DETERMINATION OF THE TAXABLE INCOME OF CERTAIN PERSONS FROM INTERNATIONAL TRANSACTIONS:

TRANSFER PRICING

(SECTION 95A OF THE INCOME TAX ACT)
1. DEFINITIONS AND TERMINOLOGY

1.1 The concepts below are defined in section 95A of the Act:

1.1.1 Goods;
1.1.2 International transaction;
1.1.3 Resident; and
1.1.4 Services.

1.2 For purposes of this Practice Note, the words below are defined as follows:

1.2.1 Advance pricing arrangement ("APA"): An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time.

1.2.2 Connected person: A "connected person" is defined in relation to each of the following categories of persons.

1.2.2.1 In relation to a natural person:

(i) any relative of such person (including by adoption), i.e. children and parents, grandchildren, grandparents, brothers and sisters, great-grandchildren, great-grandparents, uncles and aunts, nephews and nieces, the person's spouse and any person who is a relative of the spouse, the spouse of any of the above-mentioned relatives; and

(ii) any trust of which such natural person or any relative or spouse referred to above is a beneficiary. A beneficiary means any person named, in the will, trust deed or letter of wishes, as a beneficiary or as a person upon whom the trustee or the trust has a power to confer a benefit from the trust.

1.2.2.2 In relation to a trust:

(i) any beneficiary of such trust, i.e. any person named as a beneficiary in the trust deed or letter of wishes, or any other person in favour of whom the trustee of the trust exercises the trustee's discretion; and

(ii) any connected person in relation to such beneficiary, for example any of the beneficiary's relatives and any trust of which a relative may be a beneficiary. A trust and connected persons in relation to the beneficiaries of the trust, are connected persons.

1.2.2.3 In relation to a connected person in relation to a trust (other than a unit trust scheme in property shares, as authorised under the Unit Trust Control Act, 1981 (Act No. 54 of 1981)), any other person who is a connected person in relation to such trust.
All persons who are connected persons in relation to a trust are connected persons in relation to each other.

1.2.2.4 In relation to a member of any partnership:

(i) any other member of such partnership; and

(ii) any connected person in relation to any member of such partnership, for example any of that member's relatives and any trust in which a relative may be a beneficiary.

1.2.2.5 In relation to a company:

(i) its holding company, as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973)(the Companies Act);

(ii) its subsidiary, as defined in section 1 of the Companies Act;

(iii) any other company, where both such companies are subsidiaries (as defined) of the same holding company;

(iv) any person, other than a company as defined in section 1 of the Companies Act, who individually or jointly with any connected person in relation to such person, holds (directly or indirectly) at least 20 per cent of the company's equity share capital or voting rights. The person so contemplated, could be a natural person, trust, close corporation or any entity which is not a company for purposes of the Companies Act;

(v) any other company, if at least 20 per cent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company. This will be the case where companies B and C each hold 50 per cent of the equity share capital of company A; both companies, B and C, will be connected persons in relation to company A.

(vi) any other company, if such other company is managed or controlled by:

(aa) any person (A) who or which is a connected person in relation to such company; or

(bb) any person who or which is a connected person in relation to A.

Two companies will be connected persons in the event of one company being managed or controlled by a connected person in relation to the other company, as well as where the companies are managed or controlled by persons who are connected persons in relation to each other. For example, two companies, one whose shares are held by a trust and the other, whose shares are held by the beneficiary of such trust, will be connected persons in relation to each other.

Company in the definition are not limited to a company, as defined in section 1 of the Act. Company also refers to entities which are companies or corporations according to the ordinary meaning of the word. For example, a company incorporated under the law of any country other than the Republic of Namibia, which does not carry on business in the Republic of Namibia and which is not a shareholder of a Namibian company could also be a connected person, for the purposes of the application of the connected person provisions.
In relation to a close corporation:

(i) any member of such close corporation;

(ii) any relative of such member, or any trust which is a connected person in relation to such member; and

(iii) any other close corporation or company which is a connected person in relation to any member or relative or trust contemplated in (i) and (ii) above;

In relation to a person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person.

1.2.2 Controlled transaction: A controlled transaction will be any transaction between connected persons;

1.2.3 Uncontrolled transaction: A transaction which is concluded at arm's-length between enterprises that are not connected persons in relation to each other;

1.2.4 Multinational: The term multinational is used to refer to any group of connected persons with members (including natural persons) or business activities in more than one country. The term “members” refers to constituent parts (including natural persons) of that multinational, each having a separate legal existence.


1.2.6 Transfer prices: Transfer prices are the prices at which an entity transfers goods and services to connected persons.

2. INTRODUCTION

2.1 Namibia use a source-based tax system, which means that Namibia will only include in its tax base income arising within the Namibian tax jurisdiction. The residence of the tax payer will therefore be irrelevant.

2.2 The Namibian Income Tax Act has been amended with an effective date of 14 May 2005 to make provision for the determination of taxable income of certain persons in respect of international transactions. This was necessitated by the current practices in the market to shift taxable income from one entity to another to take advantage of the lower tax rates in a certain tax jurisdiction and financial assistance abuses. Rules of allocation have been identified and are predominantly based on the OECD Guidelines.

2.2 Transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other.

2.2 The transfer prices adopted by a multinational have a direct bearing on the proportional profit it derives in each country in which it operates. If a non-market value (inadequate or excessive consideration) is paid for the transfer of goods or
services between the members of a multinational, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will impact on the tax revenues of the relevant tax jurisdictions in which they operate.

2.3 Section 95A provides that the Minister may, in determination of the taxable income of either the acquirer or the supplier, adjust the consideration in respect of the international transaction to reflect an arm’s length price for the goods or services. This is based on the international taxation principles that serve a dual purpose of securing the appropriate tax base in Namibia and to avoid double taxation.

2.4 Although the Income Tax Act grants the Minister the power to adjust the consideration in respect of a transaction, the reality is that numerous transactions in respect of the same goods or services are entered into between the connected persons. In practice the Minister will exercise his discretion in respect of all transactions entered into in respect of a product or service during any period.

2.5 The OECD has continuously worked to build a consensus on international taxation principles to contribute to the expansion of world trade on a multilateral, non-discriminatory basis and to achieve the highest sustainable economic growth in Member countries.

2.6 The objective of this Practice Note is to provide tax payers with guidelines about the procedures to be followed in the determination of arm's-length prices, taking into account the Namibian business environment. It also sets out the Minister's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.

3. **THE MINISTER'S APPROACH TO THE PRACTICE NOTE**

3.1 This Practice Note 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 case will be decided on its own merits, taking into account the taxpayer’s business strategies and commercial judgement.

3.2 Status of the OECD Guidelines

This Practice Note is based on and acknowledges the principles of the OECD Guidelines. Nothing in this Practice Note is intended to be contradictory to the OECD Guidelines and in cases where there is conflict, the provisions of the OECD Guidelines will prevail in resolving any dispute.

Any amendments made to the OECD Guidelines will be deemed to be incorporated into this Practice Note.

4. **TAX TREATIES**

4.1 Article 7 of the OECD "Model Tax Convention on Income and on Capital" provides inter alia for the attribution of profits to a permanent establishment of an enterprise. Furthermore, Article 9 of the OECD Model Tax Convention stipulates that the arm's-length principle must be applied to commercial and financial relations between
associated companies residing in the contracting states. These principles are embodied in each of Namibia's tax treaties.

4.2 The "business profits" and "associated enterprises" articles in the tax treaties do not indicate priorities as to the methods to be used to determine the attribution of profits or an arm's-length price. Therefore, the Minister holds the view that no inconsistency exists between domestic law and the tax treaties, as both embody the arm's-length principle as set out in the OECD Guidelines.

4.3 The Minister acknowledges that paragraph 2 of Article 9 of the OECD Model Tax Convention provides that a contracting state must make an appropriate adjustment to the amount of tax it levies on profits, if the other contracting state has made an adjustment to the profits of a related enterprise.

The concept of corresponding adjustments for transfer pricing purposes is therefore encompassed within the scope of this Practice Note.

4.4 Even though it is accepted that section 95A by definition can only apply between separate legal entities, the contents of this Practice Note will also apply to transactions between -

a person's head office with the branch of such person; or

a person's branch with another branch of such person,

This is by virtue of the fact that the Practice Note encompasses and accepts the provisions of Article 7 of the OECD Model Tax Convention applicable to the above transactions and will consider the abovementioned transactions in terms of the OECD principles stipulated in Article 7.

5. THE ARM’S – LENGTH PRINCIPLE

5.1 The arm’s length principle is the international transfer pricing standard that OECD Member countries have agreed to be used for tax purposes by multinational enterprises and tax enterprises. This means that transactions between connected persons are to be conducted at arm's-length. In other words, transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction. The OECD Guidelines interpretation of arm’s-length will be followed in the application of this Practice Note.

5.2 The Ministry of Finance has adopted a policy that it will not be automatically assumed that connected persons under a controlled transaction have sought to manipulate their profits. The Minister will take cognisance of the genuine difficulties to accurately determine a market price in the absence of market forces or when a particular commercial strategy has been adopted.

5.3 Other than tax considerations, factors such as governmental regulations (for example price or exchange controls) may also distort the prices charged between connected persons. These factors are recognised by the OECD Guidelines and the Minister.

5.4 The determination of an arm’s-length consideration is not an exact science but requires judgement on the part of both the taxpayer and the Minister. Accordingly,
taxpayers and the Minister need to approach each case, having due regard for the unique business and market realities applicable to each individual case.

5.5 An arm's-length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where, within that range, a specific arm's-length price will lie.

5.6 Arm’s-length prices may vary across different markets, even for transactions involving the same product or service. To achieve comparability, it is important to ensure that the markets in which the parties operate are comparable. Any differences must either not have a material effect on price, or be differences for which appropriate adjustments can be made.

6. GUIDANCE FOR APPLYING THE ARM’S LENGTH PRINCIPLE

6.1 Principles of Comparability

6.1.1 The application of the arm’s length principle is generally based on a comparison of conditions in a controlled transaction with the conditions in transactions between independent enterprises. The preferred arm's-length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable.

6.1.2 To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable.

6.1.3 Factors determining comparability:

a) Characteristics of goods and services;
b) Functional analysis;
c) Terms and conditions of relevant agreements;
d) Relative risk assumed by the taxpayer, connected enterprises and any independent party where such party is considered as a possible comparable;
e) Economic and market conditions; and
f) Business strategies.

Characteristics of goods and services

The OECD Guidelines, at paragraph 1.19, mention a non-exhaustive list of features that may be relevant in comparing two products:

(i) In the case of transfers of tangible goods, the physical features of the goods, its quality and reliability, and the availability and volume of supply; and
(ii) In the case of intangible goods, the form of the transaction, the type of property, the duration and degree of protection, and the anticipated benefits from the use of the goods
Functional analysis

The compensation for the transfer of property or services between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account the risks assumed and the assets used. In determining whether two transactions are comparable, the functions and risks undertaken by the independent parties should be compared to those undertaken by the connected persons.

Economic theory predicts that when various functions are performed by a group of independent enterprises, the enterprise that provides most of the effort and, more particularly, the rare or unique functions, and assumes the most risk should earn a greater portion of the profit.

A practical way of evaluating functional comparability is to prepare a functional analysis. A functional analysis is a method of finding and organising facts about a business’ functions, assets (including intangible property) and risks. It aims to determine how these are divided between the parties involved in the transaction under review.

A functional analysis should address all of the following:

(a) The functions and risks undertaken by the relevant members of the multinational.
(b) The relative contributions of various functions: The number of functions performed by a particular member of a multinational is not decisive in determining whether that member should derive the greater share of the profit. It is the relative importance of each function that is relevant.
(c) An appraisal of risk. In the open market, this assumption of increased risk will be compensated for by an increase in the expected return. The risks assumed should therefore be taken into account in the functional analysis.
(d) It must also be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk. The functions undertaken by an entity will, to some extent, determine the allocation of risks.

Business strategies

Business strategies are also relevant in determining comparability for transfer pricing purposes. Business strategies are a legitimate aspect of arm’s-length operations. The arm’s-length principle, therefore, acknowledges those strategies. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion and other factors which have bearing upon the daily conduct of business.

Business strategies could also include market penetration schemes. A taxpayer seeking to penetrate a new market or to expand (or defend) its market share might temporarily charge a lower price for its product than the price for otherwise comparable products in that market. Alternatively, it might temporarily incur higher costs (perhaps because of start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.
The Minister may consider a number of factors in evaluating a taxpayer's claim of following a strategy that temporarily reduces profits in return for higher long-term profits, for example, whether:

a) the conduct of the parties is consistent with the professed business strategy;
b) the nature of the relationship between the parties to the controlled transaction justifies that the taxpayer bears the costs of the business strategy;
c) there is a plausible expectation that the business strategy will produce a return sufficient to justify its costs, within a period of time that would be acceptable in an arm's-length arrangement.

6.2 Recognition of the actual transactions undertaken

6.2.1 The Ministry of Finance’s examination of a controlled transaction will be based on the transaction actually undertaken by connected enterprises as structured by them.

6.2.2 However, the Ministry of Finance will deviate from this approach in the following cases namely:

(a) Where the economic substance of a transaction differs from its form; and
(b) While the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

6.3 Evaluation of separate and combined transactions

6.3.1 The Ministry of Finance is aware that in certain cases separate transactions are so closely linked or continuous that it is difficult to evaluate it adequately on a separate basis. These transactions will therefore be evaluated together by making use of the most appropriate arm’s length method of methods.

6.3.2 However, the Ministry of Finance would still evaluate other transactions of such enterprises separately. In other words, while some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm’s length, other transactions contracted between such enterprises as a package may need to be evaluated separately.

6.4 Use of an arm’s length range

6.4.1 In some cases it will be possible to apply the arm’s length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm’s length.

6.4.2 However, the Ministry is aware that there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. In these cases,
differences in the figures that compromise the range may be caused by the fact that in general the application of the arm’s length principle only produces an approximation of conditions that would have been established between independent enterprises.

6.4.3 The Ministry of Finance would therefore use its own discretion and judgement to evaluate transactions. No general rule will be stated with respect to the use of ranges derived from the application of multiple methods because the conclusions to be drawn from their use will depend on the relative reliability of the methods employed to determine the ranges and the quality of the information used in applying the different methods.

6.4.4 In the event that the relevant conditions of the controlled transaction (e.g. price or margin) fall outside the arm’s length range asserted by the Ministry of Finance, the taxpayer will be given an opportunity to present arguments that the conditions of the transaction satisfy the arm’s length principle.

6.4.5 Adjustments will be made if the taxpayer cannot provide sufficient arguments. The adjustment will be made to the point within the range that best reflects the facts and circumstances of the particular controlled transaction.

6.5 Use of multiple year data

6.5.1 The Ministry of Finance may, in certain cases, examine the data of previous years, as well.


7.1 Introduction

7.1.1 Neither Section 95A nor the tax treaties entered into by Namibia prescribe any particular methodology for the purpose of ascertaining an arm's-length consideration. Given that there is no prescribed legislative preference, the Minister would generally seek to use the methods that have been set out below.

7.1.2 The most appropriate method in a given case will depend on the facts and circumstances of the case and the extent and reliability of data on which to base a comparability analysis. It should always be the intention to select the method that produces the highest degree of comparability.

7.1.3 The choice of the most appropriate method should therefore be based on a practical weighting of the evidence, having regard to:

a) the nature of the activities being examined,
b) the availability, quality and reliability of the data,
c) the nature and extent of any assumptions, and
d) the degree of comparability that exists between the controlled and uncontrolled transactions where the difference would affect conditions in the arm’s-length dealings being examined.
7.1.4 In cases where there are no comparables or there is insufficient information to determine an arm's-length outcome, the method to be used should be a method that produces a reasonable estimate of an arm's-length outcome. Such estimate must be based on the facts in hand.

7.1.5 The application of the principles set out in this Practice Note may require the exercise of judgement. After the identification of an independent benchmark or benchmarks against which the pricing of a multinational is to be compared, it needs to be established to what extent the functions of the members of a multinational are similar to or differ from those of the independent benchmark(s). An element of judgement is required to determine the extent to which these similarities or differences have a material effect on the transfer price adopted by the multinational.

7.1.6 As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Taxpayers will not be required to undertake an intricate analysis of all the methodologies, but should have a sound basis for using the selected methodology. This could entail providing reasons why secondary methods are not appropriate.

7.1.7 This section of the Practice Note considers the principles underlying each of the various transfer pricing methods. An understanding of these principles is useful for identifying the limitations of each method and applying the methods in practice.

7.2 The principle methods referred to in the OECD Guidelines

7.2.1 Several transfer pricing methods have been developed in international practice for determining and appraising a taxpayer's transfer prices. These methods are based on measuring a multinational's pricing strategies against a benchmark of the pricing behaviour of independent entities in uncontrolled transactions.

7.2.2 The standard transfer pricing methods recognised by the OECD Guidelines, are:

a) The Comparable Uncontrolled Price Method (CUP method);

b) The Resale Price Method (RP method);

c) The Cost Plus Method (CP method);

d) The Transactional Net Margin Method (TNMM); and

e) The Profit Split Method.

7.2.3 The CUP, RP and CP methods are known as the traditional transaction methods and the TNMM and profit split method are referred to as transactional profit methods.

7.2.4 The Minister endorses the CUP, RP, CP, TNMM and profit split methods as acceptable transfer pricing methods, the most appropriate of these depending on the particular situation and the extent of reliable data to enable its proper application.
7.3 The hierarchy of methods

7.3.1 Section 95A does not impose a hierarchy for the transfer pricing methods. However, there is in effect a hierarchy, in that certain methods may provide a more reliable result than others, depending on the quality of available data and the taxpayer’s circumstances.

7.3.2 The Minister acknowledges that the suitability and reliability of a method will depend on the facts and circumstances of each case. The most reliable method will be the one that requires fewer and more reliable adjustments.

7.3.3 It is essential to have an understanding of the commercial and economic reality underlying any particular transaction before beginning with a search for, and close examination of comparable transactions between unrelated enterprises in an application of the traditional arm's-length methods.

7.3.4 As a general rule, the traditional transaction-based methods are preferred. Of these methods the CUP method is preferred, as it looks directly to the product or service transferred and is relatively insensitive to the specific functions which are performed by the entities being compared.

7.3.5 The RP and CP methods look at valuing the functions performed. Because these methods examine gross margins, operating expenses are excluded and therefore the impact of relative cost structures should not be material.

7.3.6 In practice, the traditional methods may not be able to be applied, because of information constraints, particularly the lack of comparable uncontrolled transactions or published data on gross margins. Hence it may be necessary to resort to the transactional profits methods.

7.3.7 Of the transactional profits methods, the TNMM is reasonably objective because comparables are applied. Essentially, this is either the RP or CP with varying levels of operating expenses incorporated into the calculations.

7.3.8 In theory the TNMM is inferior to the RP or CP methods where sufficient information is available to apply all three methods, because comparing operating expenses requires a similar structure of business to be truly reliable. This presents a more difficult threshold than functional comparability.

7.3.9 Where a taxpayer has considered a number of methods, it may be appropriate to document the reasons for discarding some of those methods. The availability of data is likely to be very important in a taxpayer's choice of method. Namibia is a small market and under certain circumstances this means reliable comparables may be difficult for taxpayers to locate.

7.4 The CUP method

7.4.1 Description

The CUP method compares the price charged for goods or services transferred in a controlled transaction to the price charged for goods and services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any
difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the controlled transaction may need to be substituted for the price in the uncontrolled transaction.

7.4.2 Application

The CUP method is the most direct and reliable way to apply the arm's-length principle where it is possible to locate comparable uncontrolled transactions. A comparable uncontrolled price can be determined by reference to similar products or services transferred under similar circumstances by the taxpayer to an independent party (internal comparable) or by reference to similar products or services transferred under similar circumstances by one independent party to another (external comparable).

The two transactions being compared will only be truly comparable if there are no differences between the two transactions that will have a material effect on the price, or if reasonably accurate adjustments can be made to eliminate the effect of differences that may materially affect the price.

It is important to keep in mind that two transactions will not be comparable merely because the product or service transferred is comparable. Regard should also be had to the effect on price of broader business functions and economic circumstances other than just the product comparability.

7.5 The Resale Price method

7.5.1 Description

The resale price method is based on the price at which a product, which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller’s selling and other operating costs, and to provide an appropriate profit, depending on functions performed, assets used and risks assumed by the reseller. The balance may be regarded as the arm's-length price before other adjustments in respect of, for example, customs duties.

7.5.2 Application

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the entity obtains on items purchased and sold in comparable uncontrolled transactions, as well as by reference to the resale price margin obtained by one independent party selling to another. Functional comparability is very important and it is essential that the functions performed by the independent entity are comparable to the functions performed by the member of the multinational selling to an independent enterprise. There should be no differences, which have a material effect on the price, for which reasonably accurate adjustments cannot be made.

In applying the resale price method, fewer adjustments are normally required for product comparability than under the CUP method. Minor product differences are less likely to have an effect on profit margins than on prices, as profit margins for
similar functions tend to be equal, but prices for different products will be equal only to the extent that products are substitutes for one another. For example, a distributor performs the same function to sell toasters and blenders and is therefore likely to require the same profit margin, but blenders are not comparable in price to toasters.

Although broader product differences can be allowed in the resale price method, product similarity may still be important when applying this method, for example when high value intangibles are involved. All the other factors affecting comparability will have to be considered when applying the resale price method.

The resale price method focuses only on the external sale price to third parties and the gross margin required to reward the function performed by the reseller. These factors are not overly sensitive to differences between the cost structure of a member of a multinational and an independent firm. Thus, if the member of the multinational operates a more efficient distributorship than the independent firm, this will result in a higher net profit percentage when the resale price method is used, and will not influence the gross profit percentage.

The resale price method is most appropriate where the reseller does not add substantially to the value of the product or does not possess valuable marketing intangibles.

7.6 The Cost Plus method

7.6.1 Description

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.

7.6.2 Application

This method is best suited to situations where:

a) services are provided,
b) semi-finished goods are sold between connected parties,
c) connected persons have concluded joint facility agreements or long-term buy-and-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 cost plus method if one of two conditions is met:

a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or
b) reasonably accurate adjustments 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.

### 7.7 Transactional Net Margin method (TNMM)

#### 7.7.1 Description

The TNMM examines the net profit margin that a taxpayer realises from a controlled transaction, relative to an appropriate base, for example cost, sales or assets. This ratio 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.

#### 7.7.2 Application

Although the TNMM is classified as a transactional profit method, it is more closely aligned to the CP and RP methods than to the profit split method. As with the CP and RP methods, the TNMM focuses on the functions performed by an enterprise. 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 expenses in their calculations. For example, if a multinational operates a more 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 a reliable result.

In order to maximise 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 this reason 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 recognised 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 connected 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 also usually the enterprise that is the least complex and that does not own valuable intangible property.
7.8 The Profit Split method

7.8.1 Description

The first step in the profit split method is to identify the combined profit to be split between the connected 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 connected 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.

7.8.2 Application

The profit split method is usually applied where transactions are so interrelated 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 split.

Two alternative approaches to the profit split method are outlined in the OECD Guidelines. 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:

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.

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 to that combined gross profit.

However, paragraph 3.15 of the OECD Guidelines notes that these approaches are not necessarily exhaustive or mutually exclusive. There may be alternative ways to split a profit to achieve a reliable arm's-length result.

As is explained in paragraph 3.17 of the OECD Guidelines it may, in some circumstances, be appropriate to split gross profits (as opposed to operating profits) between the connected parties and then deduct the operating expenses incurred by or attributable to each relevant enterprise. The example used in paragraph 3.17 of the OECD Guidelines is the case of a multinational that engages in highly integrated world-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 split 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 risks assumed by the relevant entities.

a) Residual Profit Split Analysis

The residual profit split approach first provides both the parties to the transaction with a basic return, based on what independent firms 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.

There is no definitive guide on how the relative contribution of the parties should be measured. It is quite likely that the transaction between the parties will be unique, so there will be no external benchmark against which to test the reliability of the assessment of relative contributions. In practice, the assessment of relative contribution may, of necessity, need to be a somewhat subjective measure, based on the facts and circumstances of each case.

b) Contribution analysis

Multinationals are organisationally different from comparable domestic enterprises. Large integrated multinationals may have the benefit of cost savings attributable to the scale of their operations, otherwise known as economies of scale. Such savings are not necessarily available to independent enterprises. For example, the administration costs incurred by a multinational which both manufactures and retails toasters are likely to be less than the aggregated costs faced by two separate firms, one of which manufactures toasters, and the other of which retails them. In the absence of intangibles, the price determined under the cost plus method would then be higher than the price determined under the resale price method. This means that there would be a negative residual if the residual profit split approach were to be used.

Economies of scale are not an aspect which can readily be evaluated in a traditional arm's-length analysis. However, it is an important factor that needs to be addressed when determining whether a multinational's transfer prices are consistent with the arm's-length principle.

One approach to this problem may be to use the contribution analysis approach. Under this approach, the combined gross profit of the two parties to a transaction is allocated between them, on the basis of their relative contribution to that profit. This
differs from the residual profit split approach, in that basic returns are not allocated to each of the parties to the transaction before the profit split is made.

8. Administration

8.1 Examination practices

The Ministry of Finance is aware that transfer pricing cases can present special challenges to the normal audit or examination practices. Transfer pricing cases are fact-insensitive and may involve difficult evaluations of comparability, markets, and financial or other industry information. However, the Ministry of Finance is in the process to set up a special unit that will specifically deal with transfer pricing. Technical assistance will also be provided to the Ministry of Finance by OECD and the South African Revenue Services.

8.2 Burden of proof

The burden of proof is on the tax payer. However, the tax payer could be assured that the burden of proof will not be misused by groundless or unverifiable assertions about transfer pricing.

8.3 The mutual agreement procedure

The Ministry of Finance is aware that double taxation may occur as a result of transfer pricing adjustments. The Ministry of Finance will, therefore, make use of mutual agreement procedures to endeavour to solve these issues with competent authorities but is not bound to reach an agreement or to resolve tax disputes. Both competent authorities will only endeavour to reach an agreement.

8.4 Corresponding and secondary adjustments

To eliminate double taxation in transfer pricing cases, the Ministry of Finance will consider requests for corresponding adjustments. However, secondary adjustments will not be considered at all.

8.5 Documentation

A taxpayer is required to be in possession of transfer pricing documentation. If the Minister, as a result of this examination, substitutes an alternative arm's-length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Minister or in the Courts.

A taxpayer needs to demonstrate that it has developed a sound transfer pricing policy in terms of which transfer prices are determined in accordance with the arm's-length principle by documenting the policies and procedures for determining those prices. On the other hand, preparing documentation is time-consuming and expensive. It will therefore not be expected of taxpayers to go to such lengths that the compliance costs related to the preparation of documentation are
disproportionate to the nature, scope and complexity of the international agreements entered into by taxpayers with connected persons. In these circumstances taxpayers would be required to submit abridged documentation identifying the relevant transactions and providing details of the methodologies applied. The taxpayer should use judgement to determine the level of documentation required.

The documentation guidelines set out below broadly follow Chapter V of the OECD Guidelines. According to paragraph 5.4 of the OECD Guidelines, the taxpayer’s process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. The Minister would expect taxpayers to have created, referred to and retained documentation in accordance with this principle.

This Practice Note does not prescribe to tax payers what kind of documentation should be available because appropriate documentation depends on each tax payer’s specific facts and circumstances.

In determining an arm’s length price, a tax payer would generally go through a process which will usually include some form of a functional analysis and information gathering on relevant comparables. Tax payers should therefore be able to justify why certain transfer prices are considered to be consistent with the arm’s length principle.

9. **Advance Pricing Agreements (APA’s)**

Due to various factors, the APA process will not in the foreseeable future, be made available to Namibian taxpayers. This Practice Note will thus not deal with APA’s.

**ISSUED BY THE DIRECTOR: INLAND REVENUE**

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