Tax Alert

Rwanda's new Transfer Pricing guidelines go further than the usual

February 2021

Paul Frobisher Mugambwa
Associate Director
T: +250 252 588203/4/5/6
M: +250 782 537 377
frobisher.mugambwa@pwc.com
LinkedIn

Mercy Ndirangu
Manager
T: +250 252 588203/4/5/6
M: +250 783 458 356
mercy.ndirangu@pwc.com
LinkedIn

Click to see how we can help

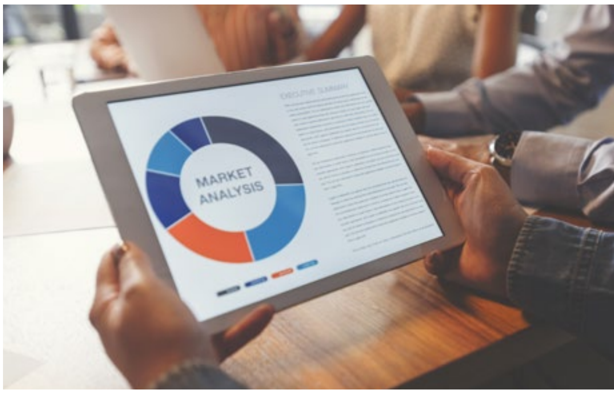
The stakes are high!

Transfer Pricing (TP) is a major concern for tax authorities all over the world. Of specific concern are transactions that lack commercial substance, such as those from which local companies derive no real value or payments that are made to low tax jurisdictions.

It is for these reasons that tax authorities in Africa have stepped up their scrutiny of multinational groups of companies (MNCs) and Rwanda is no exception. The risks to the organisation both from a local and group perspective are real.

These include large corporation and withholding tax assessments coupled with significant penalties and interest on overdue tax, tax uncertainty, protracted and costly tax disputes and, last but not least, the reputational risk to the corporate brand especially when details of transfer pricing disputes find their way into the media - both mainstream and social media!

The Ministerial Order (MO) N° 003//20/10/TC that was issued by the Government of Rwanda on 14 December 2020 did not catch tax practitioners by surprise, since a draft Order had been around since January 2015. While the enactment of the Order may be viewed as a procedural matter that legitimises existing practice, it is expected that it will embolden the Rwanda Revenue Authority (RRA) to confront transfer pricing malpractice with a renewed energy and zeal.



As expected, the Order officially makes it a requirement for affected taxpayers to have local transfer pricing documentation supporting their related party transactions.

The Order also articulates specific guidance on the transactions in scope, the transfer pricing analysis required to support related party transactions and the information that must be provided to the RRA upon request.

Overall, the new rules go further than the OECD Transfer Pricing Guidelines, in many cases, and also beyond the transfer pricing requirements in comparative jurisdictions for example with regard to the scope of transactions captured and the attendant disclosure requirements.

The Scope of transactions covered

The scope of the transactions covered by the Order is broader than that in the OECD Guidelines.

The Order brings into the TP scope two unique transactions that would normally be outside TP regimes.
These include:

- transactions between resident related persons – these are normally outside the scope of most TP regimes; and
- transactions between a resident person and a non-resident person who is located in a country considered by the RRA to provide a **beneficial tax regime,** whether such persons are related or not (deemed transactions).

Including such transactions in the scope could have been influenced by the ongoing legal reforms to support the Kigali International Financial Center in Kigali. Economic substance and non-harmful tax laws are at the heart of the center's values.

The Order defines a **beneficial tax regime** to mean one that is characterised by any of the following:

- no tax on income or a maximum rate of twenty percent (20%);
- grants tax breaks to non-resident individuals or companies;
- does not require a taxpayer to carry out substantial economic activity within this country or tax jurisdiction;
- does not tax foreign-sourced income or taxes such income at a maximum rate of twenty percent (20%);
- does not allow access to information about the corporate structure of legal entities, the ownership of assets, other rights or economic transactions.

In certain areas, the Order's guidance and rules require additional clarification. For example, the Order's "beneficial regime" limitation would capture all transactions with counterparties located in jurisdictions where the corporate income tax rate is below 20%.

One possible implication therefore is that persons that have dealings with low tax jurisdictions will not be allowed to claim a deduction for payments made to these jurisdictions irrespective of whether such costs are genuinely incurred, are at arm's length and with unrelated persons. This potentially raises the following questions:

- Do the rules discourage companies from procuring goods and services from low tax jurisdictions?
- Would Rwandan companies have to first find out whether the suppliers they are dealing with pay taxes at the rate above 20% in their home countries?
- Would this increase the compliance burden and hence the cost of doing business in Rwanda? What does this mean for Rwanda's tax treaty partners?

Most Double Taxation Agreements (DTAs) that Rwanda has concluded have non-discrimination articles which require Rwanda not to levy an additional taxation burden on foreign investments vis-à-vis domestic investments. The new TP rules could conflict with the non-discrimination DTA provisions and could likely be challenged on such grounds.

Restriction of related party transactions to 2% of turnover

It is not clear how the new rules will interact with the current restriction of certain related party transactions to 2% of turnover. The Income Tax Act restricts the deductibility of management, technical and royalty fees paid to non-resident related persons to 2% of the taxpayer's turnover. This could potentially make the TP documentation rules redundant, to a large extent. It also raises the question of whether TP documentation should be prepared for transactions whose value is below the threshold of 2% of turnover. A Practice Note clarifying this matter would be helpful.

Businesses exempted from preparing TP documentation

A taxpayer with an annual turnover below six hundred million Rwandan francs (FRW 600,000,000) [appx US$600,000] is not required to prepare TP policies and documentation. However, to be discharged from the obligation to prepare TP documentation, a taxpayer must have made controlled transactions with the value below ten million Rwandan francs (FRW 10,000,000) [appx US$10,000] or with an aggregate value below one hundred million Rwandan francs (FRW 100,000,000) [appx US$100,000]. The Order further emphasises that a taxpayer discharged from the obligation to prepare documentation must still comply with the arm's length principle.

Transfer pricing filing requirements

The Order provides for the standard filing requirements seen in other countries, for example, the TP must be in place before the deadline for the income tax declaration. While there is no requirement for the documentation to be filed along with the tax declaration, a controlled transactions schedule must be submitted. Therefore, companies whose return is due by 31 March 2021 must quickly adapt. On the other hand, documentation should only be submitted on request and within 7 days from the date of receipt of the written request. This means that the documentation should be readily available. The documentation must be submitted in any of the official languages of the Republic of Rwanda which are Kinyarwanda, English and French.

Other filing requirements include a global organisational structure of the group to which a Rwandan taxpayer belongs, indicating all related persons, their shareholding and their management structure. This must be submitted to the tax administration with the first income tax declaration.

Of interest to multinational corporations operating in Rwanda is the Country-by-Country Reporting (CbCR) requirement. Rwanda is one of the few African countries to adopt this in its legislative framework. CbCR is a reporting obligation arising from BEPS Action Plan 2 that requires corporations meeting certain conditions to file a CbC report annually containing high-level data on the global allocation of the group's income and taxes and certain other measures of economic activity. It is aimed at enhancing transparency for tax administrations. The report must be filed with RRA not later than twelve (12) months after the last day of the reporting fiscal year of the multinational enterprise group.

Administrative fines for non-compliance

As the Order does not provide for specific transfer pricing related penalties, the default penalties for non-compliance, as provided for under the Tax Procedures law, will apply. These include:

- Frw1,000,000 [US$1,000] for failure to keep records of controlled transactions and a further
- Frw1,000,000 [US$1,000] per month where such records are required to be submitted to RRA and the taxpayer fails to submit them.

Disregarding a controlled transaction for tax purposes

The Order explains circumstances in which a controlled transaction may be disregarded for tax purposes. This includes where the arrangements made in relation to a transaction between related persons differ from those which would have been adopted by independent persons behaving in a commercially rational manner in comparable circumstances, preventing the determination of a price that would be acceptable to both of the parties. It is interesting to note that in such circumstances the arm's length position would be as if the transaction had not occurred. In other words, the transaction would completely be ignored instead of adjusting to represent the arm's length position.

Methods to determine arm's length prices

The Order describes the five TP methods that are provided for in the OECD Guidelines. These are:

1. Comparable uncontrolled price method;
2. Resale Price Method;
3. Cost Plus Method;
4. Transactional Net Margin Method; or
5. Transactional Profit Split Method.

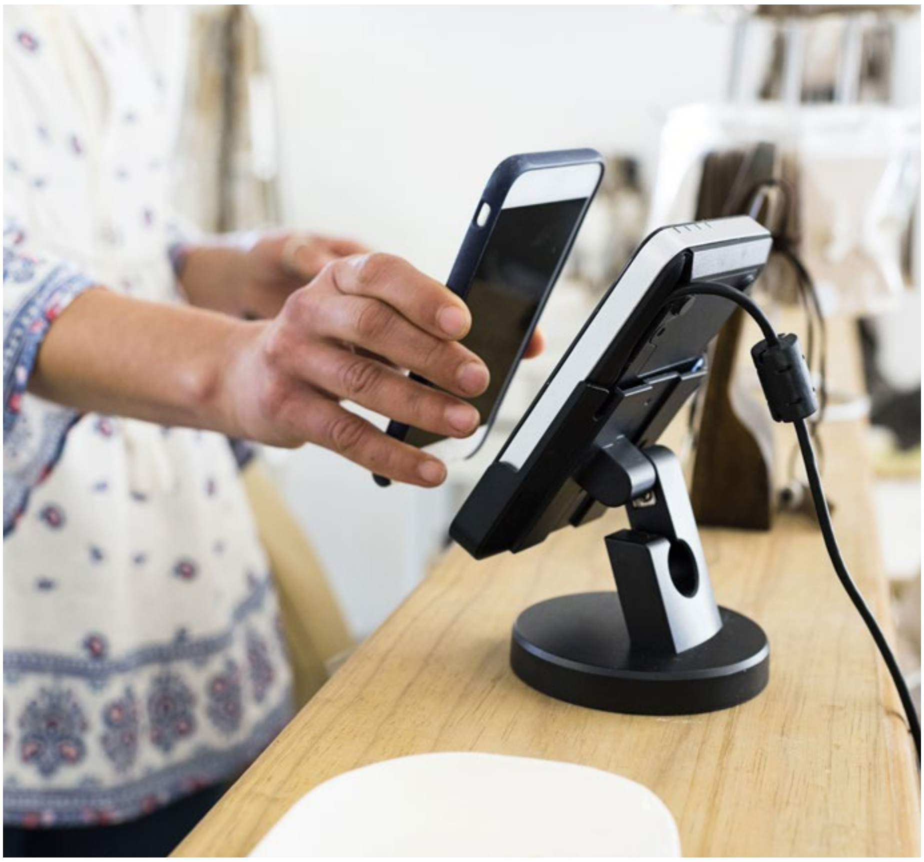
It is worth noting that the Order makes no mention of a hierarchy of methods. However, notable in the Order is the provision which allows persons to apply alternative methods where it is shown that none of the mentioned methods can reasonably be applied to determine whether a controlled transaction complies with the arm's length principle. In doing so, the Order allows for a certain degree of flexibility.

Transfer pricing adjustment could result in dividend income

The Income Tax Act defines dividend income to include income from shares in any societies, other similar income that may be generated by all entities that pay corporate income tax, as well as the outstanding balance after the taxation of income from the correction made by the Tax Administration in the transfer pricing.

This means that following any transfer pricing adjustments by the RRA (which results in a corporate income tax liability), the balance of the adjusted amount is considered a dividend, and this is subject to 15% withholding tax.

This is punitive since although no actual dividend is distributed, tax must be paid at an effective rate of 40.5% [i.e., 30% +15% of 70% (the balance of the adjustment)] on the adjusted transaction. If the transaction involves services, the total tax burden is even as high as 73.5% since VAT reverse charge



(18%) and withholding tax (15%) would have been paid for these services. If then you include fines, penalties and interest the tax burden is likely to be higher than 100% of the transaction value.

What are the likely consequences of non-compliance?

Some of the consequences for non-compliance can be inferred from the Order while others would follow standard corporate income tax procedures. For example, the Order states that non-arm's length transactions will be disregarded for tax purposes. This could potentially mean that the entire transaction will be disallowed and tax paid thereon at the full corporate income tax rate. Other consequences for non-compliance include:

i. Increased risk of tax and transfer pricing audits which could lead to uncertainty and constrain the company's resources.

ii. Adjustments to the transfer prices that could also have implications for the wider group.

iii. Penalties and interest which can be punitive.

iv. Additional withholding tax payable, for example where the payments are routed through treaty partner states and it is found that the receiving entity has no substance. The full withholding tax rate could be applied to the payment in the place of the concessional rate and

v. A recharacterization of the transaction that could result in new tax issues such as VAT. A case in point could be where a cross border purchase of goods is recharacterized as a service. The imported service would attract reverse charge VAT.

How does the Order affect you?

Any person engaging in controlled transactions will be required to have contemporaneous documentation to verify that all related party transactions must at all times be reflective of the current dynamics of the company and the controlled transactions. The guidelines provide that this should be reviewed on an annual basis.

Therefore, a critical and strategic assessment of the impact of the new TP rules on affected transactions should start immediately.

Companies whose filing deadline is 31 March should act quickly to develop their TP documentation and remedy any gaps. While the new rules may have raised certain questions, which have yet to be addressed, it is important to take a proactive position rather than a "wait and see" approach.

The current economic environment has adversely affected tax revenue collection and it is therefore expected that the RRA will be in a hurry to implement the new rules to the letter in a bid to meet its revenue targets.

PwC will continue to engage the Government to help address any potential inconsistencies within the new TP rules and the domestic laws.

How we can help

Our experienced TP team, together with the support of specialist TP staff in our global centres of excellence, provides tailored and business-oriented TP solutions such as the following:

- Preparation of local TP documentation in line with local requirements and global best practice (OECD);
- Review and localisation of global company TP policies to ensure that these fit within the parameters of local TP provisions and global best practice;
- Assisting in liaising with RRA in the event of TP audits, including objections to assessments;
- Reviewing specific transactions (including the provision of intercompany management services) and developing supporting systems to support arm's length results; and
- Assisting with developing/ reviewing TP policies.

Please reach out to any of the PwC contacts in this newsletter or your usual PwC contacts should you require our assistance or if would like to have a conversation about the new guidelines.