TAX INSIGHTS – ISSUE 3 | 4 AUGUST 2025

UNDERSTANDING THE ARM'S LENGTH PRINCIPLE IN INTERNATIONAL AND NIGERIAN TRANSFER PRICING REGULATION

Favour Opurum

Research Officer for the Research & Content Team at EOTI

Introduction

As globalization drives the expansion of multinational enterprises (MNEs), transfer pricing (TP) has become a significant issue in international taxation. Tax authorities across jurisdictions are increasingly scrutinizing how profits are allocated among related entities to prevent Base Erosion and Profit Shifting (BEPS). At the heart of transfer pricing regulations lie the arm's length principle (ALP), which is applied using comparability analysis.

This commentary explores the fundamentals of transfer pricing with emphasis on the arm's length principle, integrating insights from the Organization for Economic Cooperation and Development (OECD)'s Transfer Pricing Guidelines, the United Nations (UN) Transfer Pricing Manual, and Nigerian domestic transfer pricing rules.

Understanding TP

A significant share of global trade today occurs between affiliated entities within multinational enterprise (MNE) groups. These transactions are often influenced by shared group interests and not just open market forces alone. In such cases, determining an appropriate price known as the transfer price, for cross-border transfers of goods, services, and intangible assets within the group, becomes essential. Transfer pricing refers to the pricing of goods, services, intangibles, or financial transactions between associated enterprises (related parties) across different tax jurisdictions.

The concept itself is not inherently problematic or suggestive of tax avoidance, as setting internal prices is a routine and necessary feature of how MNEs manage global operations. However, where such prices diverge from internationally accepted standards, particularly the arm's length principle under domestic tax law, tax authorities may treat the pricing as non-arm's length, or label it as mispricing, or unjustified pricing. In such instances, concerns around tax avoidance or even tax evasion may emerge. Tax authorities would be concerned that if these transfer prices are manipulated, companies may be able to shift profits to low-tax jurisdictions, thereby eroding the tax base of higher-tax jurisdictions. Such transfer pricing practice can reduce the tax income due to governments as well as expose MNEs to possible double taxation.

To counter this trend, countries adopt the arm's length principle, which ensures that intra-group transactions reflect fair market value, just like dealings between unrelated parties would.

The ALP

The arm's length principle stands as the foundation of international transfer pricing frameworks. It is recognized by major global institutions such as the OECD and the UN. It is further incorporated into the domestic tax laws of many jurisdictions, including Nigeria. The principle is articulated in Article 9 of the OECD Model Tax Convention, which provides that:

"Where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

This simply means that MNEs must price transactions with related parties in the same manner they would with independent, unrelated entities. At its core, the arm's length principle seeks to ensure parity between controlled and uncontrolled transactions, thereby preventing artificial profit shifting and ensuring equitable tax outcomes.

It is widely accepted and constitutes a central element of the transfer pricing rules of most tax systems around the world. In Nigeria, the principle is codified in the Income Tax (Transfer Pricing) Regulations 2018 (TPR), issued by the Federal Inland Revenue Service (FIRS). (It is noteworthy that: (a) the FIRS will become the Nigeria Revenue Service (NRS) from 1 January 2026; and (b) the TPR may need to be revoked and reissued, its legal basis having been invalidated by implication in the *Check Point v FIRS* decision of the Federal High Court dated 5 May 2025 – and further replaced by the NRS (Establishment) Act 2025.)

Under the TPR, where a related-party transaction is found to deviate from the arm's length principle, the FIRS is empowered to make the necessary adjustments to the taxable profits arising from such transactions to bring them in line with the arm's length principle.

Comparability Analysis

A core element of applying the arm's length principle is the use of comparability analysis, which involves evaluating whether the conditions of a related-party transaction align with those that would exist between independent enterprises under similar circumstances. According to the OECD Transfer Pricing Guidelines, five key comparability factors must be considered:

- Characteristics of the goods or services involved;
- Functions performed, assets employed, and risks assumed (FAR analysis);
- Contractual terms of the transaction;
- Economic circumstances surrounding the transaction and market conditions; and
- Business strategies pursued by the parties.

Taxpayers are expected to document how their transfer pricing activities align with these factors using recognized methods such as the Comparable Uncontrolled Price (CUP) method, Transactional Net Margin Method (TNMM), and others. (This commentary does not attempt to discuss the various transfer pricing methods.)

Introduction of TP Regulations in Nigeria

Nigeria formally embraced transfer pricing regulation with the introduction of the Income Tax (Transfer Pricing) Regulations 2012, which came into effect on 2 August 2012. These regulations marked a significant step in aligning Nigeria's tax regime with international best practices on BEPS. In response to evolving global standards and the need for greater clarity and comprehensiveness, the 2012 regulations were revoked and replaced by the TPR which came into force on 12 March 2018.

The TPR was designed to guide the proper application of transfer pricing rules in Nigeria. It specifically provides direction on how the arm's length principle should be applied to transactions between related or associated enterprises. According to the FIRS, the TPR provides the legal framework for the application of the arm's length principle to transactions between related persons in Nigeria. The objectives of the TPR are two-fold:

- To protect Nigeria's right to tax profits in line with the actual economic activities of companies operating within its borders, especially in transactions involving related parties. This also helps reduce the risk of double taxation and provides clarity on how such transactions will be treated.
- To promote fairness and prevent tax evasion by equipping tax authorities to detect and address over- or under-pricing in related-party transactions, while ensuring that both multinational and independent businesses operate on a level playing field.

Legal Basis of the ALP in Nigeria

The Nigeria Tax Act 2025 empowers the FIRS to disregard or adjust any artificial or fictitious transactions that are not conducted at arm's length. The TPR specifically requires arm's length pricing for controlled transactions and further outlines acceptable transfer pricing methods and comparability factors for evaluating controlled transactions. The TPR also imposes administrative penalties for non-compliance, reinforcing the need for accurate pricing and transparency in related-party dealings.

Flexibility in TP Methods

To determine whether a transaction meets the arm's length standard, the TPR recognizes five traditional transfer pricing methods: (a) comparable uncontrolled price (CUP) method; (b) resale price method; (c) cost plus method; (d) transactional net margin method (TNMM); and (e) profit split method.

However, the framework is not rigid. The TPR allows taxpayers to adopt any alternative method, provided they can demonstrate that: (i) none of the traditional methods can be reasonably applied to the transaction; (ii) the chosen alternative method gives rise to a result that is consistent with the arm's length principle; and (iii) reliable information needed to apply the chosen transfer pricing method exists. This flexibility ensures that Nigeria's transfer pricing regime remains responsive to the diverse and evolving nature of international transactions.

APAs in Nigeria

Advance Pricing Agreements (APAs) are increasingly being used around the world to provide certainty in transfer pricing outcomes. Reflecting this global trend, Nigeria adopted a formal administrative APA framework through the FIRS Guidelines issued on 27 November 2024, which took effect on 1 January 2025.

Although Regulation 9 of the TPR had initially provided for APAs, the framework became operational after these Guidelines were published. An APA is a formal agreement between a taxpayer and the FIRS that establishes, in advance, the methodology or criteria for determining the arm's length pricing of controlled transactions over a specified period.

Key features of the APA Guidelines include: (i) eligibility criteria for taxpayers; (ii) types of APAs (unilateral, bilateral, multilateral); (iii) scope, duration, and renewal procedures; and (iv) application, negotiation, and review processes.

Closing Remarks

The arm's length principle is the bedrock of international transfer pricing regulation. It is recognized in Nigeria's domestic transfer pricing framework. Globally, countries such as India, Egypt, and South Africa have adopted the OECD Transfer Pricing Guidelines, with local nuances, to address specific challenges and ensure compliance with international standards. Nigeria's TPR is no different.

As such, Nigeria has taken significant steps to modernize its compliance mechanisms, notably through the issuance of APA Guidelines. Strengthening transfer pricing regulations in Nigeria will require more binding legislative instruments. This approach would reduce overreliance on administrative circulars, thereby offering greater clarity and certainty for taxpayers.

Disclaimer

This commentary is not legal or tax advice to readers. Taxpayers and businesses should consult their legal and tax advisors for specific advice regarding their transactions and businesses, including compliance requirements and recourse available to them against tax authorities.

CONTACT US

- info@eotaxinitiative.org
- careers@eotaxinitiative.org
- taxacademy@eotaxinitiative.org