong correlation between assets and the creation of value;

(a) Cost-based: where there is clear indication of correlation between cost and value created;
(b) Time spent by employees performing intra-group services;
(c) Units produced or sold;
(d) Number of employees;
(e) Space used.

11.0 PRACTICAL APPLICATION OF ARM'S LENGTH PRINCIPLE

11.1 Application of the Law

The arm's length principle is provided for under section 33 of the Tanzania Income Tax Act, Cap.332, which provides:-
"In any arrangement between persons who are associates, the persons shall quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have arisen for them if the arrangement had been conducted at arm's length". Under this provision, the associate is required to do the following:-

(a) Quantify
(b) Apportion
(c) Allocate amounts to be included or deducted in calculating income between the people as is necessary to reflect the total income or Tax payable that would have arisen further if the arrangement had been conducted at arm's length.

Under section 33 (2) of the Act, the Commissioner is empowered to adjust transfer prices where the transactions are not at arm's length.

The Commissioner in applying the provisions of section 33 of the Income Tax Act Cap.332, and regulation 33 of the Income Tax regulations may enter into agreement with a person as to the manner in which an arm's length price should be determined. Failure to abide with the requirement of the agreement gives grounds for the Commissioner to determine the income and allowable deductions by considering the prices and consideration that independent parties would have used in comparable transactions with legal entities residing in Tanzania or abroad.

11.2 Issues to consider in Transfer pricing Adjustment

In making comparability analysis for transfer pricing adjustment, the commissioner may consider the following:

(a) **Comparable Period**

It is an obligation of every taxpayer to determine his transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time of the determination. Therefore, the arm's length price should be determined by comparing the results of a controlled transaction with the results of uncontrolled transactions that were undertaken or carried out during the same year as the year of the taxpayer's controlled transaction.

Such requirement is made based on the fact that arm's length principle must be complied with contemporaneously, on a year by year basis. A contemporaneous uncontrolled transaction should provide the most reliable comparable as it is carried out in an economic environment that is the same as or similar to the economic environment of the taxpayer's controlled transaction.

There may be cases where data in a particular financial year does not provide the most reliable comparison, depending on the industry concerned and the circumstances of the case. For instance, if a tested party's accounting period ends at 31 March, data from a company in the same industry with a financial year end at 31 December is considered a better comparable to another company with financial year end at 31 December. This is because the economic environment for the company with year ending 31 December would be more relevant to that of the tested party.

(b) **Multiple Year Data**

Multiple year data is analyzed in order to identify whether the outcome of a particular year is influenced by abnormal factors. However, the use of multiple year data does not imply the use of multiple year average.

For the purpose of gaining a complete understanding of the facts and circumstances surrounding a controlled transaction, it is useful to examine data from both the years after the year under examination and prior years. The use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, a result of a particular economic condition in a prior year that caused an increase in cost in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle.

(c) **Arm's Length Range**

An arm's length range refers to a range of figures that are acceptable in establishing the arm's length nature of a controlled transaction. The range

is derived from applying the same transfer pricing method to multiple comparable data. It is established that transfer pricing is not an exact science, and that the application of the most appropriate transfer pricing methodology may produce a range of results. The facts and circumstances of a case are therefore important in determining a range, or the point in a range, that is the most reliable estimate of an arm's length price or allocation.

The arm's length range should be made using only comparable uncontrolled transactions that have, or have been adjusted to, a high level of reliability in comparison to the controlled transactions. A substantial deviation among points or between the data in the range (e.g. upper quartile and lower quartile) may indicate that comparables used are not reliable, and that material differences exist in terms of Functions performed, Assets employed and Risks assumed (FAR) which warrant comparability adjustments. In such cases, the reliability of comparable data must be carefully assessed, and adjustments made for the material differences in comparability analysis and the methodology should be reviewed.

If every effort has been made to exclude data that have a lesser degree of comparability, but some comparability defects remain and cannot be adjusted, it may be appropriate to make transfer pricing adjustments to a value that best reflects the facts and circumstances of transactions between associated persons. This value may be derived from utilising statistical tools depending on the specific characteristic of the data set.

(d) **Separate and Combined Transactions**

The arm's length principle should preferably be applied on a transaction-by-transaction basis, in order to obtain the most precise approximation of an arm's length price or profit allocation. However, depending on the circumstances of the case, transfer pricing may sometimes need to be dealt with at the level of a product line or business unit rather than at the level of each particular transaction.

When establishing transfer prices, taxpayers should set prices separately for each transaction they enter into with an associated person. However, where transactions are so closely linked (or continuous) that they cannot be evaluated adequately on a separate basis, determination of transfer price based on bundled transactions may be considered, provided it can be demonstrated that it is the normal industry practice to set one price for a combination of transactions (e.g. goods and the associated intangible property) or where it may not be reasonable to expect to find quality data available to set the price for separate transactions. Lack of reliable data on comparable transactions may be due to the complexity of the dealings or the relationships between the parties. Therefore, the total amount may be on an aggregate basis.

(e) **Re-Characterization of Transactions**

Controlled transaction ordinarily should be examined based on the transaction actually undertaken by the taxpayer insofar as are consistent with the methods described in the Guidelines. However, when reviewing an agreement between associated persons, consideration is not only on the terms of the agreement but also the actual conduct of the parties.

The Commissioner in determining an arm's length price may disregard and re-characterize a controlled transaction under the following circumstances:

(i) where the economic substance of a transaction differs from its form; or

(ii) where the form and substance of a transaction are the same; the arrangements made in relation to the transaction, when viewed in their totality, differ from those which would have been adopted by independent persons behaving in commercially rational manner and this actual structure practically impedes the Commissioner from determining an appropriate transfer price.

The rationale towards re-characterizing a transaction is based on the character of the transaction derived from the relationship between the parties, and is not determined by normal commercial conditions. The controlled transaction may have been structured by the taxpayer to avoid or minimize tax. This is supported by the fact that: -

- associated persons are able to enter into a greater variety of contracts and agreements compared to independent persons because the normal conflict of interest which exist between independent parties is often absent;
- associated persons often conclude arrangements of a specific nature that are not, or very rarely, encountered between independent persons; and
- contracts under a controlled transaction are quite easily altered, suspended, extended, or terminated according to the overall strategies of the multinational group as a whole and such alteration may even be made retroactively.

Example

An investment in an associated enterprise in the form of interest-bearing debt would not be expected to be structured in the same way had it been conducted at arm's length, given the economic circumstances of the borrowing company. In this case, it might be appropriate for a tax administration to characterize the investment in accordance with its economic substance where the loan may be treated as subscription of capital.

Example

A sale under a long term contract, for a lump sum payment, gives unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract. While it may be proper to respect the transaction as a transfer of commercial property it would nevertheless be appropriate for the Commissioner to confirm the terms of that transfer in its entirety to that which might reasonably have been

expected between independent persons. Thus, in the case described above, it might be appropriate for the Commissioner, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.

(f) **Transfer Pricing Adjustment**

The Commissioner may make an adjustment to reflect the arm's length price or interest rate for that transaction by substituting or imputing the price, or interest where he found that a price in a controlled transaction is not at arm's length, as the case may be. In such instances, the adjustment will also be reflected by a corresponding adjustment upon request of the other party of the controlled transaction. Adjustments will be made where:

(i) For the supply of property or services, the consideration is less than the consideration that would have been received or receivable in an arm's length arrangement;

(ii) For the acquisition of property or services, the consideration is more than the consideration that would have been given or agreed to be given in an arm's length arrangement; or

(iii) No consideration has been charged to the associated person for the supply of property or services.

(g) **Losses**

Losses incurred by enterprises for a variety of economic and business reasons such as start up losses, market penetration strategies, and research and development failure. However, an independent enterprise would not endure continuous losses without taking appropriate measures to correct the situation within reasonable time, as it would contradict fundamental business objectives of making profits. The fact that an associated enterprise continuously suffers losses may be an indication that it is not being compensated fairly or it is paying excess amounts for goods and services to associated parties.

It is important to ensure that the controlled transaction entered into is commercially realistic and make economic sense in determining whether the losses are acceptable. A taxpayer needs also to establish that the losses are commercial in nature within the context of its characterization. In this regard, a taxpayer is expected to maintain contemporaneous documentation which outlines the non-transfer pricing factors that have contributed to the losses.

A contract or toll manufacturer that only carries out production as ordered by a related party, without performing functions such as operational strategy setting, product research and development and sales, is expected to maintain a consistent level of profitability. Should the manufacturer suffer from losses, it must prove that these losses are not a result of its transactions with a related party.

11.3 Tax Treaties

Countries have a number of bilateral tax treaties with other countries that address, *inter-alia*, transfer pricing issues. One reason for signing such treaties is to eliminate the double taxation and fiscal evasion that often results from the allocation of tax revenues from international transactions. Section 128 (1) of the Income Tax Act, Cap.332 recognizes such international agreements and that they supersede domestic law with the exception of conditions stated under subsection 5 and sub division B of Division II part III of the Act.

If a transfer pricing adjustment has been made by a foreign tax administration that results in double taxation, a taxpayer may request competent authority consideration under the Mutual Agreement Procedure Article in Tanzania's tax treaties. This could result in a corresponding adjustment being allowed in Tanzania or the Tanzania competent Authority taking up the issue of appropriate arm's length pricing with the foreign administration.

11.4 Documentation requirements

As a general rule, the taxpayer is required to keep sufficient records as provided for under Section 80 of the Income Tax Act, Cap.332 to enable the Commissioner to ascertain income or loss from the business. Details of documentation for the purpose of Transfer pricing are explained under paragraph 13.

12.0 DOCUMENTATION

12.1 Legislation

Sections 80, 139 and 140 of the Income Tax Act, Cap.332 deal with the information and documents required to be kept by a taxpayer and the access the Commissioner has to such information and documents, as well as the documentation required to explain information to be provided in a tax return or any other document to be filed with the Commissioner. These provisions are also applicable to transfer pricing documentation requirements.

12.2 Documentation Requirements

All records as well as recorded details from which the taxpayer's tax returns were prepared, are to be retained for a period of five years from the end of the year of income or years of income to which they are relevant unless the Commissioner otherwise specifies by notice in writing.

Section 139 empowers the Commissioner, for the purpose of obtaining full information in respect of the income of a taxpayer or any part thereof, to require the taxpayer or any other person to produce for examination at such time and place as may be determined by the Commissioner.

Documents pertaining to transfer pricing are not to be submitted at the time of filing income tax returns but should be made available to the Commissioner upon request.

The Commissioner may, by service of a notice in writing require a person; whether or not liable for tax under the Act to retain documents described with reasonable certainty in the notice for such period as may be specified in the notice.

12.3 Maintaining Records

Section 80 requires that, unless otherwise authorized by the Commissioner in writing, every taxpayer shall maintain tax documents in the United Republic of Tanzania and in an official language of the United Republic of Tanzania. The official languages of Tanzania are English and Kiswahili.

Where the documents are not in an official language of the United Republic of Tanzania, the Commissioner may require the person to have these documents translated by a translator approved by the Commissioner.

An analysis under the arm's length principle generally requires information about the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed, the risks borne, the assets employed and information derived from independent enterprises engaged in similar transactions or business.

Additional information could include the nature and terms of the transaction, economic conditions and property involved in the transactions, how the product or service that is the subject of the controlled transaction in question flows among associates and changes in trading conditions or renegotiations of existing arrangements.

12.4 List of Documentation

A transfer pricing documentation may consist of the following:

(a) **Organizational Structure**

(i) Taxpayer's worldwide organizational and ownership structure (including global organization chart and significant changes in the relationship, if any), covering all associated persons whose transactions directly or indirectly affect the pricing of the documented transactions.

(ii) Company organization chart.

(b) **Group financial report**

Transfer pricing documentation should include the group financial report, equivalent to an annual report, for the most recent accounting period where transaction with related parties apply.

(c) **Nature of the business/industry and market conditions**

(i) Outline of the taxpayer's business including relevant recent history, the industries operated in, analysis of the general economic and legal issues affecting the business and industry, the taxpayer's business lines and the property or services in the controlled transactions;

(ii) The corporate business plans to the extent of providing an insight into the nature and purpose of the relevant transactions between the associated persons;

(iii) A description of the structure, intensity and dynamics of the relevant competitive environment(s).

(d) **Controlled transactions**

(i) Description of details of the property or services to which the international/domestic transaction relates; any intangible rights or property attached thereto, the participants, the scope, timing, frequency, type and value of the controlled transactions (including all relevant related party dealings in relevant geographic markets);

(ii) Names and addresses of all associated persons, with details of the relationship with each such associated person;

(iii) The nature, terms (including prices) and conditions of international transactions (where applicable) entered into with each associated person and the quantum and value of each transaction;

(iv) An overview description of the business, as well as a functional analysis of all associated persons with whom the taxpayer has transacted;

(v) All commercial agreements setting forth the terms and conditions of transactions with associated persons as well as with third parties;

(vi) A record of any forecasts, budgets or any other financial estimates prepared by the person for the business as a whole and for each division or product separately.

(e) **Pricing policies**

(f) **Assumption, strategies and information regarding factors that influenced the setting of pricing policies**

(i) Relevant information regarding business strategies and special circumstances at issue, for example, intentional set-off transactions, market share strategies, distribution channel selection and management strategies that influenced the determination of transfer prices;

(ii) Assumptions and information regarding factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the related party group as a whole;

(iii) Documentation to support material factors that could affect prices or profits in arm's length dealings.

(g) **Comparability, functional and risk analysis**

(i) A description of the characteristics of the property or service transferred, functions performed, assets employed, risks assumed, terms and conditions of the contract, business strategies pursued, economic circumstances and any other special circumstances.

(ii) Information on functions performed (taking into account assets used and risks assumed) of the related party involved in the controlled transaction as well as a description of FAR of group of companies to the extent that they affect or are affected by the controlled transactions carried out by the taxpayer.

(iii) Details of comparables, as mentioned in paragraph 9 including for tangible property: its physical features, quality and availability; for services: the nature and extent of the services; and for intangible property: the form of the transaction, the type of intangible, the rights to use the intangible that are assigned and the anticipated benefits from its use.

(iv) The data collected and the analysis performed to evaluate comparability of uncontrolled transactions with the relevant controlled transactions.

(v) Criteria used in the selection of comparables including database screens and economic considerations.

(vi) Identification of any internal comparables.

(vii) Adjustments (details and reasons for those adjustments) made to the comparables.

(viii) Aggregation analysis (grouping of transactions for comparability) where paragraph 12.2 (d) applies.

(h) **Selection of the transfer pricing method**

(i) Description of data and method considered, the analysis performed to determine the arm's length price and the rationale for the selection of this methodology including reasons for its use in preference to other transfer pricing methodologies.

(ii) Documentation of the process involved in the selection of particular methodologies.

(i) **Application of the transfer pricing method**

(i) Documentation of assumptions and judgments made in the course of determining an arm's length outcome (refer to the Comparability, Functional and Risk analysis section above);

(ii) Documentation of all calculations made in applying the selected method, and of any adjustment factors, in respect of both the tested party and the comparable;

(iii) Appropriate updates of prior year documentation relied upon in the current year to reflect adjustments for any material changes in the relevant facts and circumstances.

(j) A list of advance pricing arrangements entered into by members of the group with respect to transactions to which the taxpayer is a party.

(k) Documents that provide the foundation for or otherwise support, or were referred to, in the development of the transfer pricing analysis.

(l) Taxpayers should keep readily available documents and information that were used in preparing the transfer pricing documentation as they are necessary to support the transfer pricing analysis. This may include:

(i) Official publications, reports, studies and databases;

(ii) Reports of market research studies carried out by recognized institutions;
(iii) Technical publications brought out by recognized institutions;
(iv) Agreements and contracts entered into with associated persons or with unrelated persons, which may be of relevance to the international transactions;
(v) Letters and other correspondence documenting any terms negotiated between the person and the associated person;
(vi) Supporting documents for the economically significant activities and functions undertaken by the taxpayer. For example, where skilled and experience staff constitutes human resource assets for the taxpayer, documentation pertaining to these staff which may be relevant here include:

- Details of experience;
- Educational qualifications;
- Areas of particular expertise;
- Job description and duties;
- Remuneration;
- Written statements provided by key staff and used by taxpayer in determining the functions, risks and asset of the company;

(vii) Other relevant documents.

12.5 Acceptability of Documentation

To ensure the acceptability of the contemporaneous transfer pricing documentation, reasonable efforts should be given to:

(a) Undertake a transfer pricing analysis to ascertain that transfer prices comply with the arm's length principle and reflect commercially realistic outcomes for all controlled transactions.
(b) Maintain documents that are applicable to the circumstances and be prepared to provide additional information or documentation not contained above, but which may be relevant for the determination of the arm's length price.
(c) Prepare the documentation in accordance to the Rules and The Guidelines.
(d) Implement and review the arm's length transfer pricing policies and redesign the transfer pricing policy to accommodate any changes in the business environment.
(e) Prevent from providing vague, useless or inadequately founded information.
(f) Apply a coherent and transparent approach in identifying uncontrolled transactions.
(g) Provide detailed analysis of functions, assets, risks, market conditions and business strategies.
(h) Apply a transfer pricing method in accordance to the Rules.
(i) Ensure that the factual, economic and empirical representations in transfer pricing documentation are specifically relating to company, product and market.

(j) Ensure that the transfer pricing documentation is accurate and precise, and matches the accounting, financial and benchmarked data/comparables.
(k) Highlight and document any specific event that may have hindered the MNE's performance so that appropriate fact-based adjustments can be considered.
(l) Maintain adequate background documents and full records containing particulars about the factual assumptions and relevant factors that have been taken into account in working out the arm's length price.
(m) Avoid documentation which is not properly supporting the transactions, limited, and incomplete.

13.0 SPECIAL CONSIDERATION FOR INTANGIBLE PROPERTY

13.1 Intangible Properties

These are unique products valued for their intellectual or intangible contents which can be legally or not legally protected. Categorization of these properties can be made into two broad types:

(a) Trade intangibles such as patents created through risky and costly research and development know-how, designs and models that are used in producing a product or in providing a service; and

(b) Marketing intangibles i.e. trademarks and trade name that are used in the exploitation of the products, customer lists, distribution channel and so forth.

13.2 Existence of Intangible Properties

It is essential to first determine the existence of the property when considering the issue of intangible properties, i.e. by looking into the benefit derived from the intangible. When a company demonstrates a higher than average rate of return on assets or higher than average profits for a given level of physical assets over a period of time, it indicates the likely presence of intangibles. Intangible for the purpose of these guidelines is intended to address something which is not a physical asset or a financial asset and which is capable of being owned or controlled for use in commercial activities. Intangibles that are important to consider for transfer pricing purposes are not always recognized as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalized for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may carry significant economic value and may need to be considered for transfer pricing purposes.

Basically, the arm's length principle applies to intangible property in the same way as for any other type of property, however, the treatment of intangible property can be one of the most difficult areas to apply correctly in transfer pricing practice, due to the fact that the transaction may represent a number of components, both tangible and intangible, bundled together to form a single product. The property may have a special character complicating the search for comparable and also due to the fact that MNE may, for entirely commercial reasons, structure their transaction in a way that would not be adopted by independent firms.

In applying the arm's length principle to controlled transactions involving intangible property, some special factors relevant to comparability between the controlled and uncontrolled transaction should be considered. These factors include;

(a) The expected benefits from the intangible property (possibly determined through a net present value calculator);
(b) Any limitations on the geographic area in which rights may be exercised;
(c) Export restrictions on goods produced by virtue of any rights transferred;
(d) the exclusive or non-exclusive character of any rights transferred;
(e) the capital investment (to construct new plants or to buy special machines);
(f) The start – up expenses and the development work required in the market;
(g) The possibility of sub-licensing the licensee's distribution network and whether the license has the right to participate in further developments of the property by the licensor.

The Commissioner therefore considers the guidance provided in chapter VI of the OECD Guidelines which deals specifically with intangible property highly relevant and recommends that taxpayers and officers follow the guidance provided therein in establishing arm's length conditions in agreements with associates involving intangible property.

14.0 SPECIAL CONSIDERATIONS FOR INTRA GROUP SERVICES

MNE groups arrange for a wide scope of services to be available to its members, in particular administrative, technical and commercial services. Such services may include management, coordination and control functions for the whole group. The cost of providing such services may be borne initially by the parent, by a specially designated group member ("a group services center" or by another group member.

The main issues in the analysis of transfer pricing for intra-group services are:

(a) Whether intra – group services have in fact been provided
(b) Whether the intra-group charge for such services for tax purposes are at arm's length prices.

The following factors should serve as a guide in determining whether services have been rendered:

(i) Whether the activity provides a respective group member with economic or commercial value to enhance its commercial position and whether an independent enterprise in comparable circumstances would be willing to pay or perform in-house for its services

(ii) If the activity is not one for which the independent would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra – group services under the arm's length principle

(iii) In general, no intra – group services should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself; or that is being performed for such other group member by a third party

(iv) An associated enterprise should not be considered to receive an intra – group services when it obtains incidental attributable solely to its being part of a large concern, and not to any specific activity being performed.

(v) Passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit – making potential of particular members of the group. Each case must be determined according to its own facts and circumstances

(vi) The method to be used to determine arm's length transfer pricing for intra – group services should be determined according to these guidelines, often, the application of these guidelines will lead to use of the CUP or Cost Plus Method for pricing intra – group services.

15.0 INTRA GROUP FINANCING

15.1 Financial assistance between associated persons

Among the services between associated persons is intra-group financing. This may be in the form of financial assistance for business purposes that includes loans, interest bearing trade credits, advance or debt and the provision of any security or guarantee. The financial assistance arrangements between associated persons can arise from the following situations:

(a) Where a taxpayer, directly or indirectly, acquires from or supplies to an associated person financial assistance for a consideration; or

(b) Where a taxpayer supplies financial assistance directly or indirectly to an associated person without consideration.

In both situations, the taxpayer should charge or pay the associated person interest at a rate which is consistent with the rate that would have been charged in a similar transaction between independent persons dealing at arm's length.

15.2 Substitution and Imputation of Arm's length Interest

Where the interest rate imposed or would have been imposed on a controlled financial assistance is not at arm's length, the Commissioner may make an adjustment to reflect the arm's length interest rate or impute interest on the controlled financial assistance. Adjustments will be made where:

(a) For the supply of financial assistance, the consideration is less than the consideration that would have been received or receivable in an arm's length arrangement;

(b) For the acquisition of financial assistance, the consideration is more than the consideration that would have been given or agreed to be given in an arm's length arrangement; or

(c) No consideration has been charged to the associated person for the supply of the financial assistance.

15.3 Determination of Arm's Length Interest

An arm's length interest rate is an interest rate charged, or would have been charged, at the time the financial assistance was granted in uncontrolled transactions with or between independent persons.

In determining an arm's length interest rate for financial assistance, the comparable uncontrolled price (CUP) method is considered to provide the most reliable measure. In this context, the CUP method determines an arm's length interest rate by reference to interest rates between independent parties on loan with highly similar terms and conditions. Where differences exist, adjustments should be done to eliminate these differences.

15.4 Comparability Factors

There are comparability factors that should be considered when searching for and analyzing financial transactions and in determining arm's length interest. These include:

(a) The nature and purpose of the financial assistance;

(b) The amount, duration and terms of the financial assistance;

(c) The type of interest rate (eg: fixed or floating interest rate);

(d) Embedded options;

(e) Guarantees involved in the financial assistance;

(f) Collateral for the financial assistance;

(g) Creditworthiness of the borrower;

(h) Location of the lender and borrower.

When ascertaining the arm's length interest rate, appropriate indices such as London Inter Bank Offered Rate (LIBOR) or specific rates quoted by banks for comparable loans can be used as a reference point. Adjustments are then made on the rates used as reference point based on the outcome of comparability analysis to arrive at the arm's length interest rate.

15.5 Documenting Financial Assistance Pricing Policy

Taxpayers are required to substantiate and document that, the terms of an intercompany financial assistance, specifically the interest rate applied, are at arm's length. This encompasses preparation of an analysis on the setting of the correct level of underlying interest and documentation on other factors of comparability such as loan structure, etc. Taxpayers also need to review existing inter-company agreement on a periodic basis to ensure that all the terms and conditions of the loan remain at arm's length.

16.0 INTEREST AND PENALTIES

Penalties are generally designed to make tax underpayments and other types of non – compliance more costly than compliance. The Income Tax Act, 2004 does not impose specific penalties in respect of non – arm's length practices.

Additional tax, penalty and offence provisions applicable for failure to furnish return of income or comply with Commissioner notice or fraud in relation to return of income, negligence of authorized tax agents, underpayment of installment tax and tax remaining unpaid after the due date as contained in the Act, will apply in all cases of transfer pricing.

17.0 ADVANCE PRICING ARRANGEMENT (APA)

17.1 General

As stated in paragraph 6.2 above, the Commissioner may enter into agreement with a person to the manner in which the arm's length price shall be determined for the purpose of subsection (1) of section 33 of the Income Tax Act, Cap.332.

An Advance Pricing Arrangement ("APA") determines in advance, an appropriate set of criteria to ascertain the transfer prices of specified related party's transactions over a specified period of time. The provisions under the MAP Article of URT's tax treaties and the Tanzanian Income Tax Act enable the Tanzanian competent authority to accede to requests from taxpayers for APAs and to enter into such arrangements.

A bilateral or multilateral APA involves agreement between URT and one or more of its tax treaty partners. A unilateral APA only involves the taxpayer and TRA.
A unilateral APA may not achieve the same level of certainty for taxpayers as in a bilateral/multilateral APA, since the other competent authorities or tax authorities may dispute the unilateral APA given that it is reached in the absence of their agreement. Notwithstanding, a taxpayer is free to choose between requesting for a unilateral or bilateral/multilateral APA.

The following paragraphs elaborate TRAs' positions on the bilateral/multilateral APA process as well as provide guidance on the application of such APA process.

17.2 Key Concepts & Guiding Principles

There is no mandatory requirement for taxpayers to seek an APA. However, in recognition of commercial needs, TRA may make available the APA facility to taxpayers who are engaged in cross-border related party transactions.

Taxpayers should evaluate their own situations and weigh the pros and cons before making a request for APA. If taxpayers choose not to enter into an APA and the transaction is subsequently subject to transfer pricing adjustments, the taxpayers may rely on the MAP or other remedies available in domestic laws to eliminate double taxation.

In most tax jurisdictions, an APA is regarded as binding on the tax authority and on the taxpayer, subject to any qualifications stated in the APA. In addition, once an APA has been obtained and taxpayers implement the APA according to the stated conditions, the tax authorities would suspend audits and penalties with respect to the transactions involved as long as the terms of the APA are complied with. Hence, taxpayers should enter into APAs in good faith, with the aim of obtaining certainty that their transfer prices have fulfilled the arm's length principle.

The APA process is a facility available to taxpayers to avoid potential double taxation. If taxpayer's request for APA is rejected or the competent authorities fail to reach agreement, taxpayers may still have recourse to the MAP or the other remedies that is available under domestic laws, should the taxpayer be subsequently subject to transfer pricing adjustments. Also, taxpayer is not obliged to accept the outcome agreed between the authorities. Taxpayers may withdraw the application, terminate the process or reject the agreed outcome. In such a case, taxpayers may seek alternative recourse to eliminate double taxation.

Generally, TRA would accept an APA request if there is a genuine motive to obtain certainty for the avoidance of double taxation and the request

relates to specific current or future transactions that are not hypothetical. However, the other foreign authorities involved must also agree with the request. The acceptability of an APA request is ultimately at TRAs' discretion. However, should TRA decline an APA request, it would offer taxpayer a full explanation of the grounds for declining the request.

With regard to the appropriate period that an APA should cover, TRA is of the view that this should be addressed pragmatically, based on commercial realities. The APA should only cover periods where the critical assumptions and commercial factors that have significant impact on the validity of the APA are expected to remain unchanged. This basis should also be used to guide decisions on the suitability of applying the terms of the APA to prior years (commonly known as "roll-back" of the APA). Based on experience, most APA requests cover 3-5 prospective years, in addition to its application to 1-2 prior years.

TRA appreciates that the usefulness of an APA to a taxpayer 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 with the foreign tax authorities as soon as practicable. 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 Taxpayer and the foreign tax authorities. TRA will update taxpayers on the progress of their requests and indicate the expected timeframe for completion on a regular basis.

17.3 Guidance on Making an APA Request

17.3.1 Pre-filing Meetings

The first step to an APA application is to arrange for pre-filing meetings with TRA. At these meetings, taxpayers should present the salient information such as the company's business model and industry information, transactions to be covered, the period of the APA etc. If TRA is willing to accept the case for APA, the taxpayer will be advised on the necessary follow-up actions (such as the content of the application to be submitted etc.) and what is expected of the APA process (e.g. the expected timeframe for completion etc.).

For bilateral and multilateral APAs, taxpayers should undertake similar meetings with the relevant foreign tax authorities and seek their agreement for an APA as well as their specific requirements with respect to the APA process. It would be helpful if taxpayers share such information from their meetings with the foreign tax authorities with TRA.

17.3.2 Formal APA Submission

Unless TRA or the relevant foreign authorities do not agree to the APA request, taxpayers should proceed to submit the formal APA application, which should include the following key components:

a. General information concerning the taxpayer such as the nature of its business and its industry environment, worldwide organizational structure, etc;
b. Details and explanation of the proposed transfer pricing methodology and analysis;
c. All information and analyses needed to produce the arm's length results for the related party transactions;
d. The set of critical assumptions under which the proposed transfer pricing methodology and analysis will operate;
e. Period covered by the APA, including whether the APA would be rolled back to prior years;
f. Any other information that TRA or the other tax authorities have requested for.

In considering the details to be submitted, taxpayers may also find it useful to refer to the guidance described paragraph 13 of the guideline.

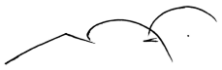
17.3.3 Review and Negotiating APA

Upon receiving the formal submission, TRA will commence the process of seeking an APA with the relevant foreign authorities.
This may include meetings with taxpayers to seek clarifications, obtaining more information, conducting site visits, consultations and negotiations with the relevant foreign competent authorities, etc.

As with the MAP, the negotiation of a bilateral or multilateral APA is a government-to-government process. Hence, taxpayers do not, as a general rule, participate in or attend as observers at the negotiations or consultations between the competent authorities but taxpayers may be called upon to provide clarification. However, as the taxpayers concerned are also stakeholders in this process, TRA would regularly update them on the outcome of the competent authority consultations and the expected time frame to complete their cases.

17.3.4 Post-Agreement Meeting and Implementation of APA

When an agreement is reached, TRA will meet with the taxpayer within thirty days of reaching the agreement to discuss the details and implementation of the agreement. TRA will also discuss with the taxpayer on the APA compliance and monitoring requirements.



Rished Bade
COMMISSIONER GENERAL

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