

Sagamore Hill.

TAX NEWSLETTER.



Transfer pricing: Understanding the Profit Split Method.

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In this issue, we discuss the critical important of appropriate FAR analysis for purposes of transfer pricing and the implication this has on the choice of the transfere pricing method.

The dispute was between ECP KENYA LIMITED and COMMISSIONER OF DOMESTIC TAXES.

ECP Kenya is a subsidiary of ECP Managers, a limited partnership based in Delaware, United States of America. ECP Kenya is mandated with the principal activity of collecting data from portfolio assigned to it by its parent entity.

The appellant argued that the tribunal had erroneously applied respondent FAR analysis of the appellant roles which the Respondent had disagreed with, and disregarded the Appellant's FAR analysis as well as its TP Policy.

The functions assigned to ECP Kenya include providing technical and administrative support to the ECP Manager and the responsibilities include providing information to ECP Manager's ExCo, subject to assignments from the ExCo in support of ECP Manager's Advisory Activities, and undertaking support services in support of ECP Manager's Operating Activities. Notably, the transfer pricing policy indicated that ECP Kenya **does not participate in ECP Manager's Fundraising Activities nor does it participate in the decisions relating to investment selection or disposal.**

As regards the adoption of transfer pricing policy, ECP Kenya adopted the Transaction Net Margin method which the tribunal and the commissioner disregarded. The case for disregarding the choice of the TP method by the tribunal and the commissioner, was that their service was integrated and thus the choice of the method. The integration was such that it was difficult for the commissioner to split the exact services rendered by the ECP Kenya and the ECP Managers.

According to guideline of the on application of Profit Split Method Inclusive Framework on BEPS; Action 10, this method is best suited where.

1. Unique and valuable contributions by each of the parties to the transaction.
2. Highly integrated business operations.

The taxpayer argued that The TPSM Guidance further states that: Contributions (for instance, functions performed, or assets used or contributed) will be unique and valuable in cases where:

- a. They are not comparable contributions made by uncontrolled parties in comparable transactions;
- b. and They represent a key source of actual or potential economic benefit in the business operations.

The two factors are often linked: comparable for such contributions are seldom found because they are a key source of economic advantage.

The respondent response was premised on the following issues.

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On the choice of the FAR analysis, the commissioner relied on the tribunals holding that the risk the taxpayer bears is far greater than indicated in the transfere Pricing policy document finding that the commissioner did not err in its FAR analysis.

The commissioner placed reliance on Section 18(3) of the Income Tax Act providing that related entities' transactions must be dealt with at arm's length, as read together with the transfer pricing regulations.

The appellant classified themselves as low value adding entity and therefore characterised itself using Standard Industrial Classification when looking for comparable. These are

1. Management and consultancy services.
2. Business consulting; and
3. Accounting, auditing, and bookkeeping.

The appellant's TP Policy provided that the parent entity provides investment management advisory services to investment funds, conducts strategic business reviews, conducts business development, fundraising, and capital structuring, maintains financial accountability, assists with environmental, sustainability, and governance, and assists with employee share ownership plans.

In coming up with the FAR analysis, the commissioner relied on the following;

- a) Interviews with the Appellant.
- b) Correspondences with the Appellant.
- c) The Appellant's TP Policy.
- d) Returns filed by ECP Manager LP, ECP Manager III LP, ECP Mena Management LP (which are other subsidiaries on the parent entity) at the Securities and Exchange Commission ("SEC")
- e) An SEC Administrative Proceeding.
- f) Job descriptions provided by the Appellant.
- g) LinkedIn profiles of Bryce Fort and Paul Maasdorp.
- h) ECP profiles of Bryce Fort and Paul Maasdorp.

From the FAR analysis carried out, it revealed the following.

- a) Identifies new business opportunities for the Funds to invest in.

- b) Carries out due diligence on prospective investee companies.
- c) Structures and negotiates transactions that require the preparation of all necessary documents to complete.
- d) Develops and executes exit strategies.
- e) Structures and negotiates financing for investee companies.
- f) Monitors investee companies.
- g) Develops and supports portfolio company strategy.

The commissioner further noted that **the assets employed were the Funds and Advisory Personnel**. Also, it is imperative to note that, based on the functions noted above, the taxpayer **was involved in the management and control of risk**. The outcome of the FAR analysis conducted by the Respondent, was different from the position presented by the Appellant in its Transfer Pricing Policy, concluding that the TP policy was not a true reflection of Functions performed, Assets used, and risk assumed by the taxpayer.

The tribunal noted that the documentation indicates that the services provided by the Appellant are highly integrated with the services rendered by ECP to the Funds. So integrated are the services that it is difficult, if not impossible, to reliably separate the services rendered by the Appellant from those rendered by ECP.



On the appropriate allocation key, the commissioner was of the argument that, the Appellant's primary asset were its personnel, **then the headcount of personnel performing the services subject to the transaction in issue would be the most appropriate allocation key**.

The appellant had done a comparative analysis and determined to use a 7% mark up to determine the amount earned and subjectable to tax in the country.

The High Courts decision.

The court made several observations.

The first issue in appreciating the jurisdiction of the court, it was indeed true that the matter before the court was on the matter of law, as provided for under section 56(2) of the tax procedures Act.

On the issue of the risks borne by the appellant, the court agreed with the tribunals findings that the risk was significantly greater than indicated in the transfer pricing policy document.

Additionally, the FAR analysis done in the transfer pricing document was erroneous and did not capture the functions of the appellant, the assets it applies to the transaction and as well as risk it bears.

Further, the court noted that an internal brochure provided that a loss of key personnel would have material adverse effect on the advisory Client. This indicated that the staff are key assets. Additionally, considering the descriptions of the work to be undertaken by the key staff, the risk that the Appellant bears is significantly greater than indicated in its Transfer Pricing Policy. The allocation key utilised by the commissioner was also upheld as being the head count of the personnel carrying out the services subject to the transaction in issue.

On the choice of an appropriate transfere pricing policy, the court agreed with the tribunal that Transactional profit split method is the most appropriate transfere pricing method applicable for the reasons that the services performed are highly integrated.

Our commentaries and take away.

Different transfer pricing methods are appropriate to different transactions.

Transaction profit split method is most appropriate in the following scenarios.

1. Each party makes it's own unique contribution. Unique valuable contribution may involve such things as patents, know how, specialised expertise or trademarks.
2. Where business operation are highly integrated. As illustrated above, business operation are highly integrated, such as highly collaborative research and development, joint manufacturing, global trading of financial instruments, etc.
3. The parties share the assumption of economically significant risks or the parties assume closely related risk.

Even though this method of transfere pricing is mostly applied in cases where there is no sufficient comparable or they are insufficient, a lack of them does not in entirety conclude the application of this methods. Other consideration as highlighted above must be taken into consideration.

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