GHANA REVENUE AUTHORITY

PRACTICE NOTE ON

TRANSFER PRICING REGULATIONS 2012 (L.I 2188)

(METHODOLOGIES AND RELATED ISSUES)

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1.0 INTRODUCTION

1.1 Background

This circular provides guidance in applying and adhering to the arm's length principle for transactions carried out between persons in a controlled relationship.

Transfer pricing refers to the determination of prices at which goods, services and intangible properties are transacted between persons in a controlled relationship. When unrelated parties deal with each other, independent market forces shape the commercial pricing of goods, services and intangibles transacted between them. However, in transactions involving persons in a controlled relationship, the lack of independence in their commercial and financial relations can potentially lead to the setting of prices that deviate from independent commercial prices.

Consequently, this results in the distortion of the allocation of profits between related entities, as well as in their tax liabilities. Where the persons in a controlled relationship are located in different tax jurisdictions, the potential distortion in profits and tax liabilities of each related entity assumes a greater concern, as the difference in the taxation level in the different tax jurisdictions may lead to one or more such entities not paying the fair share of tax in one or more jurisdictions, with the related entities enjoying a tax advantage as a group.

The arm's length principle is the internationally endorsed standard for transfer pricing between related parties. When related parties adhere to this principle, it reflect comparability to the pricing that independent commercial entities in similar situations would transact and therefore, there will be no distortion in the profits and tax liabilities. The Ghana Revenue Authority abides by this arm's length principle and believes that this is the most appropriate standard to determine transfer prices of related parties.

Increasingly, tax authorities worldwide are stepping up their audit efforts to verify that transfer pricing of cross-border related party transactions comply with the arm's length principle. Where related party transactions are found not to have complied with the arm's length principle and where the profits and tax liabilities of the related parties in their jurisdictions have been reduced, adjustments to the profits and tax liabilities would be made.

Such unilateral adjustments increase the total taxable profits arising from the related party transactions and hence result in double taxation. If a Double Tax Agreement exists between the jurisdictions where the related parties are located, a taxpayer may have recourse to the Mutual Administrative Procedure where the competent authorities of the tax jurisdictions may, through eventually agreeing on and recognising the arm's length transfer pricing, eliminate double taxation.

As tax authorities increase their transfer pricing audit efforts, taxpayers are equally concerned with ensuring that transfer prices with related parties within its group fulfill the arm's length principle. As their level of cross-border related party transactions increases over the years, taxpayers are also concerned about the potential increase in adverse effects of double taxation if the arm's length principle is not complied with. Hence, taxpayers have highlighted the need for tax authorities to apply the arm's length principle in their domestic legislation as well as the available recourse to eliminate double taxation if they should suffer double taxation as a result of transfer pricing audits.

1.1.1 This Practice Note is issued by the Commissioner General (CG) of the Ghana Revenue Authority (GRA) 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 the facts and circumstances of each transaction, taking into account the taxpayer's business strategies and commercial judgments.

1.1.2 The objective of this Practice Note is to provide taxpayers with guidelines about the procedures to be followed in the determination of arm's length prices, taking into account the Ghanaian business environment. It also sets out the CG's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing transactions.

1.1.3 Although the provisions of the arm's length principle are applicable to persons who are separate legal entities, the contents of this Practice Note will also apply to determine the arm's length consideration for tax purposes of dealings concluded by:

a. a transaction between persons who are in a controlled relationship;

b. dealings between a permanent establishment and its head office;

c. dealings between a permanent establishment and other related branches of that permanent establishment;

d. a transaction between a taxpayer and another taxpayer who are in a controlled relationship; and

e. a transaction between a taxpayer and another taxpayer who are in an employment relationship

1.1.4 The Transfer Pricing Regulations, 2012 (L.I 2188) shall be applicable but commentaries in the OECD transfer Pricing Guidelines may assist in interpretation where necessary. Transactions actually undertaken by the persons in a controlled relationship would be considered, except where the economic substance differs from its form or the structure of the transaction is not one that commercially rational independent persons would arrange. In such a case the analyses described in this note will be applied to the:

a. Substance of the transaction
b. Structure of the transaction as would be expected between independent persons.

1.1.5 This Practice Note is issued for the information of tax officers and taxpayers. It contains the CG's interpretation of and practice in relation to the Transfer Pricing Regulations, 2012 (L. I. 2188). Taxpayers are reminded that their right of objection against assessments and their right of appeal to the Courts are not affected by the application of this note.

1.2 Elimination of Double Taxation

1.2.1 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 a person. Furthermore, Article 9 of the Model Tax Convention stipulates that the arm's length principle must be applied to commercial and financial relations between persons in a controlled relationship residing in the Contracting States. These principles are embodied in each of Ghana's Double Tax Agreements (DTAs).

Double Tax Agreements cannot impose tax liability; they merely allocate existing tax liabilities between countries.

1.2.2 The “business profits” and “associated persons” articles in the Double Taxation Agreements 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 CG holds the view that the Double Tax Agreements do not restrict or limit the application of the methods for determining an arm's length transaction. The CG also takes the view that no inconsistency exists between the Transfer Pricing Regulations, 2012 (L. I. 2188) and the Double Tax Agreements as both embody the arm's length principle.

1.2.3 This Practice Note also applies the arm's length principle to internal dealings between the permanent establishment in Ghana of a foreign legal entity, its head office or other parts of the enterprise.

For purposes of this Practice Note, the profits to be attributed to a permanent establishment are the profits that the permanent establishment would have earned at arm's length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

1.2.4 If a tax authority applies its transfer pricing regulations to make an adjustment to the taxable profit of one of its taxpayers, there will be the potential for double taxation. Where the other party to the transaction is located in another country, and there is a Double Taxation Agreement between the two countries, the taxpayer in that other country may make a claim for a “corresponding adjustment” to relieve double taxation. The appropriate adjustment is however not automatic. The other Contracting State only makes the adjustment to eliminate double taxation if it considers that the figure of adjusted profits correctly reflects what the profits would have been on an arm's length basis. In other words, it has to be satisfied that the upward adjustment made by the first mentioned Contracting State is justified both in principle and amount.

1.3.0 Determination of Comparability

1.3.1 Comparability is central to the application of the arm's length principle. A transaction between related parties is termed a "controlled transaction" whereas a transaction between unrelated parties is termed an "uncontrolled transaction". When assessing whether the terms of a controlled transaction meet the arm's length principle it is necessary to compare those terms with the terms of a comparable uncontrolled transaction(s). The critical question is whether the uncontrolled transaction(s) which is sought to be compared against the controlled transaction is indeed comparable.

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

1.3.3 The practicable standard of comparability will be determined by the amount of data on which comparisons with uncontrolled situations and dealings in a particular case can be based. Comparisons with controlled dealings by other persons cannot be regarded as arm's length comparisons.

1.3.4 The search for comparables should not be separated from the comparability analysis. The search for information on potentially comparable uncontrollable transactions and the process of identifying comparables is dependent upon prior analysis of the taxpayers controlled transactions and of the relevant comparability factors.

1.3.5 A consistent approach should provide some continuity or linkage in the whole analytical process, thereby maintaining a constant relationship among the various steps: from the preliminary analysis of the controlled transactions to the selection of a transfer pricing method, through to the identification of potential comparables and ultimately a conclusion.

1.3.6 The assessment of comparability can be affected, inter alia, by the:

* a. characteristics of goods, property and services transferred;
* b. relative importance of functions performed;
* c. The terms and conditions of the relevant transaction;
* d. The assets used;
* e. The relative risk assumed by the persons in a controlled relationship and any independent party where the independent party is considered as a possible comparable;
* f. The economic and market circumstances in which the transactions take place; and
* g. The business strategies pursued by the related parties or affiliates in relation to the transactions.

1.3.6a Characteristics of the goods, property or services transferred

Differences in the specific characteristics of goods, property or services can often explain the differences in their open market value. Comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions or activities. Focus should be put on the attributes or characteristics that are valued by customers, including but not limited to the intangible benefits of design, trademark and perceived quality.

Goods and Tangible property	Intangible property	Services
Physical features	Form of the transaction	Nature of services
Quality and reliability	Type of property	Extent of services
Availability	Duration of protection	
Volume of supply	Degree of protection	
Branding and trademarks incorporated into the good or tangible property	Anticipated benefits from use	

The significance of the actual characteristics of a product or services being transferred in determining an arm's length price depends on the method applied. In applying the Comparable Uncontrolled Price (CUP) method the actual characteristics of the goods or services are critical. On the other hand when the Transactional Net Margin method (TNMM) or Cost Plus or Resale Price Method is applied, the characteristics of the goods or services transferred are not nearly as important as the functions and risks undertaken by the relevant entities.

1.3.6b **The functions performed**

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

When various functions are performed by a group of independent persons, it might be expected that the person that provides the rare or unique functions or assets, and assumes the most risk, would have the potential to earn entrepreneurial profit. On the other hand, that person might also be expected to bear the greater risk of loss.

The extent to which functional analysis should be performed depends on the transactions. A functional analysis should address the following:

* i. An overview of the organization, the overall structure and nature of business undertaken by each member of a group.
* ii. General commercial and industry conditions affecting the member of the group, an explanation of the current business environment and its predicted changes.

Direct consideration of the transaction under review, the nature and terms of the transaction, economic conditions and property involved

* i. in the transaction, how the product or service that is the subject of the controlled transaction in question flows between the related parties.
* ii. Significant assets used and significant risks borne in relation to the transaction in question, and an analysis of which parties to the transaction undertaken, use or bear each of these

1.3.6c **Functions, assets and risks**

* i. If the related parties are transacting in relation to products for which there is an open market (e.g. quoted markets for securities, commodities or financing), it may only be necessary to conduct a brief functional analysis. In complex cases, for example where intangibles are involved, the analysis needs to be more thorough and rigorous. Particular attention should be paid to the structure and organization of the person.

* ii. The compilation of list of functions, assets and risks does not in itself indicate which of the functions is the most significant, or economically the most important to the value added by the business activities of the person. The critical part of the analysis is to ascertain which are the most economically important functions, assets and risks and how the division of these between the parties to the transaction might be reflected in the price, margin or profit on the transaction.

* iii. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature and value to the respective parties to the transaction that is important.

* i. The risk assumed and extra functions performed should be considered when seeking third party comparable data because these factors have a considerable influence on profitability.

* ii. Where service income can be separated from sales revenue, the service activities should be separately rewarded rather than relying on data on more integrated business that perform both sales and services functions.

1.3.6d **Terms and conditions of relevant transaction**

The terms and conditions of an arm's length transaction define explicitly or implicitly the way the responsibilities risk and benefits are divided between independent persons. When independent persons negotiate contracts or agreements, the ultimate price or margin agreed is influenced by the terms and conditions of the proposed agreement. Examples of the terms and conditions that may influence the agreed price or margin include:

* credit and payment terms;
* volume, duration, product and service liabilities of the parties; and
* warranties and exchange risk.

Contracts/Agreements between related parties may not be adhered to as in the same way to unrelated person and the Transfer Pricing analysis will apply to the actual conduct of the parties involved where it differs from the terms of the contract/agreements.

1.3.6e Economic and marketing circumstances

Arm's length prices or margins may vary across different markets even for transactions involving the same property, goods or services. Achieving comparability requires that:

* the market in which the independent and related enterprises operate are comparable; and
* differences either do not have a material effect on price or can be appropriately adjusted if they do have a material effect

The relevant factors for comparing markets include;

* i geographical location of the markets;
* ii. size of market;
* iii. extent of competition in the market;
* iv. availability of substitute goods and services;
* v. transport cost;
* vi. the level of the market (retail or wholesale)

1.36f Business strategies

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

Business strategies of an entity are formulated by the parent company after consultation with and input from related persons and then put into operation by the relevant persons. The local entity may have the autonomy to formulate a local business strategy, or strategies may be developed by a cross-national group committee.

In a transfer pricing context, the question is whether an independent entity in similar circumstance might have participated in these strategies and if so what reward it would have expected.

Market penetration strategies involve the implementation of conditions where parties to the transactions temporarily agree to forgo some profits or incur losses to position themselves for more substantial profits in the future.

If there are costs incurred or profits forgone by the person resulting from a strategy or policy, the question to be answered is which person obtains benefit from these decisions and the attribution of the costs of such a policy or strategy.

Independent persons will not be prepared to accept strategies or policies that reduce their level of profit for the benefit of another person. In arm's length transactions, any person accepting additional risks or functions would demand an appropriate reward.

To prove that a business strategy between related parties is consistent with the arm's length principle, it is necessary to establish whether independent persons dealing at arm's length have, or might be expected to accept the terms and conditions of the strategy in the same or similar market circumstances.

1.4 Documentation

The CG, for the purpose of obtaining full information in respect of the income of a person, or of any part thereof, may require the person or any other person to produce for examination, or by any person appointed by the CG at such time and place as may be determined, any "documents" or "information" (as defined under Regulation 8 of Transfer Pricing Regulations 2012 (LI 2188) which the CG may require.

The purpose of this section of the Practice Note is to cover the broad issues relating to the types and extent of documentation which taxpayers are expected to keep, to be able to demonstrate how their methods and prices satisfy the arm's length principle. These include

* a. A general description of the organisational, legal, and operational structure of the group of associated enterprises of which the taxpayer is a member, as well as any relevant change therein during the taxable period.
* b. The group's financial report or equivalent annual report for the most recent accounting period.
* c. A description of the group's policy in the area of transfer prices, if any.
* d. A general description of the nature and value of the controlled transactions in which the taxpayer is involved or which have an effect on the income of the taxpayer.
* e. A description of the functions, assets and risks of group companies to the extent that they affect or are affected by the controlled transactions carried out by the taxpayer, including any change compared to the preceding period.

With respect to each material controlled transaction carried out by the taxpayer, a description of the transfer pricing method used by the

* a. taxpayer to demonstrate that the prices and other financial indicators associated with the transaction satisfy the requirements of the arm's length principle and a description of why such methods are the most appropriate transfer pricing methods within the meaning of Regulation 3 of Transfer Pricing Regulation 2012 (LI 2188).

* b. A comparability analysis supporting the taxpayer's application of the most appropriate transfer pricing method prepared in accordance with the provisions of Section 3.

* c. Financial data showing the results of controlled transactions sufficient to demonstrate the taxpayer's compliance with Section 1 applying the most appropriate transfer pricing method within the meaning of Section 4, paragraph 1.

The CG recognizes that compiling and maintaining transfer pricing documentation is potentially costly and burdensome for the taxpayer. The depth and complexity of analysis that taxpayers must undertake to support their transfer pricing, and the amount of documentation to be maintained, should not be out of proportion to the size, value and complexity of the transaction. For example, a relatively simple and low-value transaction between two related Ghanaian taxpayers subject to the same rate of tax may require relatively simple analysis and documentation. On the other hand, large value and/or complex cross-border related-party transactions will require in-depth documentation and analysis.

The Arm's Length Range

The application of transfer pricing methods frequently gives rise to range of prices or margins all of which will be reliable. An arm's length range is a range of relevant figures, produced by the application of the most appropriate transfer pricing method, which are all reliable, and equally reliable. These include prices, margins or shares of profit, produced by utilizing data from a number of uncontrolled transactions. Each of these uncontrolled transactions should be relatively equally comparable to the controlled transaction based on a comparability analysis conducted in accordance with the relevant section of the Transfer Pricing Regulations, 2012 (L. I. 2188).

Where a taxpayer's price or margin falls within the arm's length range no adjustment will be made. If a taxpayer's price or margin falls outside the range an adjustment will be made to the mid-point of the range.

An arm's length range comprises a relatively small number of figures, all of which can be considered to be derived from reliable comparable transactions. In some cases it is not possible to identify a range of figures which can all be confidently considered equally comparable and equally reliable. This might occur, for example, if a database is employed to identify a number of comparable transactions, but the availability of data is such that the relative reliability of each indicator is unknown. In such cases, it may be useful and appropriate to employ a statistical analysis. Where such an analysis is used, the GRA would accept ranges such as inter-quartile range that is used to determine arm's length conditions.

2.0 INTRA-GROUP SERVICE

2.1 Service Arrangements

Intra-group service arrangements encompass a wide array of service including administrative, technical, financial and commercial services. The CG accepts the principles defined by the OECD Transfer Pricing Guidelines surrounding the charging for intra-group services. However according to the Transfer Pricing Regulations 2012 (L.I 2188), three main issues must be determined when analyzing intra-group services:

* a. the charge is for a service that is actually rendered
* b. the service provides economic or commercial value to the recipient of the service, and
* c. an independent person in a comparable circumstance will pay that charge for the service.

The OECD Transfer Pricing Guidelines set out the main condition when considering whether a service has been provided:

"…whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle".

The OECD Transfer Pricing Guidelines further require the intra-group service person providing the service to determine which services:

* relate to shareholder activities;
* benefit specific group members; and
* benefit the group as a whole.

The costs of shareholder activities are not to be recharged unless they are performed on behalf of the parent by a group company in which case they should be recharged to the parent. These are activities performed for the benefit of the parent company in its role as shareholder and do not directly benefit the subsidiaries. Shareholder activity should include:-

a. meetings of the parent company's shareholders
b. issuing of shares in the parent company
c. costs of the supervisory board
d. maintaining the share register
e. activities to satisfy statutory reporting requirements of the parent company
f. an audit of the parent company.
g. services provided by a parent company for a subsidiary that duplicate what the subsidiary already performs

Example

A parent company audits the financial statements and records of an overseas subsidiary company to satisfy its own investors and legal requirements. The audit duplicates the audit the overseas subsidiary company performed on its own under its own domestic laws.

Since the audit is performed by the parent company as a steward for its own investments rather than benefiting the overseas subsidiary company, the parent company should bear the cost of the audit.

2.2 Deduction of expenditure paid for intra-group service

2.2.1 Expenditure made under an intra-group service arrangement and calculated using a particular mark-up could be deductible under section 13 of Internal Revenue Act 2000, Act 592, but the question of whether the expenditure made under the intra-group service arrangement is deductible depends on what the expenditure was calculated to achieve from a practical and business point of view.

2.2.2 An expenditure incurred in obtaining the supply of goods or services from a related party under a contract will be characterized by reference to the contractual benefits passing to the person under the contract and the way those benefits relate to the person's profit.

2.2.3 Where benefits accrue under a service arrangement and there is justification for the expenditure made, then the service arrangement will suffice to be characterized as an outgoing or expense incurred in the production of the income.

2.2.4 Where the benefits accruing to the related party under an intra-group service arrangement do not provide reasonable justification of the expenditure, the service arrangement alone, will not be sufficient to characterize the expenditure. In that case a broader examination of all the circumstances will be required to determine what the expenditure was for. Depending on the circumstances of the particular case, this may include:

* an examination of the relationship between the person and the party providing the service;
* the manner in which the parties have dealt with each other; and
* the taxpayer's purpose, motive or intention in incurring the expenditure

A service arrangement may not be sufficient to provide reasonable justification for the expenditure under section 13 of Act 592 if the service fees and charges:

* a. are excessive in relation to the benefits conferred by the service arrangement;
* b. guarantee the service provider a certain profit outcome without reasonable justification; or
* c. generate profits for the service provider without any clear evidence that the service provider has added any value or performed any functions. For example, this might occur where there is no clear separation between the service provider's business activities and those of the taxpayer
* d. of headquarters expenses is not commensurate with the services rendered.

3.0 METHODOLOGIES

3.1.0 Comparable Uncontrolled Price (CUP) method

3.1.1 The CUP compares the price for property, goods or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. An uncontrolled price is the price agreed between independent parties for the transfer of property, goods or services. If the transfer is in all material respects comparable to the transfer between related parties, the price becomes a comparable uncontrolled price.

3.1.2 There are two possible types of comparison which are:

* a. internal comparable uncontrolled price where the price to the controlled transaction is compared to the price charged in a comparable transaction between one of the parties to the transaction and an independent person and;
* b. external comparable uncontrolled price where the price to the controlled transaction is compared to the price of a comparable transaction between independent parties, both of whom are unrelated to the parties to the controlled transaction

The use of an internal comparable uncontrolled price is preferred because relatively the circumstances of the controlled transaction are likely to reflect more closely those of the uncontrolled transaction.

Example A

Company A resident in Ghana manufactures chocolate which it sells at a price of GH¢100.00 per carton to a subsidiary in France but at a price of

GH¢120.00 to an independent person also in France and carries out the same function as the subsidiary.

Assuming all other factors of comparability such as contractual terms are the same an amount of GH¢20.00 per carton sold should be added to Company A's assessable income.

3.1.3 Reliable application of the CUP method requires that there are no differences in the transactions being compared or that the effect on price of any differences that exist can be accurately accounted for by way of an adjustment. While all comparability factors should be considered, the most important are

* similarity of products
* contract terms
* economic circumstances and market conditions

3.1.4 Where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, the CUP method and another transfer pricing method can be applied in an equally reliable manner, the comparable uncontrolled price CUP method is to be preferred.
Situations where it is most appropriate to apply the CUP method include but not limited to:-

a. interest rate charged on borrowing between persons in a controlled relationship;

* a. royalty charged on licensed intangible properties (e.g. trademark, design, copyright etc.); and
* b. price charged for the sale of listed securities

3.1.5 If no comparable price can be found, other traditional transaction methods will have to be used. The main difference between the CUP method and the Resale Price and Cost Plus methods is that the former compares the consideration for a comparable product or service in comparable circumstances whereas the Resale Price and Cost Plus methods seek to compute the gross margin the person might be expected to achieve for functions undertaken, assets utilized and risks assumed.

3.1.6 If appropriate to the facts and circumstances of a transaction the Transactional Profit Split and Transactional Net Margin Method can be considered. Where the evidence does not point to a clear conclusion, an alternative method may be considered.

3.2. Cost Plus (CP) method

3.2.1 The CP method uses the costs incurred by the supplier of property, goods or services in a controlled transaction. An appropriate CP mark-up is added to this cost, to make an appropriate profit in the light of the functions performed taking into account assets used, risks assumed and the market conditions. What is arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm's length price of the controlled transaction.

3.2.2 The CP method starts by computing the cost of providing the goods or services and adds an appropriate mark-up. In contrast, the Resale Price method starts from the final selling price and subtracts an appropriate gross margin to arrive at a purchase price. The CP method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the person as well.

3.2.3 Under the CP method, the mark-up should be calculated by reference to similar internal or external uncontrolled transactions. The comparability of transactions is important and adjustments are required to account for product and other relevant differences. (i.e. functional differences)

3.2.4 The mark-up of the seller should be determined by reference to mark-ups on similar items sold at arm's length by the same seller or by comparable vendors under the same conditions. The mark-up should provide the person with an appropriate profit in view of the functions performed and the market conditions. The CP method is particularly useful in transactions between related parties such as:

* a. sale of manufactured goods; where the manufacturer does not use unique intangible
* b. joint facility agreements or long term buy and supply arrangements; and
* c. provision of service

Example B1

Company B resident in Ghana specializes in the production of chip board for a related overseas person under a contract manufacturing arrangement. Under the arrangement, Company B would be provided by the overseas related person with all the technical know-how used in the manufacturing of the chip boards and manufacturer to the order of the related parties.

Company X is an independent contract manufacturer of chip boards in Ghana. It sells the products to an independent German distributor. Similarly to Company B, it is provided with technical know-how by, and it manufactures to the order of, the German distributor. Company X is identified as an external comparable person, charges an average mark-up of 10 per cent.

Assume Company B incurred direct and indirect costs of GH¢200.00 in producing one unit, the arm's length cost plus mark-up would be GH¢20.00 (ie. GH¢200 x 10%)

Example B2

Company B resident in Ghana is a manufacturer of plywood. It sells this product to its foreign subsidiary F. Company B earns a 5 per cent gross profit mark-up with respect to its manufacturing operation. Companies P, Q, and R are independent domestic manufacturers of plywood. Companies P, Q and R sell to independent foreign purchasers and earn gross profit mark-ups with respect to their manufacturing operations that range from 3 to 5 percent.

Company B accounts for supervisory, general and administrative costs as operating expenses, and thus those costs are not reflected in cost of goods sold. The gross profit mark-ups of Companies P, Q and R, however, reflect supervisory, general and administrative costs as part of costs of goods sold.

If the CP method is used, the gross profit mark-ups of Companies P, Q and R must be adjusted to provide accounting consistency.

Example B3

Company K in Togo is a 100 per cent subsidiary of Company B which is resident in Ghana. Compared with Ghana, wages are relatively lower in Togo. At the expense and risk of Company B, television sets are assembled by Company K. All the necessary components, know-how, etc. are provided by Company B on toll manufacturing basis. The assembled product is guaranteed by Company B in case the television sets fail to meet a certain quality standard. After the quality check the television sets are brought – at the expense and risk of Company B – to distribution centres Company B has in several countries.

The function of Company K can be described as a purely toll manufacturing function. The risks Company K would bear are the eventual differences in agreed quality and quantity. The basis for applying the CP method can be computed by aggregating all the costs connected to the assembling activities.

Example B4

Company G of a multinational group agrees with Company B which is resident in Ghana, and a member of the same multinational group, to carry out contract research for Company B. All risks of a failure of the research are borne by Company B, which also owns all the intangibles developed through the research and, therefore, has the right to the profit potential that may arise from the research.

This is a typical setup for applying a CP method. Where a CP method is available and appropriate, all costs for the research, which the related parties have agreed upon, have to be compensated plus the appropriate mark-up.

3.3.0 Resale Price (RP) method

3. 3.1. The resale price method is based on the price at which a product that has been purchased from a related party is resold to an independent person. This resale price is reduced by the resale price margin representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties) as an arm's length price of the previous transfer of property between the related parties.

3.3.2 If an enterprise performs all the functions an independent distributor might be expected to perform, the resale price method can be particularly suitable. If an enterprise is performing part of a manufacturing process (for example primary manufacture) and is not the owner of valuable intangibles, or is providing some limited service which supports the group's core activity while not itself being pivotal to the earning of profits, then the cost plus method may be more appropriate.

3.3.3 The resale price method will be most useful where the reseller contributes little to the value of the product ultimately on-sold on an arm's length basis. This is because reliable comparables are more likely to be found. The method will be most reliable if the reseller on-sells within a short time because the more time that lapses, the greater the risks assumed in relation to changes in the market, in rates of exchanges, etc. This, and similar issues, will become significant if there are significant variances between such business practices carried out by the tested party, and those carried out by parties identified as comparables. If there are significant differences that, at arm's length, are likely to impact upon the return to resellers, it will be necessary to make comparability adjustments.

3.3.4 The resale price margin represents the amount out of which a reseller would seek to cover its selling and other operating expenses and in the light of the functions performed taking into account assets used and risks assumed, make an appropriate profit. The resale price margin should be calculated by reference to the margin in similar internal or external uncontrolled transactions.

3.3.5 The resale price margin is expected to vary according to the amount of value added by the reseller. Different situations can occur where the combination of functions, assets and risks add value to the product. This can be illustrated as follows:-

a. if the reseller performs limited services as a forwarding agent or broker, the comparable resale profit margin may be derived from an examination of commission or brokerage fees;

* a. if the reseller takes legal title in the goods, assumes the business risks, warehouses and distributes them to customers, the resale profit margin applicable to a principal would be relevant;

* b. if the reseller, in addition to the functions and risks in (b) also undertakes marketing, education and other activities, assumes warranty and other risks and employs intangible assets such as a developed distribution network, the additional functions undertaken, risks assumed and intangibles used should result in higher expected returns in line with that earned by independent resellers with a similar profile of functions, risks and assets.

3.3.6 The appropriate resale profit margin might be expected to increase with increased assets, functions and risks. If the reseller incurs a significant amount of marketing expenditure for the promotion of a trademark, that is owned by a related party and risks its own resources in these activities, the reseller would be entitled to a commensurately higher expected return than an agent.

3.3.7 Where the reseller has the exclusive right to resell the goods, the appropriate resale price margin is influenced by such matters as:

* a. size of the geographical market and the existence and relative competitiveness of possible substitute goods;

* b. level of activity undertaken by the reseller (e.g. substantial resources are committed to marketing the property or a monopolistic turnover is realized without much effort) and

a. risks, including those associated with having the only source of supply and being tied to the other enterprise's product development cycles

Example C1

Company C resident in Ghana purchased fashion and clothing from its U.K. parent company and sells them through various retail outlets in Ghana. Company Y, independent distributor purchases similar products from various suppliers in the Far East sells the same to end customers and earns an average gross margin of 40 per cent. Company Y carries out comparable functions (including assets used and risks assumed) to Company C.

Assume Company C sold a particular line of women's clothing it purchased from the UK parent company and derived sale proceeds of GH¢2.0 million. The arm's length price for this line of clothing it purchased from the UK parent company should be GH¢1.2 million (i.e. GH¢2.0m * (1 – 0.4).

Example C2

Assume that a warranty is offered with respect to all products so that the downstream price is uniform. Distributor Y, which purchases goods from an independent supplier, performs the warranty function. Distributor Z, which purchases goods from a related party supplier, does not perform the warranty function which is performed by the supplier (i.e. products are sent back to the factory).

If Distributor Y is to be used as a comparable to Distributor Z, then adjustments may be needed.

If Distributor Y accounts for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the differences is automatic. If the warranty expenses are accounted for as operating expenses, there is a distortion in the margins which must be corrected. The reasoning in this case would be that, if Distributor Z performed the warranty itself, its supplier would reduce the transfer price and therefore Z's gross profit margin would be greater.

3.4.0 **Transactional Profit Split (PS) method**

3.4.1 The Transactional Profit Split (PS) method identifies the aggregate profit to be split for the related parties from a controlled transaction(s) and then splits those profits between the related parties based on an economically valid basis. The combined profits to be split are the profits combined earned by the associated enterprises from the controlled transaction under review.

3.4.2 The traditional transaction methods might continue to work in circumstances where the functions of group members are inter-related. However, there are situations when group functions are so intertwined that they cannot be evaluated separately and the most appropriate way is to examine the whole process from initial manufacture to end sale and work out the real economic contribution made by each enterprise by way of a functional analysis.

3.4.3 If the final prices of goods do not reflect the cost of manufacture but the functions (research, technology, marketing and promotion) that are spread among group members, all of whom are adding value, and operating in various tax jurisdictions, it may be difficult to compute the price at which the goods, in different states of incompleteness at different points in the process, would have been passed between independent enterprises.

3.4.4 After the functional analysis has been carried out to identify the real economic contribution made by each enterprise to the process, the next step is to allocate to each enterprise the share of profit or loss which it would have anticipated at the time the relevant arrangements were set up, had each been transacting with independent unconnected parties. The aim of the profit split method is to identify the aggregate profit to be split for the related parties from a controlled transaction(s) and then split those profits between the parties according to an economically valid basis that approximate the division of profits that would have been anticipated and reflected in an uncontrolled transaction or uncontrolled transactions made at arm's length between independent persons.

3.4.5 The profit may be the aggregate profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the persons. Factors to be taken into account in undertaking a profit split are:

* a. whether the profit split is to be undertaken on a particular product line, an aggregation of products, or a whole of entity basis;

* b. whether it is necessary to identify the persons in relation to the transaction and the profits of each person so as to determine the profits to be split among them if the person transacted with more than one connected person;
* c. whether the accounts of the related persons need to be put on a common basis as to accounting practice and currency and then consolidated in order for the combined profit to be determined

Example D1

Company D and Company E are related persons resident in Ghana and another tax jurisdiction respectively. Company E manufactures goods and sells them to Company D, which distributes them to independent persons.

The manufacturer employs unique manufacturing processes or owns valuable product intangibles (such as patents), and, at the same time, the distributor owns and employs unique marketing intangibles (such as brands).

The combined profit from the transaction is GH¢60 being GH¢20 to the manufacturer and GH¢40 distributor. These two entities are dealing in products that do not have reliable comparables. In this instance the profit split is more applicable than applying a one-sided method such as Cost Plus method, Resale Price method or a TNM method.

The profit is split as follows:-

Company E (Manufacturer)			Company D (Distributor)		
Sales to Company D		GH¢200	Sales to customers		GH¢ 320
Less			Less		
Direct cost	100		Purchases materials from E	200	
Indirect cost	20		Indirect costs	20	
		120			220
Gross profit		80	Gross profit		100
Deduct Admin. & other costs		60	Deduct		
			Selling & other costs	40	
			Administration & other costs	20	
					60
Net profit		**20**	Net profit		**40**

The profit split is 40 / 20 in Company D's favour.

If a profit split method is to be used, it will be necessary come to a view on how the profit would have been split between the parties had they been independent parties acting at arm's length. In this case, it will be necessary to consider the extent to which value is added by a) the product intangibles held by manufacturer E, and b) the marketing intangibles held by distributor D. The answer will be dependent on the facts and circumstances of this specific case, and will entail careful analysis.

Let us assume in this case that it is determined that both the product and marketing intangibles are valuable in this case, and both contribute to a premium profit earned in the manufacture and sale of these goods. In order to apply the profit split method, their relative contribution needs to be assessed. Again, any method for determining this would be heavily dependent on the facts and circumstances of the individual case. In some cases it may be appropriate to simply estimate the relative value of the product and marketing intangibles by means of an analysis of the economic and commercial environment in which the business is conducted.

Let us assume that analysis shows that the value of the intangibles held by the two parties to the transaction can be estimated by reference to historical spend on developing them. For example, it may be established that the value of any spending by D on marketing diminishes over a period of 3 years, Taking this into account, an analysis of marketing expenditure over the previous three years might establish a present value of, say, 100. A similar analysis on R&D expenditure over a relevant period might establish a present value of, say 300. If this analysis is accepted, then the profit split might be 3:1 in favour of manufacturer E.

3.4.6 Projected profits or actual profits

The profit split may be undertaken on the basis of a projected or actual profit. If a profit split is used to establish a transfer pricing as opposed to reviewing a transfer price, the projected profits will have to be used because the actual profits would not be known at this time. If there were variations between projected and actual profits, the person should make appropriate adjustments when reviewing its profit split projection for future years if, and on the basis that independent parties might be expected to do.

3.4.7 Where prices have been set using a basis other than a profit split method any profit split evaluation to test compliance with the arm's length principle should be undertaken on the actual profits achieved by the application of the other basis using the same information that was available at the time of the price setting.

3.4.8 Splitting using a contribution analysis

Splitting profits on the basis of a contribution analysis means that the aggregate profits from controlled transactions are divided between the participating connected persons based upon the relative value of the functions performed assets used and risks assumed by each of the connected persons participating in those transactions, supplemented by external market data that indicate how independent persons would have divided profits in similar circumstances.

3.4.9 Splitting using a residual analysis

Splitting profits on the basis of a residual analysis involves the division of the combined profit from the connected persons' transactions using a two-stage approach.

3.4.10 Each participant is first allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. The basic return would be determined by reference to the market returns achieved for similar types of transactions by independent persons. It is frequently possible to employ cost-plus, resale-price or TNMM to determine basic returns. The basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants.

3.4.11 Any residual profit or loss remaining after the first stage division would be allocated among the participating connected persons based on their relative economic contribution and an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent persons.

3.4.12 At each stage, it is necessary to have regard to the relevant functions performed, assets contributed and risks assumed by each party.

Example D2

Company E manufactures goods that it sells to its connected person, Company D resident in Ghana, which resells the goods to independent parties. The total combined profit from the operations is GH¢1,000. Company D is rewarded GH¢250 for the marketing, distribution and other functions undertaken based upon an analysis of typical returns for that type of business activity using TNMM or RP while Company E is rewarded GH¢150 based upon an analysis of returns for similar manufacturing functions.(e.g. using CP)

The remaining profit of GH¢600 is then allocated on the basis of the contribution of each of the companies to the value of the intangibles, say 10% (being GH¢60) to Company E and say 90% (being GH¢540) to Company D.

* Profits

	Company E	Company D	Total profits
Return to basic manufacturing and distribution (Taking into account tangible assets, functions & risks)	GH¢150	GH¢250	GH ¢400
Return to intangibles	(10%) 60	(90%) 540	600
Total	**210**	**790**	**1000**

When an overall loss is incurred, the same logic should be followed. If the total loss from operations is GH¢500, Company D is still rewarded GH¢250 for the marketing, distribution and other functions undertaken while Company E is still rewarded GH¢150 for the manufacturing function undertaken. The residual loss of GH¢900 is then allocated on the basis of the contribution of each of the enterprises to the value of the intangible, say10%, being GH¢90 to Company E and say, 90% being GH¢810 to Company D.

* **Losses**

	Company E	Company D	Total profits
Return to basic manufacturing and	GH¢150	GH ¢250	GH¢400
distribution (Taking into account			
tangible assets, functions & risks)			
Intangibles	(10%) -90	(90%) -810	-900
Total	**-60**	**-560**	**-500**

While this example is based on fixed contributions, market reality may be such that a distributor's margin may change because of a range of factors including low levels of sales, promotion costs and discounts arising from competition. The possibility, therefore, exists for lower than normal rates of return during lean years and commensurately higher returns during good years.

3.4.13 Other approaches to splitting profits

There are other possible approaches that may be used in splitting the profits between related parties. These include splitting:

* a. the combined profits so that each connected person participating in the transaction earns the same rate of return on the capital employed in that transaction. The method should be used cautiously, particularly if some of the group members are providing high value added services;

* b. the combined profits based on the division of profits that actually results from comparable transactions among independent persons. The use of this method is extremely remote because it will be difficult to find independent persons engaged in transactions that are

* a. sufficiently comparable. If such comparable can be found, then the traditional methods should have been adopted;

* b. profits using a flexible methodology that recognizes the contributions by different persons over economic and product life cycles;

* c. profits using a formula. Weightings used in the formula must be based on some form of external market data.

3.5.0 Transactional Net Margin Method (TNMM)

3.5.1 The transactional net margin method examines the net profit margin relative to an appropriate base such as sales, costs or assets that a person realizes from a controlled transaction or transactions that it is appropriate to aggregate. This is compared with the result achieved by independent persons on a similar transaction(s). The main difference between the transactional net margin method and the profit split method is that the former is a one-sided method" that is applied only to one of the connected persons, whereas the latter is applied to all the relevant connected persons.

3.5.2 The transactional net margin method requires the comparison of net margins obtained in its related party dealings against either:

* a. the net margins of the person's dealings with independent persons in comparable circumstances; or
* b. the net margins earned in comparable dealings between two independent persons.

3.5.3 The focus is initially on examining the net margin relative to an appropriate base. The relative usefulness of the various profitability ratios depends largely on the facts of the case and the extent of reliable data being available for the person and any comparables. Any ratio analysis should be directed at net profit or some similar point because the transactional net margin method emphasizes the comparison to be undertaken at the net profit rather than the gross profit level.

3.5.4 Under the Transactional Net Margin Method (TNMM), margins are calculated after operating expenses but before interest and taxation. As a result, differences in transactions that would not have an effect on a gross margin need to be accounted for under this method. Multiple year data should be considered in the transactional net margin method for both the person under examination and independent persons to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions. The following ratios are useful for this purpose: Ratio of

* a. net profit before tax to sales;
* b. net profit (before interest and tax) to sales;
* c. gross profit to operating expenses;
* d. net profit before tax to shareholders' funds;
* e. earnings before interest and tax to assets;

* f. net profit (before interest and tax) to operating expenses and cost of goods sold.

Example E1

3.5.5. Distributor A, a company based in Ghana, purchases food products from a related party in Nigeria and distributes those goods to independent customers. Its accounts for 2012 show a net return of 0.5%.

A comparability analysis shows that it is possible to find entities in Ghana that carry out sufficiently comparable functions to A. Reliable financial data available on those comparable entities is available only at the net profit level. Accordingly, it is decided to employ a TNM method, with A as the tested party, and using net profit/sales as the applicable indicator.

By means of a database search, 17 Ghanaian entities are found that conduct functions that are comparable to those conducted by A. A financial analysis of those entities reveals a range of net margins (by reference to sale) of 0.4% to 5.5%, with an inter-quartile range of 3.5% to 4.2%.

The reported profit falls outside the interquartile range, and the profit of A must be adjusted, for tax purposes, to a point that falls within the range.