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Introduction of transfer pricing rules

Following the review and amendment of the draft version, Administrative Instruction 2/2017 on Transfer Pricing has been signed by the Minister of Finance and entered into force on July 28 2017.

The purpose of this Instruction is to determine the rules and procedures for the implementation of Article 27 (Transfer Pricing) of Law 05/L-029 on Corporate Income Tax.

What is it?

Transfer pricing (TP) relates to all aspects of intra-group pricing arrangements between related business entities. TP rules are set to prevent profit shifting by multinationals from high to low or no-tax jurisdictions. They consist of legislative acts and guidelines that are used to help determine the taxable profit of taxpayers that participate in controlled transactions with related parties in foreign tax jurisdictions.

The transfer pricing policies of multinational companies have recently attracted a high level of international attention, due in part to the rapid rise of multinational trade, the opening up of several developing economies and the increased impact of transfer pricing on corporate income taxation.

The TP rules prescribed in this Instruction generally follow the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, whereas documentation requirements are as per the EU code of conduct on transfer pricing documentation for associated enterprises in the European Union (2006/C 176/01).

When does it start?

These rules and requirements will be applicable for taxpayers starting from FY 2017.

Who is affected?

This Instruction applies to Kosovo CIT taxpayers that have entered into controlled transactions with related parties established in foreign tax jurisdictions.

'Related parties' are considered to be persons having a special relationship that may materially affect the economic results of the transactions between them.

Examples of related parties include when:

- one person holds or controls 50% or more of the shares or voting rights in the other person's company
- one person directly or indirectly controls the other person
- both persons are directly or indirectly controlled by a third person
- a person is a relative of the first, second or third degree as defined in the Kosovo Law on Inheritance.

'Close family members' include the spouse, parent(s) or child(ren).

A related person is considered to 'effectively control' business decisions of another person if:

- they hold or control 50% or more of the voting rights of another person who is a legal person
- they control the composition of the board of directors of another person who is a legal person
- they have the right to distribute 50% or more of the profits of another person, or
- the other person is a relative or a related party to a relative, and
- based on verified facts and circumstances, they control the business decisions of another person.

The burden of proof for 'effective control' lies with the Tax Authority of Kosovo ("TAK").

What does it mean?

Related party transactions that are covered by this Instruction include controlled transactions between Kosovo residents (including permanent establishments of non-residents in Kosovo) and non-residents, as well as all transactions between Kosovo residents (including permanent establishments of non-residents in Kosovo) and residents of certain low or no-tax jurisdictions[1].

The nature of the transactions covered includes goods, services, intangibles, financial transactions (e.g. rents, loans, interests, guarantees, etc.), capital transactions (e.g. purchase or sale of shares or other securities, including long-term tangible and intangible assets), etc.

[1] Andorra, Antigua & Bermuda, Antigua, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, Brunei, Costa Rica, Dominica, Fiji, Gibraltar, Grenada, Guadalupe, Guam, Guatemala, Guernsey, Guyana, Haiti, Hong Kong, British Virgin Islands, Cook Islands, Falkland Islands, Normand Islands, Solomon Islands, Turks and Caicos Islands, Christmas Island, Mariana Island, Marshall Island, US Virgin Island, Isle of Man, Jamaica, Jersey, Liberia, Liechtenstein, Macao, Madeira, Maldives, Martinique, Mauritius, Micronesia, Monaco, Montserrat, Nauru, Netherland Antilles, Niue, Oman, Palau, Panama, Philippine, Dominican Republic, Samoa, San Marino, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Surinam, Tanzania, Tonga, Trinidad & Tobago, Tuvalu, Vanuatu.

Arm's length principle

TP rules prescribe that controlled transactions be conducted in line with the 'arm's length principle', which means essentially that compensation for any intercompany transaction should conform to the level that would have applied had the transaction taken place between unrelated parties; all other factors remaining the same.

Although the principle can be simply stated, the actual determination of arm's length compensation is quite difficult. Important factors influencing the determination of arm's length compensation include the type of transaction under review as well as the economic circumstances surrounding the transaction. In addition to influencing the amount of the compensation, these factors may also influence the form of the payment.

Comparability

In order to demonstrate compliance with the arm's length principle, controlled transactions have to be compared to comparable uncontrolled transactions to determine the transfer price. Such comparable uncontrolled transactions can be internal (transactions between the controlled party and an independent party) or external (transactions between two independent related parties).

Comparability is determined by considering a variety of factors, including characteristics of the property, goods or services transferred, functions undertaken, risks assumed, assets used and capital employed by each party, contractual terms, economic circumstances and business strategies.

TAK may use uncontrolled transactions for the purpose of making adjustments to the taxpayer's transfer price, but only if such transactions do not contain confidential tax information and other sources of information are available for those transactions.

In the absence of domestic comparables, TAK allows the use of foreign (non-domestic) comparables, conditional upon the taxpayer making comparability adjustments (where necessary) to account for geographical and other differences that impact the financial indicator used.

In cases where information on comparables is not available for the same tax period in which the controlled transaction takes place, taxpayers may use the most recent information available.

TP methods

As per the OECD guidelines, this Instruction recognizes the following TP methods:

1. *Comparable Uncontrolled Price Method (CUP)*

The CUP method compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The price is the appropriate financial indicator for this method.

2. *Resale Price Method (RP)*

The RP method considers the retail price of a product purchased from an associated enterprise, sold to an independent party and reducing it by the resale price margin (i.e. the amount from which a reseller would seek to cover selling and other operating expenses and, in light of functions performed, make an appropriate profit). The resale price margin is the appropriate financial indicator for this method.

3. *Cost Plus Method (C+)*

The C+ method considers the costs (direct and indirect) incurred by the supplier of property or services in a controlled transaction and adds a mark-up to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. The cost plus margin is the appropriate financial indicator for this method.

When the above traditional methods cannot be applied, the following transactional methods can be used:

4. *Transactional Net Margin Method (TNM)*

The TNM method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction and compares it to uncontrolled transactions. There are a variety of financial indicators appropriate for this method.

5. *Profit Split Method (PS)*

The PS method identifies the combined profit to be split between associated enterprises from a controlled transaction and then splits those profits based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

When traditional methods cannot be used, the transactional methods listed above should be considered but, in any case, strengths, weaknesses, appropriateness, availability of information and comparability should be considered when selecting the TP method to be applied. While only one method is required to be used, taxpayers can apply additional recognized methods or a combination thereof to support their TP.

- *Low value-adding intra-group services*

Low value-adding intra-group services are services performed by one member or more of a multinational enterprise (MNE) group on behalf of one or more group members.

They are of a supportive nature (not part of the core business of the MNE group), do not require the use of unique and valuable intangibles (or do not lead to the creation thereof) and do not involve (or do not lead to) significant risk assumed by the service provided.

A simplified approach to determining arm's length is applied in such cases to reduce the compliance cost to taxpayers and provide greater certainty for MNEs when offering such services to their group members. This approach involves calculating, on an annual basis, total costs of all group members for the low value-adding intra-group services, identifying and excluding direct charges and expenses attributable to specific members and distributing such costs among members based on certain allocation keys.

For such services, there is no need to prepare a transfer pricing study, but instead a profit mark-up to a maximum 7% on costs is allowable. If this threshold is exceeded, TAK may not accept it and can require a comprehensive TP analysis to be provided to support the applied margin.

Regardless of the above, TAK may request supporting information and documentation on such services, including a description of services provided/received, beneficiaries, economic rationale, allocation, contracts, calculation and documentation of costs, etc.

- *Adjustments by TAK*

TAK can make adjustments to the prices charged by a taxpayer in controlled transactions only with the approval of the General Director. When financial indicators used are outside the arm's length range, TAK will use the median of the arm's length range, unless it is proven by either TAK or the taxpayer that the arm's length price is not the median but another point in that range.

When there is lack of sufficient information for comparability purposes, TAK can use the interquartile range instead of the arm's length range.

Corresponding adjustments are possible if Kosovo and the corresponding country have a double tax treaty in place. Taxpayers can request TAK to apply corresponding adjustments and the latter will respond within 3 months, notifying them of the approval or rejection (in full or in part) of their request.

How do I comply?

Taxpayers with controlled transactions exceeding EUR 300,000 in a calendar year are required to:

1. Prepare TP documentation as per the EU Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union (2006/C176/01).

    - Update financial indicators of comparable uncontrolled transactions *annually*.

    - Update database searches for external comparables every 3 years (except when significant changes have occurred).

2. Submit an Annual Controlled Transactions Notice to TAK by March 31st of the following year, along with statutory financial statements and CIT declaration.

The TP documentation should include at least the following:

- A summary of taxpayer activities and organizational structure.
- A comparability analysis, including:
    - characteristics of property and services
    - functional analysis (functions performed, assets used, risks assumed)
    - contractual terms

   - economic circumstances and
   - any relevant information on comparable uncontrolled transactions (internal/external) – including any comparability adjustments
- The rationale behind the application of selected TP method and financial indicators.
- Any other information that may be relevant in demonstrating the application of arm's length principle.

The taxpayer's burden of proof ceases when documentation is prepared as per the above Code. Nevertheless, TAK can make adjustments to controlled transactions despite the absence of documentation.

Documentation or the TP file may be submitted in one of the official languages (Albanian or Serbian), as well as in English in special circumstances and upon agreement with TAK. The file should be made available to TAK within 30 days of their request, and failure to prepare and submit documentation in time may be subject to administrative penalties up to EUR 2,500.

For taxpayers with controlled transactions of EUR 300,000 or less in a calendar year, the above apply with the exception of a) submitting the Annual Controlled Transactions Notice (not required); and b) updating of financial indicators of comparable uncontrolled transactions (required every 3 years).

How can PwC help?

With over 3,100 professionals in over 93 countries, PwC's leading transfer pricing network is well positioned to advise you on a strategy that can help advance your goals within the ever-shifting compliance landscape.

PwC Kosovo draws upon its local tax knowledge and experience, together with the transfer pricing know-how and expertise of its global and regional network, to provide clients with end-to-end TP services, specialized TP experience in financial services and TP compliance solutions across industries.

Learn more about TPand PwC by exploring our International Transfer Pricing 2015/16 guide and our TP Talks podcast series.

For more detailed information regarding this legislative change and how PwC can help you comply with TP requirements in Kosovo, please contact us to discuss further.

[Sources: Administrative Instruction 2/2017 on Transfer Pricing; Law 05/L-029 on Corporate Income Tax; Law 03/L-222 as amended on Tax Administration and Procedures]

This Tax Newsflash publication is produced by PwC Kosovo's Tax and Legal Department.