NBSM

HIGHLIGHTS OF
TRANSFER PRICING DIRECTIVES, 2081 (2024-25) | NEPAL

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TABLE OF CONTENTS

I. BACKGROUND AND INTRODUCTION

Transfer pricing refers to how multinational companies determine prices for transactions between their related parties in various countries. In the absence of effective regulations, these companies can transfer profits to low-tax jurisdictions, which diminishes the tax revenue of higher-tax nations.

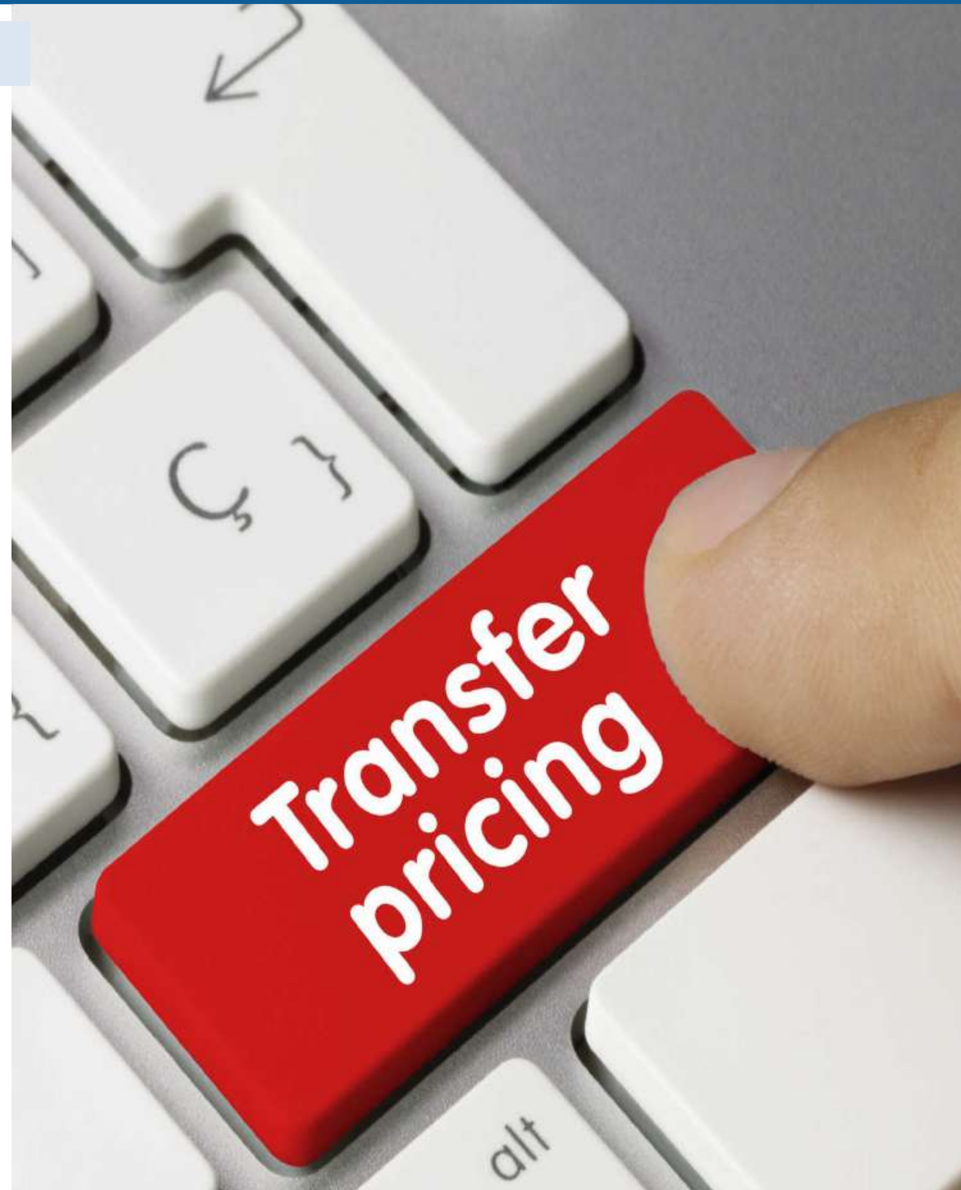
The new Transfer Pricing Guidelines for 2024 aim to ensure that prices for cross-border controlled transactions are established at arm's length, meaning they should be comparable to prices charged between unrelated parties under similar circumstances.

Section 33 of the Income Tax Act, 2058 contains provisions related to transfer pricing and other arrangements between related parties. According to this section, the Internal Revenue Department calculates income from transactions between related parties based on standard market practices, which may involve the distribution, allocation, or allotment of amounts for tax purposes.

The department also has the authority to reassess these distributed, allocated, or shared amounts. Essentially, the principles of transfer pricing among related parties are established by the department.

Since this section provides guidelines for documentation and the structure for reporting transactions, as well as for determining the arm's length market value, this directive has been issued under the authority granted by Sections 33 and 139 of the Income Tax Act, 2058.

This directive is effective from FY 2081/82 (2024-25).



II. DEFINITIONS

- **"Associated person"** means one or more persons or group of such persons acting at the behest of another person and the term includes the following persons: -
  1. A natural person and a relative of that person or a person or a partner of that person,
  2. Foreign permanent establishment and persons having ownership in such establishment, and
  3. An entity that controls fifty per cent or more of the income, capital or voting rights of any entity, or receives benefits from it, by itself or any other person related to it or a subsidiary entity or any other person or entity related to such subsidiary entity. But the following persons shall not be associated persons
     - Employees
     - A person determined by the department not to be an affiliated entity.

- **"Comparability Analysis"** refers to the comparison of controlled transactions with those between independent parties to determine whether the transactions are comparable or not.

- **"Comparable uncontrolled transaction"** refers to a transaction between two independent parties that has been compared to a controlled transaction based on comparability analysis

- **"Controlled transaction"** refers to transactions involving goods, services, assets, or loans between associated persons. Essentially, this term includes any business arrangements or financial transactions that impact the income, profits, losses, assets, or liabilities of those persons.

- "**Transfer Pricing**" means the determination of the value of cross-border controlled transactions between associated persons. Essentially, this term signifies that if a transaction between associated persons is conducted according to normal market practices (arm's length), the taxable income or payable tax can be established based on the results of such transactions. This includes the distribution or allocation of amounts that have been included or deducted in the calculation of income between those persons.

II. DEFINITIONS

- **"Permanent establishment"** means a place where a person carries on business wholly or partly and that term includes:-

1. a place where a person carries on business wholly or partly through an agent other than an ordinary agent acting in an independent capacity in the ordinary course of carrying on business,
2. The place where any person's main equipment or main machinery is or is used or connected
3. One or more persons of any country who have provided technical, commercial or consulting services through any individual employee or otherwise for more than a 90 days at a time or more than once during any twelve- month period; or
4. A place where a person is involved in a construction, connection or installation project for a 90 days or more, and a place where activities related to the supervision of that project are conducted.
5. If you have a significant digital presence in Nepal while staying outside of Nepal, that location, preferably Nepal, if you have conducted data or service transactions in Nepal for at least 90 days in the last twelve months.

- **"Cross-border transaction"** shall mean the transaction of goods or services or property or debt between two or more countries. In addition, the term shall also refer to any other business activity or financial transaction affecting the income, profit, loss, assets or liabilities of that entity.

II. DEFINITIONS

"Resident person" means the following person in respect of any income year:

1. In respect of Natural Person,
    a) Whose normal abode is in Nepal,
    b) Who has resided in Nepal for 183 days or more during a continuous period of 365 days or
    c) Who is deputed by the Government of Nepal to a foreign country in any time of the income year.
2. A partnership firm,
3. In respect of a trust, such trust
    - Which is established in Nepal,
    - The trustee of which is a resident person in an income year, or
    - Which is controlled by a resident person or by a group of persons comprising such a person, directly or through one or more interposed entities
4. In respect of a company, such company,
    a) Which is incorporated under the law of Nepal, or
    b) Management of which is effective in Nepal in any income year.

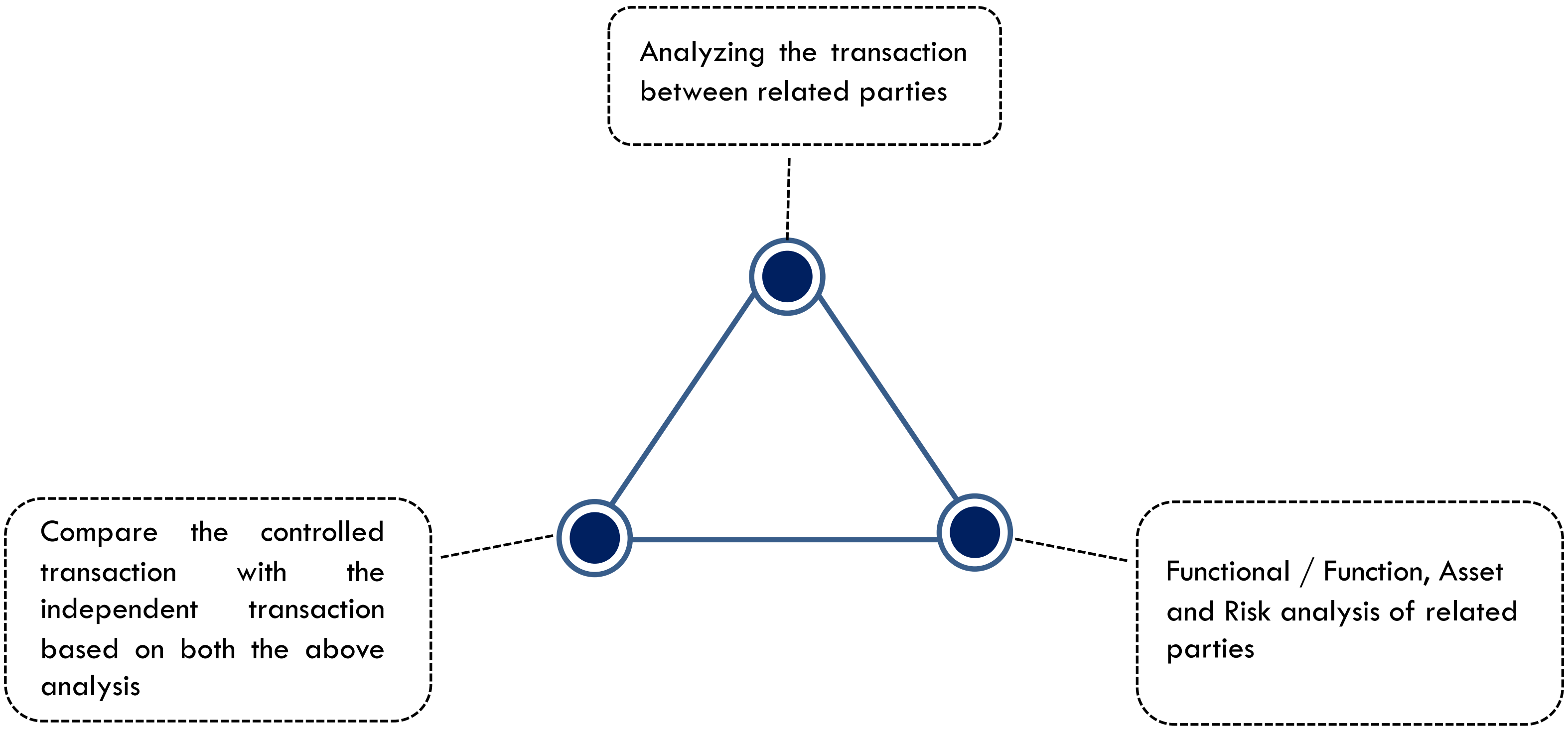
4a. Government of Nepal or Provincial Government,

5. Rural Municipality, Municipality, or District Coordination Committee,
6. In respect of an entity of any foreign government or provincial or local government under that government, such entity,
    a) Which is established under the laws of Nepal, or
    b) Management of which is effective in Nepal in any income year.
7. An organization or entity established under any treaty or agreement, and
8. A foreign permanent establishment of a non-resident person situated in Nepal.

III. COMPARABILITY

The purpose of comparative analysis is to identify comparable uncontrolled transactions for determining the arm's length price. A suitable comparable transaction can only be selected after thoroughly examining all relevant factors, including the nature of the transaction, business performance, external economic conditions, and contract terms

Comparability Analysis Activities



III. COMPARABILITY

Steps of Comparability Analysis

1. Analysis of economically significant characteristics of business and transaction
2. Examination of comparability of factor of controlled transaction
3. Selection of tested party
4. Identification and selection of comparable
5. Appropriate adjustment to comparable
6. Selection of appropriate arm's length method

IV. ARMS LENGTH PRICE

Methods for determining the Arm’s Length Price (ALP)

01 **Comparable Uncontrolled Price (CUP) Method**

This method compares controlled transactions of goods or services with identical or similar uncontrolled transactions to determine the arm's length price. It uses the transfer price between associated enterprises as the basis and can incorporate both internal and external comparable transactions.

02 **Resale Price Method**

Focuses on the resale price of goods purchased from an associated enterprise when sold to an unrelated entity, with adjustments for a suitable gross margin.

03 **Cost Plus Method**

Determines the arm’s length price by adding an appropriate mark-up to the cost of goods or services transferred between associated enterprises.

04 **Transactional Net Margin Method**

Focuses on net profit margins relative to an appropriate base (e.g., sales, assets) and compares this with uncontrolled transactions.

05 **Transactional Profit Split Method**

Splits the combined profit from related party transactions based on the relative contributions of each party.

IV. ARMS LENGTH PRICE

Determination of Arm's Length Price

Based on comparability analysis, relevant comparable transactions are selected, and necessary financial indicators are extracted using the appropriate market value method. The objective is to identify how many of these derived indices align with general market behavior. The following methods will be utilized for this assessment:

1. **Range Method:**

The range method is used when there are seven or more comparable transactions, with an acceptable range of 35% to 65% based on market behavior. Financial indicators are considered reflective of general market behavior if they fall within this range or within 5% above or below the minimum and maximum indicators. If they fall outside this range, they are deemed not to represent general market behavior, requiring necessary adjustments.

2. **Average Method:**

The average method applies when there are six or fewer comparable transactions. It involves calculating the average of the financial indicators. If the tested party's indicator is within 5% above or below this average, it reflects normal market behavior. If it exceeds this range, it is considered outside normal market behavior, prompting adjustments to the financial index and determining tax based on the difference from the average of the comparable transactions.

V. OTHER PROVISIONS

Documentations

According to section 77 of Income Tax Act permits the Department to specify the format for necessary documents detailing the information required for the implementation of the Income Tax Act and its regulations. Taxpayers must maintain records of cross-border controlled transactions with related parties, as well as additional documentation outlined in Schedules 1 and 2 of these guidelines. However, this requirement is not mandatory for taxpayers with an annual turnover of less than Rs. 10 crore

Qualification of Auditors

Only auditors who are registered with the Institute of Chartered Accountants of Nepal (ICAN) and possess a professional certificate under Section 28 of the Nepal Chartered Accountants Act, 2053, are permitted to certify transfer pricing documents.

Companies that conduct cross-border transactions involving goods or services worth more than NPR 50 crore are required to have certification from an auditor distinct from the one conducting the financial or tax audit. This auditor should also have at least five years of experience in auditing.

Fines, Interest and Penalties

If a taxpayer fails to maintain the required documents or submit statements, a fee will be imposed under Section 117. Additionally, if tax installments are not paid on time, interest will be charged under Section 118. Moreover, late payment of tax also incurs interest under Section 119, and if it is determined that a lower tax amount has been paid, a fee will be assessed under Section 120.

Advance Pricing Arrangement (APA) availability

Rule 15 of the Regulation allows for advance price determination based on the normal market behavior of a person, as specified in subsection (1) of Section 33 of the Act. Taxpayers may submit applications to the Department regarding transfer pricing methods and procedures. The Department will issue guidelines on these pricing methods and other necessary arrangements for implementing advance pricing agreements

Dispute resolution

If a taxpayer is dissatisfied with the assessment made by the assessing officer, they may submit an application for an administrative review to the IRD, in accordance with Sections 114 and 115 of the Income Tax Act 2058, by paying the full amount of undisputed tax and one-fourth of the disputed amount.

The Department may fully or partially accept or reject the issues raised in the application and will notify the applicant in writing. If the Department does not issue a decision within sixty days of the application date, the taxpayer has the right to appeal to the Revenue Tribunal under Section 116 of the Income Tax Act.

Subsection (5) states that when appealing to the Revenue Tribunal under subsection (1), the taxpayer must pay the full undisputed tax amount and provide a bond or bank guarantee for 50% of the disputed tax, along with any applicable fees and penalties.

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