International Journal of Innovative Research and Advanced Studies (IJIRAS)
Volume 3 Issue 12, November 2016

ISSN: 2394-4404

Ripple And Negative Effects Of Transfer Pricing On Nigerian Tax Base

Dr. Patrick .I. Zaiyol

Okoli Jude

Nkom Cynthia Nnambae

Department of Accounting and Finance,
Faculty of Management Sciences, University of Agriculture,
Makurdi, Nigeria

Abstract: Transfer pricing has become a global issue as a result of globalization and international trade. Tax authorities all over the world have turned their attention on transfer pricing as a means of preventing the erodent of the countries tax base. This paper therefore focus on Nigerian transfer pricing experience with Multinational companies and also highlights the negative effect of transfer pricing on the tax base of Nigeria. A conceptual approach was taken to review several literatures to highlight methods and negative effect of transfer pricing on Nigeria tax base. Also identified are the FIRS regulations on transfer pricing and recommendations were made on the way forward.

Keywords: Transfer pricing, Tax base, Multinational Companies (MNC'S), Tax avoidance.

I. INTRODUCTION

The nature of transaction with multinational companies is based on the company's driven forces which differ from market forces. The large volume of international transactions is not stimulated by market forces but common interest in the company. This situation gives rise to "transfer pricing". Transfer pricing is a general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to setting of prices for transactions between associated enterprises involving the transfer of property or service. These transactions are referred to as controlled transactions, as distinct from "uncontrolled" transaction between companies that are not associated and can be assumed to operate independently (on arm's length basis) in such terms for such transactions. Where transfer pricing does not accord with arm's length principle under domestic law, tax administrators considers it "mis–pricing" "incorrect pricing" "unjustified pricing" or "non-arm's length transaction" and issues of tax avoidance and evasion will arise.

Multinational companies will always want to maximize shareholders value through higher stock prices, a function of current and long term profit to this end tend to minimize tax.

Williamson (1975) stated that when a firm expands its operations either domestically or internally, transactions are influenced by visible hand of managerial authority rather than invisible hand of competitive price system. Accordingly, one of the primary advantages of multinational firms versus domestic firms lies in its flexibility to transfer resources across borders through globally maximizing networks (Kogut, 1983). It is clear that the potential for tax arbitrage that result from globalization creates a considerably and continuing incentives for domestic corporations to internationalize their business (Plender and Simon, 2004). The fact that transfer prices are values assigned to intermediate goods, which moves within organizations, the fact that they are related party transactions within organizations can erode the tax base of a country. Investigation suggest that transfer pricing threatens the tax base of counties and tax authorities face substantial difficulty in unveiling complex operations between subsidiaries of multinational companies.

II. TRANSFER PRICING IN NIGERIA ECONOMIC ENVIRONMENT

Investigations have shown that most multinational companies in Nigeria have been running circles around Nigerian tax authorities using a complex but noxious tax avoidance scheme called transfer pricing, for any economy it is slow death. For corporate organizations determined to escape the tax authority but still cleverly staying on the right side of the law, transfer pricing is the new cellar door constructed by most ingenious Accountants. It is a global disease to which developing economies like Nigeria are most vulnerable.

Multinational companies employ transfer pricing to move profits offshore, leaving behind a shrinking tax base in the host countries and inexorable cut to public services. In Nigeria, tax avoidance has been one of the factors starving government of revenue needs for development.

A. THE NIGERIAN CONTEXT

Since transfer pricing is an international taxation issue, Nigeria is no exception. It has continued to befuddle both the tax payer and tax authorities (Humphrey, 2010), it is a valid business practice for associate companies in the pricing of inter-related sales within the group and on the other hand of the divide, it creates a suspicion for tax authorities that the pricing may be form of profit shifting with the result of providing avenues for tax avoidance. In the Nigerian context, the issue is helped further as there has been difficulties in bringing multinational companies to the tax net especially as a result of online transactions where there is no clear cut regulation covering such transactions. An increasing share of world trade consists of cross border transactions within groups of affiliated companies, more so the advent of considerable foreign direct investment in Nigeria. These has literally collapse the national boundaries between countries and this situation has created difficult transfer pricing questions in cases where there are inter- related transactions.

These transactions may involve the transfer of tangible goods, intangible property such as technology or brand names, services and financing. Tax authorities are therefore interested in the methods companies use to set transfer prices since the prices directly affect the tax base of the country.

Under the Nigerian tax laws, the basis for charge of tax on transactions between related companies is provided in section 12 (2) (d) companies income tax act (CITA), CAP C21 laws of the federation 2004 (section 11 (2) (d) CITA CAP 60 LFN 1990 as follows:

The profit of a company, other than a Nigerian company from any trade or business shall be deemed to be derived from Nigeria –

- ✓ Where the trade or business or activities is between the company and another person controlled by it or which has a controlling interest in it and conditions are made or imposed between the company and such person in their commercial or financial relations which in the opinion of the Board to reflect arm’s length transaction. The Act has empowered the federal inland revenue service (here in after called “the Revenue”) to make adjustments in order to reflect arm’s length transactions in situations where in its opinion it deems the trade or business or activities between related parties to be artificial or fictitious.
- ✓ Section 22 of the company income tax Act LFN (18) 1990, provides the meaning of artificial transactions as: “where the Board is of the opinion that any disposition giving effect to any transaction which reduces or would reduce the amount of any tax payable is artificial or fictitious, it may disregard such disposition or direct that such adjustments shall be made as respect liability to tax as it considers appropriate so as to counteract the reduction of liability to tax affected, or reduction which would otherwise be affected, by the transaction and any company concerned shall be assessable accordingly. The thrust of this provision is that the revenue shall disregard any disposition, which in this effect means any transaction or agreement that would reduce the tax payable and direct such adjustment in order to counteract the reduction of liability to tax.

B. TREND OF TRANSFER PRICING IN NIGERIA

To depict the nature of transfer pricing in Nigeria premium time’s investigation by Emmanuel M. (2015) reveals that:

- ✓ MTN Nigeria has routinely been shipping billions of naira overseas to avoid paying its fair of tax in Nigeria
- ✓ That in 2013 MTN set aside ₦11.398 billion from MTN Nigeria to be paid to MTN Dubai. In a rare disclose in 2013, MTN admitted it made unauthorized payment of ₦37.6 billion to MTN Dubia between 2010 – 2013. The transfer were then “un-paid” to Mauritus a shell company with zero number of staff and which physical presence in the capital is nothing more than a post office letter box. The disclosure amounted to a confession given that MTN made dodgy transfers without seeking approval from National Office for Technology Acquisition and Promotion (NOTAP) the body mandated to oversight such transfers.

On the basis of an earlier management fees agreement that was technically quashed by NOTAP and on the basis of MTN’S reported revenues, it is estimated that ₦90.2 billion could have been transferred out of Nigeria in management fees alone since the company was founded in 2002.

Furthermore, between the periods of 2005 – 2007 Nigeria lose £502 million in transfer pricing via trade miss- invoicing (Christian Aid report, 2009, p.5). Developing countries like Nigeria are vulnerable to the use of transfer pricing to avoid taxes especially by the multinational oil companies (Kapoor, 2007, p 13). In Nigeria, oil companies such as shell international petroleum, Halliburton and chevron in 2003, 2002 and 1999 are estimated to have avoided US$17,857,142.86million , US$14,285,714.20 million and US$710,506,000 in taxes respectively using a novel design of accounting transactions with domestic and foreign government

 ISSN: 2394-4404

(Bakre 2006, p.16-19). Nigeria is vulnerable to this strategy of tax avoidance and related capital flight because it lacks sufficient information from parent company to be able to challenge transfer pricing. According to Adediran (2006:15) “no Indian companies in Nigeria have come out with meaning profit instead they would be posting losses as a result of over – invoicing of the transfer goods and services”. This of course is not healthy for our country because it reduces the revenue accruable to the government.

C. HOW TRANSFER MIS-PRICING IS CARRIED OUT

- ✓ *ARTIFICIAL OPERATING COST:* To pay little or no tax, companies determined to cheat begin by seeking ways to create artificial operating cost in the country where they operate. It makes huge profit but decides to declare a much lower-profit before tax to achieve this it pays the parent company and/or subsidiary company for services not rendered and ships cash to them. Where services are rendered, the costs are inflated. Such services may include royalty for use of brand name, procurement services, technical services and management services. Typically the recipient company is located offshore territory under a different financial jurisdiction.
- ✓ *TRANSACTIONS WITH COMPANIES IN TAX HEAVENS:* Where the resident company in Nigeria have an inter-company transaction with controlling entity in tax heaven, any payment made to oversee would raise the suspicion that the entity in tax heaven served the purpose of tax shifting to tax heaven (onyeukwu, 2007, p.3)
- ✓ *SUBSIDIARY OF FOREIGN COMPANY IN NIGERIA:* In Nigeria, where there is controlling interest by the parent company in the activities of the subsidiary company, it will lead to artificial transaction which would give rise to transfer pricing.
- ✓ *PRESENCE OF INTER-COMPANY INTANGIBLE TRANSACTIONS:* Where there is large royalty payment by loss-making affiliate is a factor that can trigger transfer pricing.
- ✓ *THIN CAPITALIZATION:* When the capital of a company is made up of a much greater contribution of debt than equity, it is said to be thinly capitalized. Multinationals uses interest on debt to reduce taxable profit since such transactions are non-tax deductible.

D. NEGATIVE EFFECT OF TRANSFER MIS-PRICING ON NIGERIA TAX BASE

- ✓ Transfer pricing has the potential of increasing the burden on other tax payers while multinationals profit increases, since where the government chooses not to increase the burden on other tax payers to complement revenue shortfall, the consequences is revenue-expenditure gap which will deprive citizens of the basic social goods and services or reduction in the quality or quantity of goods and services. It is safe to say that transfer mis-pricing by multinationals increases their profit at the expense of other tax payers
- ✓ The end result of transfer mis-pricing is that revenue ordinarily due to the government are converted into higher profit for multinational companies when they are shifted artificially away from the jurisdiction entitled to it to another. This shrinks the tax base of the country thereby leaving the country to source revenue else where
- ✓ According to Baistrocchi (2006:950), transfer pricing manipulations produces two major consequences, firstly it puts national tax jurisdictions under stress because it is an income shifting system that allows MNC’s to maximize after tax profit by channeling taxable income to jurisdiction with lower taxes, secondly, it raises horizontal equity issues because it provides substantial advantage to MNC’s over non-MNC’s only the former can use this type of international tax planning strategy.

III. FIRS REGULATION ON TRANSFER PRICING

A. CITATION

The regulation may be cited as the income tax (transfer pricing) regulation no. 1 2012 and shall come into force in 2012 and replace any arrangement in place with any company before the commencement of this regulation.

B. SCOPE

The Regulation shall apply to transactions between connected persons carried on in a manner consistent with the arm’s length principle and includes;

- ✓ Transactions between a Permanent Establishment (PE) and its head office or other related branches. Branches are treated as separate entities
- ✓ Sale and purchase of goods and services
- ✓ Sales, Purchase or Lease of tangible assets
- ✓ Transfer, Purchase or use of intangible assets
- ✓ Provision of Services
- ✓ Lending or borrowing of money
- ✓ Manufacturing arrangement
- ✓ Any transaction which may affect profit and loss or any other matter incidental to the foregoing

C. COMPARABILITY FACTORS

- ✓ For the purpose of determining whether a transaction(s) is consistent with the arm’s length principle, the Service shall determine whether such a transaction is comparable with a similar or identical transaction by an unconnected taxable person.
- ✓ In determining whether two or more transactions are comparable the following factors shall be considered to the extent that they are economically relevant to the facts and circumstances of the transactions—
  - The characteristics of the goods, property or services transferred or supplied;
  - The functions under taken by the person entering into the transaction taking into account assets used and risks assumed;
  - The contractual terms of the transactions;
  - The economic circumstances in which the transactions take place; and

 www.ijiras.com | Email: contact@ijiras.com

- The business strategies pursued by the connected taxable persons to the controlled transaction.

D. CONNECTED TAXABLE PERSON

'Connected Taxable Person' includes, without limiting the generality hereof, persons, individuals, entities, companies, partnerships, joint ventures, trusts or associations (collectively referred to as 'persons' in these Regulations) and including the persons referred to in: (i)Sections 13 (2) (d), 18 (2) (b) and 22 (2) (b) of the 1990 CITA; (ii) Section 15 (2) of the PPTA; (iii) Section 17 (3) (b) of the 1993 PITA; (iv) 'Article 9' of the OECD Model Tax Convention (v)'Associated enterprise' of the OECD Guidelines.

E. APPLICATION OF UN AND OECD DOCUMENTS

- ✓ Subject to paragraph (2)This Regulation shall be applied in a manner consistent with—
  - The arm's length principle in Article 9 of the UN and OECD Model Tax Conventions on Income and Capital for the time been in force; and
  - The OECD Transfer Pricing Guidelines for Multi-national Enterprises and Tax Administrations approved by the Council of the OECD for publication on 22 July, 2010 {Annex I to C (2010)99} as supplemented and updated from time to time.
- ✓ Where there is any inconsistency between the relevant Acts and this Regulation or the UN Practical Manual on Transfer Pricing or the OECD documents referred to in paragraph1 above, the relevant Acts shall prevail. This regulation shall prevail in the event of inconsistency with other regulatory approvals such as National Office for Technology Acquisition and Promotion (NOTAP).

F. CONSISTENCY WITH ARM'S LENGTH PRINCIPLE

All transactions between connected taxable persons shall be conducted at arm's length prices and conditions as required by the UN Practical Manual and OECD documents as referred to in Regulation 6.

- ✓ Where a connected taxable person has entered into a transaction or a series of transactions to which this Regulation and relevant Acts apply, the person shall determine the income and expenditure resulting from the transaction or transactions in a manner that is consistent with the arm's length principle.
- ✓ Where a connected taxable person fails to comply with Paragraph 7 (1), the Service may make necessary adjustments to ensure that the income and expenditure resulting from the transaction or transactions are consistent with the arm's length principle.
- ✓ In determining whether the result of a transaction or series of transactions is consistent with the arm's length principle, the most appropriate transfer pricing method shall be used taking into account— (a)The respective strengths and weaknesses of the transfer pricing methods in the circumstances of the case; (b)The appropriateness of a transfer pricing method having regard to the nature of the controlled transaction determined, in particular, through an analysis of the functions undertaken by each person that is a party to the controlled transaction; (c)The availability of reliable information needed to apply the transfer pricing methods; and (d)The degree of comparability between controlled and uncontrolled transactions, including the reliability of adjustments, if any, that may be required to eliminate differences.
- ✓ Where any connected taxable person has used an appropriate transfer pricing method in accordance with any of the methods listed in this Regulation, the Service may examine whether or not the income and expenditures resulting from the connected taxable person's transaction or transactions are consistent with the arm's length principle.
- ✓ A connected taxable person may apply a transfer pricing method other than those listed in this Regulation, if the person can establish that:
  - None of the listed methods can be reasonably applied to determine whether a controlled transaction is consistent with the arm's length principle; and
  - The method used gives rise to a result that is consistent with that between independent persons engaging in comparable uncontrolled transactions in comparable circumstances.

G. TRANSFER PRICING DISCLOSURE

- ✓ For each year of assessment a connected taxable person shall without notice or demand make a disclosure in the prescribed form (TP disclosure form) details of transactions that are subject to this Regulation.
- ✓ The TP disclosure form shall be filed along with the connected taxable person's annual income tax returns for each year of assessment.

H. OFFENCES AND PENALTIES

A taxable person who contravenes this regulation shall be liable to a penalty of Two Hundred Thousand Naira (N200, 000.00) or 1% of tax unpaid or underpaid (whichever is higher) in addition to payment of the amount of tax unpaid or underpaid or imprisonment for a term not exceeding 3years or fine of Two Hundred Thousand Naira (N200, 000.00) or both fine and imprisonment.

I. TRANSFER PRICING METHOD

The regulation recommends five methods as follows:

- ✓ Comparable Uncontrolled Price (CUP) method -It is a direct comparison between the price charged for a specific product in a con- trolled transaction and the price charged for a closely comparable product in an uncontrolled transaction, in comparable circumstances.
- ✓ Resale price method - It is based on the price at which a product purchased from a related 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.

- ✓ Cost plus method- It requires an estimation of an arm's length consideration, by adding an appropriate mark-up to the costs incurred by the sup- plier 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. It is often used where the controlled transaction is the provision of service
- ✓ Comparable profits method -it attempts to measure how much profit a related party in a controlled transaction would have realized had that party been involved in an otherwise identical uncontrolled transaction. Under this method, the tested party's overall results, rather than its transactions, are compared with the overall results of similarly situated enterprises for which reliable data is available.
- ✓ Profit split method- It provides an alternative in cases where no comparable transaction between independent parties can be identified. This would normally happen when transactions are very interrelated that they cannot be evaluated separately. The method is based on the concept that profits earned in a controlled transaction should be equitably divided between associated parties involved in the transaction according to the functions performed.

J. CHALLENGES OF IMPLEMENTING THIS REGULATION

- ✓ Levels of education and expertise of the tax administrators
- ✓ The legal environment, including characteristics of transfer pricing legislation and responsibility for and the scope of the regulation
- ✓ Networks of comprehensive bilateral tax treaties including articles relating to associate enterprise
- ✓ Availability of information technology system that allow for the most effective strategies to encourage compliance
- ✓ Transfer of intangibles to related enterprises, difficulty in valuation
- ✓ Specific payment (e.g interest, premium, royalties to related parties)- quantifying the value.
- ✓ Shared services relationship with resulting income.
- ✓ Poor/ non-existent documentation

IV. CONCLUSION

From all data and statistics available, it is undisputable that transfer pricing has been a tool that multinationals use to evade tax thereby shrinking the tax base of the country attributable from business transactions of MNC's. Most MNC's are keen on developing strategies to evade tax as such, there goal differs from the host countries. For all accruable revenue to be brought to tax net there will be need for FIRS to enforce the transfer pricing policies at all levies and the introduction of transfer pricing regulation in Nigeria will go a long way in curbing the excesses of MNC's if adequately implemented. Finally, proper implementation of transfer pricing rules in Nigeria will lead to rapid increase in the tax base of the country.

V. RECOMMENDATIONS

- ✓ There should be regular and adequate enforcement of legislation made to checkmate activities of MNC's transfer pricing transactions.
- ✓ Professional accounting bodies like ICAN should begin to punish members that aid MNC's in the menace of the game of transfer pricing
- ✓ FIRS should ensure periodic reviews of documentations of MNC's transfer pricing transactions
- ✓ There should be corporation with border countries on transfer pricing related transactions since activities cut across national borders to ensure repatriation where necessary.
- ✓ FIRS should develop thorough benchmarking analysis for evaluating and comparing the performance of independent parties carrying out similar activities in a similar environment
- ✓ There is need for adequate training of tax administrators to be very conversant with transfer pricing procedures, to significantly breach the gap in level of understanding of the principles to tax payers and tax authorities to reduce potential disputes.
- ✓ MNC's should regularly reassess their transfer pricing policies to ensure that they are consistent with arm's length principle as this will aid them in obtaining tax efficiencies without breaking the law. It could reduce tax enquiries, which can be very costly and time consuming and could lead to additional tax and penalties.
- ✓ FIRS should establish thin capitalization rules to avoid MNC's taking advantage of thin capitalization
- ✓ FIRS should harmonize there regulations with NOTAP and promote corporation among the regulating agencies to avoid overlap of functions.

REFERENCES

[1] Adediran S.A. (2006): *Multinational transfer pricing, international taxation and comparative financial report practices* a Ph.D seminar presented at lgbinedion University Okada.

[2] Afolabi E. (2012) *Transfer pricing in Nigeria: the new reality*, Templers

[3] Ajay D. (2012) Transfer pricing rules in Nigeria. FIRS publication

[4] Baistrocchi. E. (2006): *The Transfer Pricing Problem Tax Lawyer*, Vol. 59 No. 4. Argentina Universidad Torcuato Di Tella, Buenos Aires.

[5] Bakre, O. M. (2006) *Tax Avoidance, Capital Flight and Poverty in Nigeria: The unpatriotic collaborations of the elite, the multinational corporations and the accountants:* Some evidence. Retrieved November 13 2014, from http://visar.csustan.edu/aaba/Bakre2006

[6] Christian Aid Report (2009) *False Profits: Robbing the poor to keep the rich tax free. A Christian Aid Report*, March 2009.

[7] Ernst & Young (1991), *International Transfer Pricing, New York:* Business International

[8] Humphrey O. (2010) *Transfer pricing in Nigeria context*

[9] Kapoor, S. (2007) *Hemorrhaging Money, A Christian Aid Briefing on the Problem of Illicit Capital Flight.*

[10] Kogut, M. (1983). *"Endogenous transfer pricing and the effects of uncertain regulation",* Jounal of International Economics 24, 147.

[11] KPMG (2012) *Transfer pricing a rising new dawn in Nigeria. KPMG.*

[12] Nnaemeka O.(2015), *The Impact of Transfer Pricing on Economic Growth in Nigeria*, International Journal of Academic Research in Business and Social Sciences, Dec 2015, Vol. 5, No. 12

[13] OECD. (1995); *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* Paris: OECD

[14] Okpe, I. I. (2000). *Personal income tax in Nigeria*. Enugu: Ochumba Printing and Publishing Company.

[15] Ola, C. S. (1981). *Income tax laws for corporate and unincorporated bodies in Nigeria*. Ibadan: Heinemanna Educational Books ltd

[16] Olusanya g. (2013) *Transfer pricing and thin capitalization* CITN Tax Conference

[17] Onyeukwu, Humprey (2007) *Transfer Pricing in the Nigerian Context.* Selected Works January 2007, Retrieved November 15 2014 from http://works.bepress.com/humphrey_onyeukwu/s

[18] Plender, J and M. Simons (2004), *"A big squeeze for governments: how transfer pricing threatens global tax revenues",* Financial Times (London, England) July 22

[19] Premium time news (2015) *an investigation into MTN transfers pricing dealings* by Emmanuel m, Retrieved from www.premiumtimesng.com/.../192159-investigation-how-mtn-ships-billions-abroad-p

[20] PricewaterhouseCoopers, (2006); EU *Transfer Pricing Documentation*. New York: PricewaterhouseCoopers.

[21] PWC (2012) *Transfer pricing Nigeria implementation imperative*: PricewaterhouseCoopers.

[22] PricewaterhouseCoopers, (2012); T*ransfer pricing frequently asked question.*

[23] Uduayanga .D. Akpanuk E. and Asuguo A. (2009*) Multinational transfer pricing and international taxation what, why, how and reporting challenges*, an international Multi-Disciplinary journal Ethiopia. vol. 3 (5) Oct. 2009

[24] United Nations (2013) *Practical manual on transfer pricing for developing countries*, United Nations New York.

[25] Williamson, O., (1975), *Markets and Hierarchies*, New York: The Free press

[26] http://www.vanguardngr.com/2014/07/shifting-tax-monies-transfer-pricing-phenomenon/