TRANSFER PRICING: DOES KENYA'S TAX LAW PROVIDE ADE

QUATELY FOR THIS?

BY:-

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DECLARATION

I, **RISPAH MUTHONI MWANGI-SIMIYU,** do hereby declare that this dissertation is my original work and has not been submitted for a degree in any other university.

Signed: ....

Date: 15th Dec 2008

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This thesis has been submitted for examination with my approval as University Supervisor

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DEDICATION

This work has been dedicated to my dear mother Dr. Margaret Oteng'o Mwangi who sacrificed so much to give me the light of education and has been a constant inspiration in my life.

ACKNOWLEDGEMENTS

"We are what we repeatedly do. Excellence is not an act but a habit". This is a quote from Aristotle who lived between 384 and 332 BC. It has been indeed true for me to see how I began as a novice but over time and with the help of dedicated lecturers, I have experienced a transformation through continuous struggle to excel in this course. This is what makes Aristotle's quote a truly realistic episode in my short yet dazzling stint at this distinguished university.

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To all of you I say "Asanteni sana" for your prayers and encouragement.

LIST OF ABBREVIATIONS

1. BOP- Bottom of the Pyramid
2. CP- Cost Plus
3. CUP- Comparable Uncontrolled Price
4. EC- European Community
5. FDI- Foreign Direct Investments
6. HRMC- Her Majesty's Revenue and Customs
7. ITA- Income Tax Act Cap. 470
8. KRA- Kenya Revenue Authority
9. MNCs- Multinational Companies
10. MNEs- Multinational Enterprises
11. OECD- Organisation for Economic Cooperation and Development
12. RP- Resale Price
13. TNCs- Transnational Corporations
14. TNMM- Transactional Net Margin Method
15. TP- Transfer Pricing
16. U.K.- United Kingdom
17. U.S.- Unites States of America
18. UKL- Unilever Kenya Limited
19. UUL- Unilever Uganda Limited
20. WTO- World Trade Organisation

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CHAPTER ONE

SETTING THE AGENDA FOR THE STUDY

1.1: Background of the study

With globalization, international taxation has assumed great significance and urgency for legislation in many countries around the world. Multinational corporations, the engines of globalization and world trade and investment, are able to avoid their tax obligations through strategic transfer pricing practices for their goods and services, and intangible assets, to their affiliates, and deny their business partners (host governments and domestic joint venture partners) their equitable share of returns on their investment. This deprives the host government of much needed domestic revenue to finance recurrent and development expenditure, leading to heavy reliance on foreign grants and debts to balance the budget. This act of depriving the host government of the much needed revenue is known as transfer pricing.

Transfer pricing can also be defined in simple terms as a manipulation of prices by a business entity which trades in more than one country, to raise prices in a tax favourable regime in order to compensate the losses on profits they have suffered in unfavourable tax regimes. An OECD observer has defined transfer pricing as the allocation of profits for tax and other purposes between parts of a multinational corporate group.[1]

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[1] http://www.oecdobserver.org/news/printage.php.aid/670/Transfer_pricing:_Keeping_it_at_arm's_length. Last accessed on 25th August 2008.

The Income Tax Act[2] (ITA) does not define transfer pricing. It however states in section 18(3) that;

"where a non-resident person carries on business with a related resident person and the course of that business is so arranged that it produces to the resident person either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length."[3]

In the 2006 budget speech,[4] the then Finance Minister Hon. Amos Kimunya issued the Transfer Pricing (TP) rules[5] under the ITA,[6] which provide guidelines for the determination of an arm's length value of a transaction for purposes of section 18(3) of the ITA. It makes administrative regulations, including types of records and documentation to be submitted to the Commissioner General (Commissioner) by a person involved in transfer pricing arrangements.

In essence, section 18(3) of the ITA and the TP Rules dictate the scope and application of the arm's length principle. This principle requires that the price of a controlled transaction be similar to the price that unrelated parties would adopt when undertaking similar transactions under similar circumstances. A controlled transaction is a transaction between a non-resident and a related resident which is subject to section 18(3) of the ITA

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2 Chapter 470 of the Laws of Kenya, revised in 2006.
3 *Ibid*, Section. 18(3).
4 Budget speech read on 15th June 2006.
5 The Income Tax (Transfer Pricing) Rules 2006, Legal Notice No. 67
6 *Supra* note 2, S. 18(8).

and the TP Rules requiring that such transactions be conducted at arm's length. The ITA defines a controlled transaction as a transaction which is monitored to ensure payment of an arm's length price for goods and services.[7] For purposes of section 18(3) of the ITA and the TP Rules, persons or enterprises are related if either of them participates directly or indirectly in the management, control or capital of the other or if a third person participates directly or indirectly in the management, control or capital of both.

Section 18(3) of the ITA and the TP Rules outline a summary of the arm's length principle and of the accepted methodologies for the determination of arm's length prices. The detail on the basis of determining which method may be the most appropriate in particular circumstances and the manner of applying various methodologies must therefore be determined by reference to rules or guidelines which provide guidance on best practice in this regard.

In the case of *Unilever Kenya Limited v. The Commissioner for Income Tax* ("Unilever case")[8], the High Court of Kenya acknowledged that The Organisation for Economic Co-operation and Development Guidelines on Transfer Pricing ("OECD Guidelines") represented internationally accepted principles which could not be disregarded in applying transfer pricing legislation and which are to be applied in the absence of specific guidelines in the legislation. The OECD Guidelines therefore continue to be of relevance for purposes of providing details required for the application of section 18 (3) of the ITA and the TP Rules.

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[7] *Supra* note 5, Section 2.
[8] HCC No. 753 of 2003, Nairobi.

The Unilever Case[9] was an appeal from the decision of the Local Committee of the Income Tax Department which was delivered on 17th September 2003. The facts of the case are as follows: The Appellant, Unilever Kenya Limited (UKL) once known as East African Industries Limited is part of a world wide Unilever Group of Companies and is substantially owned by Unilever plc., a company incorporated in the United Kingdom. UKL is engaged in the manufacture and sale of various household goods including foods, detergents and personal care items. UKL and Unilever Uganda Limited (once known as Uganda Associated Industries Limited) (UUL) are related companies. UKL and UUL entered into a contract dated 28th August, 1995, whereby UKL was to manufacture on behalf of UUL and to supply to UUL such products as were required in accordance with orders issued by UUL. UKL supplied the products during the years 1995 and 1996. At the same time, UKL was manufacturing and selling goods to the Kenyan domestic market and the export market, to customers not related to UKL.

The prices charged by UKL for identical goods in the domestic export sales were different from those charged by it for local domestic sales. The prices charged by UKL to UUL differed from both the above sales and were lower than those charged in domestic sales and domestic export sales for identical goods, i.e. UKL charged lower prices to UUL than it charged domestic buyers and importers not related to UKL. The Commissioner of Income Tax (The Commissioner), while relying on S. 18(3) of the ITA raised assessments against UKL in respect of the years 1995 and 1996, in respect of sales made to UUL, on the basis that UKL's sales to UUL were not at arm's length prices.

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[9] *Ibid.*

The court observed that reading section.18 (3) of the ITA, it literally means that a seller in Kenya is bound to pay income tax on profits which he/it could have earned had he/it sold its products to an out of country buyer at such a price as would be "arm's length price" UKL would be entitled to calculate the tax-payer's profits on such basis. The important and most relevant words in section 18(3) are:

"The course of that business is so arranged that it produces to the resident person either no profits or less than ordinary profits which might be expected to accrue from that business if there had been no such relationship........."

The issues in this case therefore were whether or not the course of business between UKL and UUL was so arranged as to produce less profits. The Commissioner argued that the transaction between UKL and UUL resulted in less taxable profits to UKL and that the lower price comparable to prices charged to Kenyan buyers or to outside Kenya importers represents a transfer price and hence the difference becomes subject to taxation on the basis of sales at arm's length prices. The Commissioner further argued that the prices charged by UKL to UUL are nothing but "discounted prices. UKL's argument was that the Commissioner had not issued guidelines on how companies were expected to comply with Transfer Pricing(TP) requirements and that he had not responded to the submissions made by UKL on the main issue which is whether the absence of specific guidelines from the Kenya Revenue Authority (KRA) on this issue, the OECD guidelines and the methods prescribed there-under for the calculation of an arm's length price are a proper, reasonable and objectively acceptable basis for the determination of an arm's length price as required under section 18(3) of the ITA.

UKL submitted that in arriving at the arm's length price, the following considerations had to be taken into account:-

i. That transfer prices adopted by a multinational in respect of transactions between its various subsidiaries and affiliates, have a direct bearing on the proportional profit it derives in each country in which it operates;
ii. That a state is entitled to make appropriate adjustments to tax charged on profits of multinational enterprises in its jurisdiction;
iii. That Kenya has promulgated TP legislation adopting the arm's length principle which enables Kenya to adjust the transfer price charged on sales between related companies by invoking the arm's length principle;
iv. That South Africa, Tanzania and the United Kingdom have promulgated similar transfer pricing legislations;
v. That the purpose of the legislations was to ensure that transactions between related parties were conducted at arm's length;
vi. That the provisions merely empower the revenue authority to make such adjustments as may be considered necessary to ensure adherence to the arm's length principle;

vii. That in the absence of specific guidelines issued by the KRA under the ITA, the determination of these principles ought to be made in accordance to the OECD guidelines;

viii. That TP guidelines adopted by other countries endorse the OECD guidelines and require that this be followed in determining arm's length prices;

ix. That even countries who are not members of the OECD have adopted these guidelines;

x. That the KRA is basing its determination of arm's length prices on "comparable prices" which is in fact endorsed by OECD but is doing so erroneously;

xi. That onus is on UKL to demonstrate the consistency of its TP Policy within OECD guidelines;

xii. That the guidelines provide a detailed description of various methods to be used to apply the arm's length principle, namely traditional transaction methods and transactional profit methods;

xiii. That the Commissioner has attempted to apply the first and most recommended method under the OECD guidelines, that is the Comparable Uncontrolled Price method (The CUP method) which compared prices charged in a controlled transaction to those charged in a comparable uncontrolled transaction;

xiv. That having applied the CUP, the Commissioner ought to consider whether the average price charged by UKL in domestic sales in a comparable uncontrolled price to the prices charged by UKL on its sales to UUL, and whether the average price charged by UKL in Domestic Export Sales is a comparable uncontrolled price to that charged by UKL to UUL;

xv. That neither of these prices were comparable since there are wide differences in selling prices per unit weight of the different products and no two sales would comprise a similar mix of products in similar proportions;

xvi. That the commissioner made no allowances for the cost of marketing the goods in Kenya with all resultant overheads and the price of selling the goods to UUL, for UUL to market in Uganda;

xvii. That similar principles applied to foreign countries where Unilever has no sister company and if UKL was to sell to UUL at prices comparable to local or other foreign buyers, the buyers would result to buying the goods from Unilever India or Unilever South Africa and UKL would consequently loose the Ugandan market;

xviii. That is was not possible for UKL to estimate with accuracy the additional costs incurred in Uganda and the only way to make such adjustments was to assume that UKL bore additional costs and to add the aggregate of these to the transfer price to see if the price equated with the Domestic Sales price or export prices;

xix. That if neither the Domestic Sales price nor the Domestic Export Sales prices are comparable for purposes of section 18(3) of the ITA, then there was no Comparable Uncontrolled price of applying the CUP method;

xx. That in the absence of a Comparable Uncontrolled transaction, the OECD lays down the Resale Minus Method and the Cost Plus Method which should essentially achieve the same result from opposite approaches;

xxi. UKL submitted that it is the Cost Plus method that was adopted on its prices to UUL and that even though its internal policy is not binding on the KRA, it is the proper method to be applied in assessing further tax liability in the absence of any guidelines;

xxii. That the TP Policy has the arm's length principle as the underlying principle and that prices set within the Unilever Group of companies "should approximate those set by unrelated parties for comparable goods and under comparable circumstances in an open and free market";

xxiii. That the Unilever TP Policy requires that pricing between companies in the Unilever Group be based on market prices, where it is possible to establish such market prices and where neither the CUP or market price are available, the companies would apply one of the other two internationally accepted principles, of which the Cost plus method is the preferred one;

xxiv. That unless the Commissioner demonstrates that UKL did not correctly apply the TP Policy or that the price charged to UUL was not the Standard Transfer Price, then the court must find that the prices charged to UUL were arm's length prices and that the profits resulting to UKL during the 1995 and 1996 years of income were not less than ordinary profits which would have been expected to accrue to UKL had the company been dealing with an unrelated party and thus the Commissioner's assessment should not stand.

The respondent submitted that the OECD Model Tax convention on Income and on Capital (OECD Convention) and its related guidelines such as the "Transfer Pricing" guidelines for Multinational Enterprises and Administration did not have any application in the appeal because they are used to guide other countries entering into double taxation agreements which is not the case here. Secondly, they argued that the guidelines were not part of the law of the country and that UKL was working on hypothetical figures in comparing the prices. Thirdly, they argued that UKL had sold its products to buyers in Somalia and Tanzania at higher prices than those charged to UUL and that the two entities had arranged between them as two related enterprises to fixing or setting prices of goods between themselves without considering market forces. Lastly, it was submitted that UKL had not demonstrated that the Unilever Group TP Policy did not offend the provisions of S. 18(3) of the ITA, and that in fact, the Policy offended the requirements of S. 18(3) of the ITA.

In his judgement, Judge Alnashir Visram held that he was unable to see the arrangement between UUL and UKL that was to enable UKL make no or less profits, and that the OECD guidelines were not primarily for countries with double taxation guidelines. He also held that the ways of doing modern business has changed very substantially in the last 20 years or so and it would be fool-hardy for any court to disregard internationally accepted principles of business as long as these do not conflict with Kenyan laws and to do otherwise would be highly short sighted. He also held that the language of S.18(3) of the ITA was obscure and a tax payer is entitled to demand that his liability to a higher charge should be made out of reasonable clarity, before he is adversely affected.[10] In addition he said that in the absence of guidelines provided by the ITA, other guidelines should be looked at.

In disagreeing with the respondent's and the Local Committees' method of arriving at the arm's length method for computation of tax, Visram J. said that based on the reasons provided, he did not think that the cost plus method used by UKL was a wrong method of arriving at an arm's length price in the particular circumstances of that case.

It is as a result of this celebrated case that the TP guidelines were introduced in the budget reading of June 2006 and they came into effect on 15 June 2006 through Legal Notice No. 67.

The TP Rules provide that a taxpayer may choose a method to employ in determining the arm's length price from among the following methods which are listed and defined in Rule 7: (See Appendix A)

- The comparable uncontrolled price method ('CUP');
- The resale price method ('RP Method');
- The cost plus method ('CP Method');

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[10] *Scott V. Russell (1948)2 ALL E.R. 1 and Kanjee Nazanjee V. Income Tax Commissioner* (1946) E.A. 257 at 262 H.

- The profit split method ('Profit Split Method');
- The transactional net margin method ('TNMM'); and
- Any other method as may be prescribed by the Commissioner from time to time, where in his opinion and in view of the nature of the transaction, the arm's length price cannot be determined using any of the methods contained in the guidelines.

The TP Rules also provide that a taxpayer shall apply the method most appropriate for his enterprise having regard to the nature of the transaction or class of transaction or class of related persons or functions performed by such persons in relation to the transaction. Rule 4 gives the taxpayer the choice of determining which method amongst those listed in Rule 7 is the most appropriate in determining the arm's length method. Rule 4 has been reproduced in appendix A. The most appropriate transfer pricing method will depend on the relevant facts and circumstances as well as the reliability and availability of the data on which to base a comparability analysis.

The study will focus on the CP method in the services industry as guided by the OECD guidelines, and its application to the services industry, vis a vis KRA's approach to the principle.

1.2: Statement of the Problem

Kenya's tax law on transfer pricing is not as mature as that of for example the United Kingdom, India and South Africa. Following the Unilever case, The Income Tax (Transfer Pricing) Rules, 2006 which are modeled on the OECD guidelines were introduced through the 2006 budget speech with the intention of providing clarity to the transfer pricing concept and the arm's length principle. This, in my view, has not been achieved since the rules created more confusion for both the taxpayer and the taxman, instead of remedying the existing vague situation as it was.

This study deals with the situation prior to and after the Unilever case, and pursues the difficulty of measuring arm's length. It has also addressed the gaps in Kenya's transfer pricing legislation, as well as proposed remedies to the gaps existing in the said legislation.

1.3: Significance of the Study

The Kenyan tax law had no adequate provision for dealing with transfer pricing despite the fact that this was a topical area of law and was of great concern to KRA. Section 18(3) of the ITA is very general and does not address transfer pricing. Rather the section is just a provision to assist the Commissioner confirm that prices between cross-border related parties are appropriate. The transfer pricing rules therefore came into force to augment the previously vague provisions of section 18(3) of the ITA.

In my view the transfer pricing rules brought about more confusion than clarity in this area of law. This study therefore, has analysed this vague area in order to assist all players affected by this field of law.

1.4: Limitation of the Study

The transfer pricing area of tax law is a very novel area thus there was a tendency to rely mainly on secondary sources of data as well as on information from jurisdictions other than Kenya.

1.5: The Conceptual Framework

The study deals with a concept of transfer pricing. As stated in the background to the study, transfer pricing means the allocation of profits for tax and other purposes between parts of a multinational corporate group.[11]It is this practice in international trade that created the arm's length principle as mentioned in the statement of the problem.

In the 60 years since the end of World War II, there has been a marked expansion of international trade and commerce. More recently in Kenya, following liberalisation of the economy in the early 1990s, this trend has intensified, with wide-ranging changes in the volume, complexity and, thanks to modern telecommunications and the internet, the speed with which international trade is carried out. We now talk of a global village!

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[11] *Supra* note 1

Aiming to plug tax collection leaks, recover reasonable tax revenues and bring Kenya in line with international trends, the then Minister of Finance in his 2006 budget presentation[12] published the Income Tax Rules on Transfer Pricing. These rules apply to the pricing of goods and services exchanged between related companies for the purpose of calculating the taxable profits of the entity located in Kenya and therefore taxes payable to the KRA.

In the past, the services sector players may have taken comfort from the traditional focus of transfer pricing on the exchange of goods. However, this is about to change as the new TP rules make it clear that they will apply to the exchange of services as well. The new TP Rules provide better clarity on the application of the arm's length standard and are largely modeled on the OECD principles.

The OECD principles are familiar to many readers but hardly is their historical significance appreciated. This is the organisation dreamt by and inspired by the great American Post World War II Secretary of State, George C. Marshall. At that time Europe, ravaged by years of fighting, found itself in deep economic recession, with high unemployment rates, unable to even feed her people. It was the Secretary's idea that Europe could only revive her economies by coming together and pursuing joint economic policies. So successful was this effort – better known as the Marshall Plan, that it would eventually lead to the birth of the OECD, whose mandate continues to be to spur and stimulate international trade. It did not take long for the OECD to realise that one of the

[12] *Supra* note 4.

barriers to growth in international trade is double taxation. Investors do not like to be taxed twice on the same profits, in the country where they have made their investment and in their home country.

The practical solution to the problem of double taxation is to adopt a common standard for taxing business profits – the arm's length principle. Under this principle, each jurisdiction may tax the part of the enterprise doing business in its jurisdiction as if the part was a separate business dealing at arm's length with the other parts.

To apply this principle, the OECD has come up with complex rules or guidelines on transfer pricing. The guidelines are meant to guide Multinational Enterprises and Tax Administrators on how to apply the arm's length standard, which simply put, requires that the prices paid for transactions involving related companies should be similar to the open market prices for such goods and services.

The tax legislation in Kenya has always required that transactions between a resident and a non resident related company should be at arm's length prices. What was not clear was how the arm's length price was to be achieved. Valuers are likely to agree with the notion that the principle of an arm's length price (or open market price as understood by most people) is simple in theory but very difficult to apply in practice.

This can be attested to by anyone who has tried to obtain a valuation for a car or a house. Different professional valuers can attach a multiplicity of values to the same car or house.

The difference in valuation of the former Grand Regency hotel by different valuers is a good case in point.[13] This difficulty has led to protracted tussles between taxpayers and the KRA culminating in 2006 in a landmark ruling in the Unilever case, in which the High Court sitting in Nairobi endorsed the use of OECD guidelines in the absence of detailed guidance from the KRA.

The then Finance Minister Hon Amos Kimunya did well to respond to this judgement by introducing rules that are based on the OECD guidelines. However, the government should have gone the extra mile and adopted the OECD guidelines in their entirety.

The new Transfer Pricing rules, which came into effect on 1 July 2006, will affect all Kenyan based companies that have transactions with related non-resident companies and include

- Kenyan companies with regional operations;
- Kenyan Branches of non-resident companies; and
- Multinationals

The service industry players can expect closer scrutiny of their intra-group transfer prices from the KRA.

For this reason, players should review their intra-group transactions and ensure that they are priced at appropriate arm's length rates. The TP Rules require one to produce, on

[13] Business Daily, September 5, 2008

request, documents setting out their transfer pricing policy and how it has been applied to transactions in question. These documents should be prepared at the time the price is set. Without this ammunition, service industry players could find themselves exposed to punitive penalties and interest in the event of a KRA investigation into their transfer prices for services.

On the balance, we believe that the introduction of Transfer Pricing Rules in Kenya will create certainty and the level of compliance will improve. However we would like to see the rules extended to adopt the OECD guidelines in their entirety to ensure that Kenya shares a common platform with the rest of the world.

1.6: The Research Methodology and objectives of the research

This study was largely dependent on secondary sources of data that included literary materials, however scarce, on Transfer Pricing, as well as the internet. Nonetheless, the thesis examined the following;

1. The provisions of the Kenyan law on the arm's length principle of transfer pricing, its applicability and hence its review if need be;
2. An analysis of the cost-plus method of achieving the arm's length principle and its practicability.
3. An analysis of the judgment in the Unilever Case and its contribution to the arm's length principle.

4. It suggests ways in which KRA can raise reasonable and sound assessments.

1.7: Hypotheses

The study sets out the following assumptions;

1. That The Income Tax (Transfer Pricing) Rules 2006 are not adequate in dealing with the issue of transfer pricing and it is fundamental that the KRA officials are thoroughly trained to enable them to appreciate this field of tax law and thus raise justifiable assessments.
2. That the inclusion of total costs, i.e. both fixed and variable together with a mark-up will enable the taxpayer comply with the arm's length principle.

1.8: Chapter Breakdown

Chapter One is devoted to setting the agenda. It introduces the concept of Transfer pricing generally. It gives the statement of the problem, the significance of the study, the limitation of the study, the conceptual framework, the research methodology, the objectives, the hypotheses and the thesis profile.

Chapter Two discusses the arm's length principle of the transfer pricing concept, the OECD perspective of this concept, and how the Kenyan law has embraced this principle.

Chapter Three discusses the KRAs' perception of the Transfer pricing concept and in particular the Cost Plus method and assessments on taxpayers. This chapter also analyses the transfer pricing provisions in ITA and whether these have adequately addressed issues on Transfer Pricing in Kenya.

Chapter Four concludes by stating that the Kenyan transfer pricing legislation is insufficient and suggests the way forward. It also makes recommendations on what can be done to improve the application of the transfer pricing rules and thereby tax compliance generally between Kenyan companies trading with cross-border related parties.

CHAPTER TWO

THE OECD APPROACH – THE BEST PRACTICE IN APPLYING PRINCIPLES OF TRANSFER PRICING, THE ARM'S LENGTH PRINCIPLE AND REACTION BY THE KENYAN TAX LAW

2.1: Introduction

No country, poor, emerging or wealthy wants its tax base to suffer because of transfer pricing. That is why the OECD has spent so much effort on developing its Transfer Pricing Guidelines. While they help corporations to avoid double taxation, they also help tax authorities to receive a fair share of the tax base of multinational enterprises. The abuse of transfer pricing may however be a problem for developing countries as companies might take advantage of it to get round exchange controls and to repatriate profits in a tax free form. The OECD provides technical assistance to developing countries to help them implement and administer transfer pricing rules in a broadly standard way, while reflecting on their particular situation.[14]

Applying TP rules based on the arm's length principle is not easy, even with the help of the OECD's guidelines. It is not always possible and certainly takes valuable time to find comparable market transactions to set an acceptable transfer price.

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[14] *Supra* note 1.

2.1.1: Multinational Companies and International Trade

Accompanying the increase in world trade over the period since the second world war, there has been an equally rapid growth of private foreign investment. Much of this has taken the form of companies and many medium-sized companies operating in more than one country. Such companies have come to be variously referred to as Multinational Companies (MNCs), Multinational Enterprises (MNEs) or transnational corporations (TNCs). The largest among them have overseas operations that match or exceed the size of their domestic operations. Such companies invariably operate on a global basis, planning their activities on a regional or international scale.

Overseas investment by companies to set up a new overseas subsidiary or acquire a controlling interest in another company is referred to as direct investment abroad or foreign direct investment (FDI). This is different from investment by individuals and financial institutions in the purchase of Interest-bearing securities which is called portfolio investment.[15] Direct investment abroad is one way in which companies can expand their operations internationally. Through FDIs, intra-firm trade in goods and services within the MNCs have been on the rise. One explanation for this increase may be the opportunities which intra-firm trade creates for transfer price manipulation. The term transfer price or transfer pricing is used when MNCs use prices in intra-firm transactions which diverge from those used in equivalent arm's length transactions. There are several reasons why MNCs may wish to manipulate transfer prices. Such practices have also

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[15] Nigel Grimwade, International Trade: New Patterns of Trade, Production and Investment, Business and Economics (2nd edition, 2000).

invited much criticism on the grounds that they undermine the sovereignty of national governments.

The question as to whether or not transfer pricing takes place is also of interest for another reason. If a large growing proportion of world trade constitutes intra-firm trade, the use of transfer pricing will mean that the prices used in trade are not market determined prices as is assumed in trade theory. There may also be implications for the efficiency of certain economic policy weapons such as devaluation, since a lowering of the exchange rate may fail to effect any change in a country's export or import prices.

Although transfer pricing is applied to intra-firm trade in goods, taking place between a parent company and its affiliates, or between any two affiliates of the same MNC, transfer pricing in practice may extend to a wider range of transactions than these. First, there is the question of the relationship between the buying and selling company. How closely are they related in ownership? In cases where an entity is partly controlled by an MNC, the prices used in trade may not be manipulated in quite the same way as when an overseas company is wholly and largely owned by an MNC. However, prices may still not correspond to prices freely determined in an equivalent arm's length transaction.

Secondly, the concept of transfer pricing need not be confined to trade transactions. It may also apply to non-trade flows within the MNC. An MNC may divert funds from one unit to another through non-trade channels, such as the payment of fees to the parent company for the provision of services, the payment of royalties for licences covering patents or other forms of know-how or the payment of interest on loans from the parent company. Transfer pricing in non-trade transactions is often more difficult to identify because the payments involved are typically for resources which are highly specific to the firm and which therefore have no equivalent free market arm's length for comparison. It is for such reasons that the OECD was established. Determination of the cost of services will also be addressed below through the cost plus method.

2.1.2: The Formation of the OECD

According to its Convention, the OECD was established in 1961 in order to establish policies within its member countries that would:[16]

1. Achieve the highest maintainable economic growth and employment and a sustained rising standard of living in member countries;
2. Result in sound economic expansion; and
3. Contribute to the expansion of world trade through a multilateral, non-discriminatory basis.

At the time the new transfer pricing guidelines were issued, countries subscribing to the OECD were Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the

[16] PricewaterhouseCoopers , International Transfer Pricing (2008) pg 21.

United States. The Czech Republic, Hungary, Korea, Poland and the Slovak Republic have been subsequently admitted and have embraced the OECD's Guidelines.[17]

2.1.3: The OECD Report and Guidelines on Transfer Pricing

The US Tax authorities as well as other countries started to pay attention to transfer pricing in the 1960's and 1970's. The OECD member countries recognised that it would be helpful to provide some general guidance on transfer pricing in order to avoid the damaging effects that double taxation would have on international trade and investment. The result was the OECD report on transfer pricing, in which the US experience was extremely influential.[18] Later reports addressed related issues, in particular *Transfer Pricing and Multinational Enterprises* – Three Taxation Issues (1984) and Thin Capitalisation (1987).[19]

The Guidelines contained in the 1979 report (the OECD Guidelines), which were drawn up in consultation with industrial and Trade Union Committees of the OECD, were based on experience gained over a number of years by experts in this field, supplemented by the experience of tax authorities and multinationals located in the OECD countries.[20] The basis principle reflected in the 1979 Guidelines is that arm's length prices should be used in all inter-company transactions. The tax authorities in virtually all the developed countries have adopted the arm's length standard for transfer pricing between related parties. In some cases, this has been achieved by a simple recognition of the OECD

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[17] *Ibid*, pg. 36.
[18] OECD Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises (1979).
[19] *Supra* note 13.
[20] *Ibid.*

principles. In other countries, detailed legislation and supporting regulations have been promulgated, Kenya being a good case in point.

2.1.4: Revisions to the Guidelines

In the changing environment of international trade and following concerns about early drafts of the US transfer pricing regulations (following the 1986 Tax Reform Act), the committee of key OECD member countries began the work needed to update the 1979 report *Transfer Pricing and Multinational Enterprises*.[21] In the absence of agreement on the Underlying principles as to how the arm's length standard should be interpreted, there was a great degree of potential for disagreement on transfer pricing matters between the tax administrators of major developed countries which would have been bound to result in an increased incidence of double taxation.[22]

The OECD published the first chapters of the revised Guidelines in July 1995 but because this is such a complex area, the committee was unable to reach agreements on all aspects. It published chapters on intangible property and intra-group services in 1996. In 1997, it published a chapter on cost contribution arrangements and a draft discussion paper on the taxation of global trading of financial instruments. In February 1998 the OECD released two new annexes and a revised glossary to the Guidelines. The annexes include guidelines for monitoring procedures on the OECD Transfer Pricing Guidelines and the involvement of the business community and examples to illustrate the Transfer Pricing

[21] See the OECD report, Tax Aspects of Transfer Pricing within Multinational Enterprises: the United States proposed Regulations, published in 1993.
[22] *Supra* note 13, pg 22.

Guidelines. In 1999, the OECD issued a new annex to the Guidelines on conducting Advance Pricing Agreements under the Mutual Agreement Procedure of tax treaties. In December 2006 final versions of Parts I, II and III of the Report on Attrition of Profits to Permanent Establishment dealing with general considerations in relation to taxation of permanent establishments and application of these principles to banks and in the context of global trading were issued.[23]

In highlighting key points, the 1995 OECD Guidelines:[24]

1. Adopt the arm's length principle and express a strong preference for the use of traditional transaction-based methods;
2. Set out the levels of comparability that emphasise functions performed, risks assumed and assets employed;
3. Introduce a profit-based method, called the 'transactional net margin method'; and
4. Acknowledge the need for taxpayer documentations of the arm's length character of its transfer pricing and role played by penalties in encouraging compliance.

2.1.5 The Arm's Length Principle Defined

The OECD guidelines define the arm's length principle as the international standard that OECD Member countries have agreed should be used for determining transfer prices for

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[23] *Ibid.*
[24] *Ibid.*

tax purposes.[25] It is set forth in Article 9 of the OECD Model Tax Convention as follows: 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".*[26]

In other words, related taxpayers must set transfer prices for any inter-company transaction as if they were unrelated entities but all other aspects of the relationship were unchanged. The transfer price should equal a price determined by reference to the interaction of unrelated firms in the marketplace. For example, if companies A and B who are related entered into a transaction, for it to be at arm's length, it would have to match a similar transaction between companies C and D who are independent companies.

When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces.[27] Commercial and financial relations between associated enterprises may not be directly affected by external market forces in the same way, although associated enterprises often

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[25] The Organisation For Economic Cooperation and Development Transfer Pricing Guidelines, For Multinational Enterprises and Tax Administrators, pg G-1.
[26] *Ibid*, pg I-1.
[27] *Ibid.*

seek to replicate the dynamics of market forces in their dealings with each other. It is incorrect for tax authorities to make the assumption that the intention of the related/associated enterprises is to manipulate profits. Despite the fact that these enterprises attempt to replicate the dynamics of market forces in their dealings, one has to appreciate the difficulty in doing this accurately. The need to make adjustments to approximate arm's length dealings arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of parties to minimize tax. A tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises, and may be appropriate even where there is no intent to minimize or avoid tax.

The tax liabilities of associated enterprises and the tax revenues of host countries could be distorted if the transfer pricing does not reflect market forces and the arm's length principle. OECD Member countries have therefore agreed that for tax purposes, the profits of associated enterprises may be adjusted as necessary to correct any such distortions thus satisfying the arm's length principle. Member countries also agree that an appropriate adjustment is achieved by establishing conditions of the commercial and financial relations that they would expect to find between independent enterprises in similar transactions under similar circumstances. Other factors besides tax considerations that may distort the conditions of commercial and financial relations established between associated enterprises are such as conflicting governmental pressures (in the domestic as well as foreign country) relating to customs valuations, and anti-dumping duties, and exchange or price controls. Cash flow requirements of enterprises within a MNE may also cause transfer price distortions.

In general, the arm's length principle is applied to a controlled transaction by replacing (hypothetically) the actual terms (price etc) under which a transaction was done, with arm's length terms and (for tax purposes) recalculating profits. This principle enjoys international consensus. The complexities of applying the arm's length principle in practice should however not be underestimated. Because of the closeness of the relationship between the parties, there can be genuine difficulties in determining what arm's length terms would have been, especially where it is not possible to find wholly comparable transactions between unconnected parties. There are many factors to take into account. Consequently, the exercise can be as much an art as it is a science.

2.1.6: Why Adopt the Arm's Length Principle

A question begging to be answered is why OECD Member countries and other countries have adopted the arm's length principle. Many reasons have been floated for adoption of the arm's length principle, but the major reason as per the OECD guidelines is that the arm's length principle provides broad parity of tax treatment for MNE's and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of International trade and investment.[28]

Another reason for the adoption of the arm's length principle is that it has been found to work effectively in the vast majority of cases. For example, there are many cases of commodities and the lending of money where an arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances. However, there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialised services.[29]

2.1.7: Challenges Facing the Arm's Length Principle

Arguments have been advanced that the arm's length principle is inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.

A difficulty of applying the arm's length principle may arise in a situation where associated enterprises undertake transactions that independent parties may not undertake.

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[28] *Supra* note 22, pg I-3.
[29] *Supra* note 22, pg I-4.

Such transactions may occur because in business transactions with each other, members of an MNE group face different commercial circumstances than would independent enterprises. For example, an independent enterprise may not be willing to sell an intangible for a fixed price, such as a right to explore the fruits of all future research, if the profit potential of the intangible cannot be accurately determined. The independent enterprise would not want to risk an outright sale because the price might not reflect the potential for the intangible to become extremely profitable. The intangible owner may, however, be prepared to offer terms to associated enterprises that are less restrictive because the use of the intangible can be more closely monitored. In instances where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or not direct evidence of what conditions would have been established by independent enterprises.

The arm's length principle may also result into an administrative burden to both the taxpayer and the tax authority, in evaluating significant numbers and types of cross-border transactions. The taxpayer may be required to demonstrate that the conditions of the transaction are at arm's length, despite the fact that this may have been established at the time of deciding whether or not to enter into the transaction. The tax authority may, after a period of time, engage in a verification process of the said taxpayer's transaction and thereafter, attempt to gather information about similar transactions, the market conditions at the time the transactions took place, etc, for numerous and varied transactions. Such an exercise usually gets more difficult with time.

The arm's length principle requires a substantial amount of data to enable both the taxpayer and the tax authority evaluate uncontrolled transaction of independent enterprises and to compare these with the transactions and activities of associated enterprises. Such information may be difficult to obtain for reasons of an entity's geographical area, or the accessible information may also be incomplete or difficult to interpret. Confidentiality concerns may also be a bar to accessing information from independent enterprises or worse still, information about an independent enterprise which could be relevant may not exist. All the above reasons for the difficulty in applying the arm's length principle call for judgment on the part of both the taxpayer and the tax authority, since transfer pricing is not an exact science.

Despite the above-mentioned difficulties, OECD Member countries continue to maintain that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle may not always be straightforward to apply, but it generally produces appropriate levels of income between members of MNE groups, acceptable to tax authorities. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

Experience under the arm's length principle had become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. This experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations.[30] In sum, OECD Member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. The global formulary apportionment approach, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice.[31]

2.1.8: Basis of Applying the Arm's Length Principle

The arm's length principle is usually applied by comparing the 'conditions' (e.g. price or margin) of a controlled transaction with those of independent transactions. The Guidelines allow the use of inexact comparables that are 'similar' to the controlled transaction but not the use of 'unadjusted industry average returns'. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

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[30] *Supra* note 22, pg I-6.
[31] *Ibid.*

When evaluating the terms of a potential transaction, independent enterprises will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive to them. For example, it is almost impossible for an enterprise to accept a price offered for its product by an independent enterprise if it is aware of existing potential customers who are willing to pay more for the same product under similar conditions. In making comparisons for purposes of ensuring compliance with the arm's length principle, it is important that the tax authorities take differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability. Therefore, it is not possible for unadjusted industry average returns themselves to establish arm's length conditions.

A number of factors should be considered when assessing the comparability of a transaction. These include:[32]

1. **The specific characteristics of the property or services**

   Differences in the specific characteristics of the property or services account to some extent for differences in their value in the open market. Generally, similarity in the characteristics of the property or services transferred will matter most when comparing prices of controlled and uncontrolled transactions and less when comparing profit margins. Important characteristics to consider in the case of transfers of tangible property include the physical features of the property, its quality and reliability, and the availability and volume of supply. Important

[32] *Supra*, note 13, pg 23.

characteristics to consider in the case of services include the nature and extent of the services and in the case of intangible property, it is important to consider the form of the transaction, for example licensing or sale, the type of property for example patent, trademark, or know-how, the duration and degree of protection, and the anticipated benefits from the use of the property.

2. The functions that each enterprise performs, including the assets used and, most importantly, the risks undertaken

Compensation between two independent enterprises usually reflects the functions that each enterprise performs, taking into account, the risks taken and the assets used. Comparison of this nature is based on a functional analysis which seeks to identify and compare the economically significant activities and responsibilities undertaken by independent and associated enterprises. Particular attention is paid to the structure and organisation of the group. The principle functions performed by the party under examination are identified and adjustments made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature and value to the respective parties to the transactions that is important. [33]

[33] *Supra* note 22, pg I-10.

In identifying and comparing the functions performed, it is important to consider the assets to be employed such as plant and equipment and valuable intangibles. The nature of the assets should be taken into consideration such as the age, market value, location and property right protections.

Also important to consider when comparing the functions performed by respective parties are the risks assumed by them respectively. The general assumption in the open market is that increased risk will also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which risks are actually realised. Types of risks to be considered include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant and equipment; risks of success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks, to mention but a few. Generally, a parties' conduct should be taken as the best evidence concerning the true allocation of risk. For example, if a service provider provides services such as financial support services to a related party in another country and the cross border party is claimed to assume all exchange rate risks but the transfer price appears to be adjusted to insulate the cross border related party from the effects of exchange rate movements, then the tax authorities may wish to challenge the purported allocation of exchange rate risk.

3. The contractual terms

Contractual terms of a transaction generally define how responsibilities, risks and benefits are to be divided between the parties. An analysis of contractual terms should be part of the functional analysis discussed in paragraph 2 above. Terms of a transaction may also be found in correspondence or communication between parties other than a written contract, in the absence of which contractual relationships of parties may be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

The divergence of interests between independent parties ensure they will ordinarily hold each other to the terms of the contract, which would be modified after the fact only if the modifications serve interests of both parties. Divergence of interests may not appear between related parties, and it is thus important to examine whether the conduct of parties conform to the terms of the contract or whether the parties' conduct indicates that contractual terms have not been followed or are a sham. Further analysis would be required in such a case to determine the true terms of the transaction.

4. The economic circumstances of different markets, for example, differences in geographic markets, or differences in the level of the market such as wholesale vs. retail

Achieving comparability across different markets requires that the markets in which the independent and associated enterprises operate are comparable, and that differences do not have a material effect on price or that appropriate adjustments can be made. It is therefore essential to identify the relevant market or markets taking into account available substitute goods or services.

Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth.[34]

5. Business strategies, for example, market penetration schemes when a price is temporarily lowered.

Business strategies take into account many aspects of an enterprise such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, and other factors bearing upon the daily conduct of business.[35]Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

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[34] *Supra* note 22, pg I-13.
[35] *Supra* note 22, pg I-13.

Business strategies also include market penetration schemes whereby a taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. [36] The taxpayer may also, in an attempt to penetrate a new market or defend its market share, temporarily incur higher costs and hence achieve lower profit levels than other taxpayers operating in the same market.

Several factors could be evaluated by tax authorities in determining a taxpayer's claim of following a business strategy that temporarily decreases profits in return for higher long-run profits. These are such as the conduct of the parties to determine if it is consistent with the professed business strategy (for example the low prices charged to the related party which amount to cost savings on the related party should be reflected in the price charged to the said party's customers or in greater market penetration expenses by the related party), whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing costs of the business strategy (for example, in arm's length dealings a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy), whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement, and whether the strategy in question could plausibly be expected to

[36] *Ibid.*

prove profitable within the foreseeable future (while recognizing that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions. A business strategy like a market penetration strategy may fail, but it is recognised that the failure does not of itself allow the strategy to be ignored for transfer pricing purposes.

Generally, if a subsidiary corporation manufactures a sports shirt and then sells that shirt to its foreign parent for distribution for example, it must establish an inter-company price for the shirt. Under the arm's length standard, this inter-company price should be determined by analyzing what comparable sports shirt manufacturers receive when they sell shirts to unrelated distributors. Although there are several acceptable methods for determining arm's length prices, each is based on a comparable transaction.

2.1.9: Reaction to the OECD Guidelines by the Kenyan Tax Law

Globally, transfer pricing legislation is becoming more common as governments attempt to protect their jurisdictions from loss of revenue. With such increased legislation comes the need for greater compliance by multinational corporations in the area of transfer pricing. Kenya is one such country where the government, through the KRA has made an attempt, both through the principle and subsidiary legislation, to prevent loss of revenue by the country to other jurisdictions.

S.18 (3) of the ITA was enacted to curb the problem of loss of revenue by the KRA, to the tax authorities in other jurisdictions through related party transactions. The section empowers the Commissioner to adjust profits of a Kenyan entity which enters into non-arm's length transactions with a related cross border party, with the intention of evading tax.

Despite the existence of the above-mentioned section in the ITA, it has been an uphill task for both taxpayers and the tax authorities alike, to determine what an arm's length price is. This has placed a heavy burden of proof on the part of the taxpayer to prove that the transactions entered into with cross-border related parties were at arm's length. The difficulty to prove this is what gave rise to the Unilever case that was settled in the High Court in the year 2003. It was acknowledged by counsels to the appellant that Kenya has promulgated transfer pricing legislation adopting the arm's length principle which enables Kenya to adjust the transfer price charged on sales between related companies by invoking the arm's length principle. South Africa, Tanzania and United Kingdom were sighted as jurisdictions that have similarly promulgated transfer pricing legislations. These provisions are empowering provisions in that they merely empower the relevant revenue authority to make such adjustments in transfer prices as may be necessary to ensure adherence to arm's length principles.

In the absence of specific guidelines having been issued by KRA under section 18(3) of the ITA, the determination of these principles ought to be made in accordance with international best practice as represented by the OECD Guidelines. Guidelines adopted by other countries which have promulgated the arm's length principle essentially endorse or adopt the principles promulgated by the OECD guidelines and require that these be followed in the determination of the arm's length prices. Countries that are not members of the OECD have also adopted these guidelines. They include Argentina, Brazil, Bulgaria, India, Malaysia, Namibia, Philippines, Russia, Thailand, Zambia, to mention but a few. It was therefore imperative for Kenya to join the bandwagon in adopting the OECD Guidelines, both to support globalization, in terms of trade and investment as well as to avoid being isolated from the rest of the world, and loss of revenue prevention. This would mitigate the frustration experienced by parties engaged in cross-border transactions as well as the uncertainties in how best to deal with the incompatible marriage of local compliance requirements, coupled with very subjective notions of "the arm's-length standard'.

As a result of the judgment in the Unilever case, the then Minister for Finance Honorable Amos Kimunya through S. 18(3) of the ITA issued Legal Notice No. 67 of 15 June 2006 which introduced guidelines for the determination of the arm's length value of a transaction and also specified the requirements necessary for the carrying out of provisions of the said section. The introduction of the TP Rules following the court's judgment in the Unilever case was a very positive move towards resolving the issue of how to determine an arm's length transaction. The issue arising is whether the guidelines issued (The Income Tax (Transfer Pricing) Rules 2006), which have adopted best practice are sufficient in curbing issues relating to the arm's length principle in transfer pricing. This will be addressed in the next chapter which will also analyse one of the methods recognised by the OECD, i.e. the Cost plus method and how this can be used by a taxpayer to determine the arm's length price.

2.1.10: Conclusion

Having discussed the OECD's approach to the arm's length principle and Kenya's reaction to the same through the adoption of TP rules modeled on best practice, one would argue that clarity has been provided to the arm's length principle through the TP Rules. Despite this clarity, the issue still remains whether the said Rules have adequately addressed the transfer pricing issues. This has been addressed in the next chapter.

CHAPTER THREE

FOCUS ON KENYA'S ARM'S LENGTH EFFORT

3.1: Introduction

Having discussed OECD's approach to the arm's length principle in transfer pricing and the reaction by Kenyan Tax law to this, this chapter addresses KRA's perception of the transfer pricing concept, in particular the cost plus method of determining arm's length prices and KRA assessment on taxpayers. The chapter also analyses the transfer pricing provisions in the Kenyan ITA and how they have addressed transfer pricing in Kenya.

3.1.1: Kenya Revenue Authority's View of Transfer Pricing

Kenya has been receiving an increasing share of the world foreign direct investments by multinationals in the recent years. It is therefore necessary and urgent to authenticate the extent to which multinational corporations in Kenya engage in transfer pricing or 'income shifting' by moving income from Kenya, being a high taxing country, to the low-taxing or off-shore global destination and to assist the government manage the transfer pricing activities of multinationals operating in Kenya by recommending favourable policy options and tax laws for improved compliance. These lead to increased government revenue for tackling the poverty problems at the "bottom of the pyramid (BoP)".

Revenue authorities, the world over, have in general become more aggressive in the transfer pricing arena over the last decade. There are many reasons for this sharpened focus, but a key incentive for challenging taxpayers on their transfer prices is that authorities see transfer pricing as a soft target. Since there is no absolute rule for determining the 'right' transfer price for any kind of international transaction with associated enterprises, whether it involves tangibles, intangibles, services, financing or cost allocation/sharing arrangements, companies may be more inclined to press for an early settlement and pay the demand raised by local revenue authorities in order to avoid a lengthy and complicated dispute. The risks of falling prey to this approach include:[37]

- Increased local tax liability;
- Potential double taxation;
- Penalties and interest on overdue tax;
- The potential for carry forward of the impact of unfavourable revenue determinations;
- Uncertainty as to the group's worldwide tax burden; and
- Long-term problems in the group's relationships with local tax authorities.

Careful advance planning for transfer pricing allows a group to evaluate tax risk controversies in advance as well as consider implications beyond direct taxation. For instance, the effect on corporate restructuring, supply chain, resource allocation, customs valuation and management compensation plans can be considered. Planning is also necessary to adequately equip business units in implementing the policy by processing

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[37] *Supra* note 13, pg 1.

inter-company transactions accurately and efficiently. The planning process can also provide an excellent forum for gathering information about the business and identifying tax and commercial opportunities that have hitherto gone unnoticed. The development of a transfer pricing policy will involve financial, tax and operational personnel. It provides a useful opportunity for a varied group to communicate their respective positions and assess business priorities.

Needless to say, imprecise pricing standards make neither governments nor taxpayers happy. Taxpayers object not only to the resulting uncertainty, which makes business planning difficult, but also to the possibility that different governments will generate inconsistent pricing decisions, leaving some income within the "primary taxing jurisdiction" of both (and hence subject to two full sets of taxes). It is not unusual for a taxpayer to feel like a hostage, caught between two feuding governments. Moreover, both taxpayers and governments are averse to spending time and money required to resolve cases in the absence of straightforward standards. This generalized unhappiness has led to numerous reform proposals, some of which have been adopted.[38]

Transfer pricing policies are not purely about taxation; they will often directly impact company management behaviour where managers are remunerated by a bonus linked to local company operating profits. Another area often overlooked when considering transfer pricing matters is the question of indirect taxes. For instance, the movement of goods across international borders often gives rise to a customs duty liability. The link

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[38] Stephan P.,Wallace D and Roin J, International Business and Economics: Law and Policy: Mitchie Company Law Publishers, pg 770 (2004).

that may or may not exist between indirect tax authorities and direct tax authorities must always be borne in mind. Aspects of intellectual property protection arising from cost sharing, treasury management in coordination centre arrangements also have to be given due regard. Ultimately, transfer pricing policy should benefit a company from a risk management as well as business perspective. To this end, building a foundation of internal support by multinationals is imperative in order to enable compliance with tax regulations as well as effective management decision making.[39]

The pace of legislative change around the world in the transfer pricing arena has increased considerably. Transfer pricing rules have been recently introduced or reformed in a number of countries, South Africa being the first country in Africa to respond while Kenya came second. Many other countries are in the process of reviewing the effectiveness of their existing transfer pricing rules and practices. In parallel, Revenue authorities are stepping up the pace of transfer pricing audits, presenting fresh challenges of policy implementation and defense to the taxpayer. A multinational that has either been ignoring transfer pricing matters in the past, or has successfully escaped attack when audited by Revenue authorities should not feel complacent about the future. It must remain vigilant to ensure that its transfer pricing policies meet the standards of tax authorities around the world and also continue to meet its own business objectives. In this environment, entities will be expected to demonstrate in detail how their transfer pricing policies are implemented in practice and why they comply with the arm's length principle as set out in the tax laws of the countries involved.

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[39] *Supra* note 13, pg 2.

The immediate future presents a great challenge to both taxpayers and tax authorities. Taxpayers have to cope with legislation that is growing by the day across jurisdictions, which is often not consistent. For instance, importation of rules in one jurisdiction may present a non-controversial alternative and yet could be countered in another jurisdiction. Similar difficulties are encountered while dealing with fundamental definition of arm's length range, where different parties have differing legislative meanings and judicial interpretations. Enforcement mechanisms have also been tightened up over the years. The onus is on the taxpayer to establish arm's length transfer pricing by way of extensive country-specific documentation. Draconian penalty provisions are an integral constituent of many transfer pricing regimes around the world, which may apply in the event of default in the maintenance documentation sufficient to justify the arm's length nature of transfer pricing arrangements. Such penalties should not to be applied where the taxpayer acts in good faith and with due diligence.

Tax authorities are also competing with their counterparts from other transacting jurisdictions in order to secure what they perceive to be their fair share of taxable profits of multinational enterprises. This frequently leads to double taxation of the same profits by revenue authorities of two or more transacting countries and this has a great potential of being a stumbling block to international trade and investment.

While there is an element of competition between governments for tax revenues, transfer pricing is also an anti-avoidance issue and to this end, tax authorities have to work together to ensure that increasing trade and commerce by multinationals and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions does not lead to tax evasion, for example through the artificial use of tax havens and other forms of 'tax shelter'. Inevitably, there will have to be trade-offs between these conflicting considerations.

Prior to the precedent setting Unilever case in Kenya, both the KRA and taxpayers did not appreciate the impact of s.18 (3) of the ITA on cross-border transactions and what proof of an arm's length transaction entailed. In their view, and correctly so, when a taxpayer entered into a transaction with a related party where the related party was charged at lower than cost price or lower than what third parties were charged, the KRA cast a doubtful eye on the taxpayer's transaction and concluded that the main purpose for which the transaction was designed or effected was to avoid or reduce liability to tax for the given year of income. This is what triggered the Unilever case.

With many revenue authority related issues, the burden of proof would normally be placed on the taxpayer to prove that they are not evading tax in the process of carrying out their transactions. The Unilever case was, however, different in that the burden of proof shifted to the KRA as it bore the task of proving that the method applied by UKL in establishing the arm's length price in its transaction with UUL was incorrect. KRA was unable to prove and thus lost the case. This was the driving force behind the enactment of The TP guidelines/rules. Even with the enactment of TP guidelines, KRA acknowledges that they cannot provide an exhaustive discussion of transfer pricing issues.

3.1.2: The Cost Plus Method

There are various internationally accepted methods for determining an appropriate arm's length consideration. The aim of any taxpayer should be to adopt the method that is most appropriate or best suited to the circumstances of each particular case. This has been reiterated in Rule 4 of the TP guidelines. The choice for the most appropriate transfer pricing method or methods should be based on a practical weighing of the evidence having regard to:[40]

- The nature of the activities examined;
- The availability, coverage and reliability of the data;
- The degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings, including all the circumstances in which the dealings took place; and
- The nature and extent of any assumptions.

The method chosen must be applied in practice and must produce an arm's length result that is a reasonable estimate of what would have resulted if the dealings had been undertaken on an arm's length basis. The cost plus method is one of the recognised methods applied to show proof of an arm's length transaction between related parties. This method compares dealings between parties to third party dealings in terms of costs

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[40] Australian Government , Australian Taxation Office International transfer pricing, "Applying the arm's length principle". April 2004, pg 6.

incurred and the arm's length gross margins in the light of the functions performed and the market conditions. The taxpayer may also need to consider other special conditions, including factors bearing on comparability, such as economic circumstances and business strategies adopted.

The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. The cost plus markup that would be earned in comparable transactions by an independent enterprise may serve as a guide. For purposes of the cost plus method, two conditions have to be met for the uncontrolled transaction to be comparable to a controlled transaction. First, none of the conditions if any between the transactions being compared or between enterprises undertaking those transactions should materially affect the cost plus mark up in the open market. Secondly, reasonably accurate adjustments can be made to eliminate material effects of such differences.

Despite the fact that the cost plus method is centered on the fact that an appropriate mark-up should be applied to the costs incurred by an entity in providing services in order to attain an appropriate mark-up, OECD guidelines recognise that it is not always that a mark-up has to be applied.[41] The point emphasized is that it is not always that the charge must result in a profit for the service provider despite the fact that in an arm's length transaction, an independent transaction would seek to charge for services in such a way

[41] *Supra* note 22, paragraph 7.33, pg VII-11.

as to generate profit. The economic alternatives to the recipient of the service also need to be taken into account in determining the arm's length charge.[42]

There are however circumstances in which an independent enterprise may not realise a profit from the performance of service activities alone, for example where a supplier's costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities or where this generates goodwill. Another instance would be where the market value of intra-group services is not greater than the costs incurred by the service provider. This could occur where, for example, the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the MNE group. [43]

An example of a scenario where the arm's length principle could still be complied with, even where the market value is lower than the cost is the case of *Watson Brothers v Hornby*[44]. In this case, the appellants, (Watson brothers) were the owners of a poultry farm. In addition to keeping about 3,000 birds for laying purposes, they also possessed a hatchery where over 900,000 chicks were hatched every year for sale as "day old chicks." Some of these chicks were transferred from the hatchery to the farm and for purposes of assessment of tax, it became necessary to fix the price of these chicks. It was proved that the cost of production of each saleable day old chick was 7*d*, but the average price obtained for them in the open market was 4*d*.

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42 *Ibid.*

43 *Supra* note 22, paragraph 7.34, pg VII-12.

44 (1942) 2 All ER 506.

Relying on the mutuality principle, the Inland Revenue contended that a man cannot make a profit by trading with himself and therefore the chicks should have been transferred at the cost of rearing them. Market conditions, however, dictated that the chicks could have been sold only for something less than cost; some of the chicks sold at auction had fetched four pence each whereas the cost of rearing had been seven pence each. The Court upheld the claim that the arm's length principle should apply and allowed the market value, in this case the lower than cost as the transfer price. The court also in computing the profits of the hatchery business stated that chicks transferred to the farm should be deemed to have been bought by the farm from the hatchery at the market price of 4*d* per chick and not at the cost of production.

In determining whether the intra-group services represent the same value for money as could be obtained from an independent enterprise, a comparison of functions and expected benefits would be relevant to assessing comparability of transactions. An MNE group may still decide to provide the service intra-group rather than using a third party for a variety of reasons, perhaps because of other intra-group benefits (for which arm's length compensation may be appropriate). It would not be appropriate in such a case to increase the price for the service above what would be established by the CUP method just to make sure the associated enterprise makes a profit. Such a result would be contrary to the arm's length principle. It is, however, important to ensure that all benefits to the recipient are properly taken into account. The Kenyan transfer pricing guidelines do not recognise the above position in that this is not expressly stated in the guidelines.

3.1.3: Determining the Cost Base for the Cost Plus Method

There are a number of allocation keys that might be applied to allocate costs between members of a group. The OECD guidelines in paragraph 7.25, for example, make reference to allocation keys based on turnover, staff employed, and capital applied.[45] Whether the allocation method is appropriate may depend on the nature and usage of the service. For example, the usage or provision of payroll services may be more related to the number of staff than to turnover, while the allocation of stand-by costs of priority computer back-up could be allocated in proportion to relative expenditure on computer equipment by group members.

In performing cost allocations, it is important not to lose sight of the big picture. KRA's aim is to ensure that a taxpayer has adopted a realistic method of allocating costs and not accounting perfection. Taxpayers should be seeking to determine a fair charge for services provided to a subsidiary, and at the same time, making a reasonable effort to establish a coherent basis for determining the price for future services. It is also important that taxpayers perform any cost allocation with regard to the services being provided. The question would be; what costs are being incurred to provide the service? Care must be taken to exclude costs that do not relate to the services under consideration. [46]If taxpayers are in doubt over an appropriate cost allocation, they may find it useful to discuss the allocation they propose with their account manager at KRA. While the advice

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[45] New Zealand Inland Revenue, Transfer Pricing Guidelines, A guide to the application of section GD 13 on New Zealand's Income Tax Act 1994, appendix to *TIB Vol 12, No. 10 (October 2000)* pg 69.

[46] *Ibid.*

from the revenue officials would not be binding on them, it may give taxpayers a useful insight into how the revenue authority may approach the issue.

The cost plus method presents some difficulties in proper allocation, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of providing the relevant service, there are other circumstances where there is no discernible link between the level of costs incurred and a market price (e.g. where a valuable discovery has been made and the owner has incurred nominal research costs in making it). In addition, when applying the cost plus method, one should pay attention to apply a comparable mark-up to a comparable cost basis. For example, if the supplier of a service to which reference is made in applying the cost plus method in carrying out its activities employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. The cost plus method essentially relies on costs achieved by the controlled supplier of services and the mark up achieved by one or more uncontrolled entities on their costs with respect to comparable transactions. Differences between the controlled and uncontrolled transactions that have an effect on the size of the mark-up must be analysed to determine what adjustments should be made to the uncontrolled transactions' respective mark up. [47]

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[47] *Supra* note 22, page II-13, paragraph 2.37.

It is particularly important to consider differences in the level and types of expenses, i.e. operating expenses and non-operating expenses including financial expenditures, associated with functions performed and risks assumed by the parties or transactions being compared. Consideration of these differences may indicate the following;[48]

1. If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus mark-up may be required.
2. If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may amount to the provision of additional services for which an appropriate reward may be determined.
3. If differences in the expenses of parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.

In general, costs and expenses of an enterprise are understood to be divisible into three broad categories. First, there are direct costs of producing a product or service, such as the actual time spent in providing the service or cost of the equipment or tools used to provide the service. Secondly, there are indirect costs of provision of the service, which although closely related to the process may be common to several services, e.g. lighting and floor space in which the service amongst many others is provided. Finally, there are

[48] *Supra* note 22, page II-13, paragraph 2.38.

operating expenses of the enterprise as a whole, such as supervisory, general and administrative expenses.

Generally, a cost plus method would use margins computed after direct and indirect costs of providing the service, whereas a net margin method would use margins computed after operating expenses of the enterprise as well. Because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories of expenses described above. TP Rules 2006 recognise the cost plus method as one of the traditional methods of determining an arm's length price in a transaction between related parties. No guidelines have however been issued by the revenue authority stating what costs exactly should be factored in, when determining the cost base of the service provided. The lack of guidance in this area is likely to cost the taxpayer money as a result of KRA assessments.

In the UK, where services are recharged on a cost plus basis, the amount of the mark-up will often be the subject of negotiation with the tax authority. Like in Kenya, no guidelines have been published to outline standard acceptable rates of marking up costs in specified situations. It has not been unknown for revenue inspectors of Her Majesty's Revenue and Customs (HRMC) to look for a higher mark up according to what they consider the value of the services provided to be. This position has also been experienced by some Kenyan tax payers as the KRA audits have increasingly focused on related party transactions.

To curb this problem in the absence of any general rule, and to place the onus of proving that the cost base has been arrived at incorrectly on KRA, any method applied by a taxpayer in determining costs should be consistent as between the controlled and uncontrolled transactions and consistent overtime in relation to particular enterprises. For example, in determining the appropriate cost plus mark up, it may be necessary to take into account whether the services can be supplied by various sources at widely differing costs. Related parties may choose to calculate their cost plus basis on a standardised basis. An unrelated party probably would not accept to pay a higher price resulting from the inefficiency of the other party. On the other hand, if the other party is more efficient than can be expected under normal circumstances, the other party should benefit from that advantage. The associated enterprise may agree in advance which costs would be acceptable as a basis for the cost plus method.

3.1.4: Tax Assessments by the Kenya Revenue Authority

Beyond the requirement to produce documentation in support of an averred application of the arm's length principle, the TP Rules do not contain any guidance to taxpayers as to what they may expect in connection with a transfer pricing audit. There is no knowledge of such advice having been communicated internally within the KRA. KRA however appears to be taking guidance on transfer pricing from the OECD guidelines and the expectation is that KRA officers will be guided by the OECD Guidelines in conducting a transfer pricing investigation. From discussions with a few KRA officials, there are indications that KRA regards transfer pricing as a potentially major revenue earner and it is expected that it will be taking an aggressive approach.

Previously, KRA was not conducting special transfer pricing audits, but since the introduction of TP Rules, questions about cross border related party transactions and requests for supporting transfer pricing documentation have been included in the information request that KRA sends to taxpayers ahead of regular tax audits conducted, presently every three years. All multinationals are potential targets for a transfer pricing audit and those with transactions which fall within the provisions of section 18(3) of the ITA and the TP Rules should take transfer pricing seriously and develop and maintain properly documented and defensible transfer pricing policies. The present recommendation is that documentation should, where possible be contemporaneous and regularly updated. Until KRA practice in this respect is clearly established, taxpayers are advised to update their transfer pricing documents at least every three years. This was also once the case in South Africa, but presently, South African taxpayers are advised to update their documents annually. Kenya may eventually be forced to move towards that direction.

3.1.5: Analysis of the Transfer Pricing Provisions in the Income Tax Act and their Adequacy

Kenya has always had a general provision within its tax legislation requiring transactions between non-resident and resident related parties to be at arm's length, that is, section 18(3) of the ITA.

It is evident that the intention of the Commissioner, through this provision, was to ensure that a taxpayer in Kenya engages in arm's length cross-border transactions with related parties. This would ideally curb the problem of false repatriation of profits either to the jurisdiction of the parent company or to a tax haven as this would defeat the provision allowing for taxation of Kenyan sourced income in Kenya. The Commissioner however failed to go the extra mile in providing guidance to taxpayers on how to demonstrate that their related party transactions were at arm's length. This failure to provide guidance led to protracted disputes between taxpayers and the KRA culminating in the Unilever case, which led to the introduction of TP rules providing guidance on the application of the arm's length principle. The case disapproved the Commissioner's assumption that related parties entered into transactions with an aim of evading tax. The contrary was proven in this case since despite lack of guidance from the KRA, the taxpayer adopted international best standards which are internationally accepted in demonstrating that the related party transaction was being conducted at arm's length.

In the Unilever case, Judge Visram correctly noted that the very lengthy submissions made by UKL on guidelines adopted by other countries had been ignored by the Commissioner on the basis that they did not apply to Kenya. The Judge held that the guidelines did not form the laws of the countries which recognised them but are simply "guidelines" guiding the world of business, that is business enterprises and the taxing authorities of those countries in arriving at proper transfer pricing principles of computation of income tax. The judge therefore disputed the Commissioners argument that in view of the alleged wording of section 18(3) of the ITA, no guidelines are necessary in Kenya. The judge stated that we live in a global village and we cannot overlook or sideline what has come out of the wisdom of taxpayers and tax collectors in other countries and especially because of the absence of such guidelines in Kenya, taxpayers cannot be barred from looking elsewhere. He further said that innovation should be encouraged as well as the application of creative solutions based on lessons and best practices available to us. This is how the law will develop and our jurisprudence will be enhanced and eventually encourage business and investments to thrive in the country.

The judge also held that transfer pricing principles have evolved in other jurisdictions after considerable debates and taking into account appropriate factors to arrive at results that are equitable to all parties. In my view, the conclusion of this case by the judge was proper, however, my contention is that the reasoning was flawed to some extent. The reasoning should have been that tax statutes should be interpreted strictly. The state should only be given by way of tax that which it has identified and is supported by the law other-wise, the contra-preferendum rule must apply. I find it being very dangerous for a court to scout for guidelines elsewhere to determine matters of tax liability especially where it is meant to assist the state in collecting the tax which it has not identified. There should be no taxation by inference, by *ejusdem generis,* nor by even imagining what the state or tax authority meant. It can only be by what the law clearly stated.

Following an analysis of the rules, I have established as indicated below that a number of issues need to be addressed in order to bring clarity into this issue of transfer pricing.

Firstly, the purpose of adopting these rules was to provide guidance to taxpayers in determining the arm's length prices of goods and services between related parties as well as to provide administrative regulations, including types of records and documentation to be submitted to the Commissioner by a person involved in transfer pricing arrangements. Guidelines assist in the determination of correct prices in circumstances which would assure the tax position of a given country, thus the use of the arm's length principle, that is, the market price determined by market forces and not by any under-table maneuvers or dealings. This is reiterated in Rule 3 of the TP rules. Providing guidelines appears limiting to the concept of transfer pricing since it is a dynamic and volatile concept the limits of which can only be fixed by how far business men can go in manipulating prices to maximise profits as against taxes in various regimes. This is an issue that needs to be addressed.

Secondly, Rule 5 which addresses the scope of the guidelines states that besides the application of these guidelines to transactions between associated enterprises within a multinational company, where an enterprise is located in, and is subject to tax in Kenya, and the other is located outside Kenya, they also apply to transactions between a permanent establishment and its head office or other related branches, in which case the permanent establishment shall be treated as a distinct and separate enterprise from its head office and related branches. This specific provision casts doubts on section 18(3) of the ITA as it restricts its application to "resident persons' which excludes branches. This position notwithstanding, it would be prudent for branches to apply the Rules in their dealings with the head office for two reasons. Firstly, the intention, both at the local level and at the international level in the OECD that the arm's length principle should be extended to branches is clear. It is therefore important and for clarity on the part of the taxpayer that the KRA seeks an amendment to section 18(3) of the ITA to include branches. Secondly, the arm's length principle is an implicit requirement in other sections of the ITA, for instance with the requirement of reasonableness of head office costs incurred by branches. It is therefore important for the current investors and the potential investors to know where they stand in terms of applicability of the TP rules to branches.

Thirdly, transfer pricing as a concept that is evolving should be based on judgment as opposed to hard and fast rules in order to accommodate changes in price manipulation by the business entities. Most of the transfer pricing cases turn on their own facts and precedence is fairly hard to come by.

Fourthly, Rule 4 and Rule 8(2) provide flexibility to taxpayers in that they have a free hand in choosing the transfer pricing method they think would best reflect their business or would be most appropriate their business, having regard to the nature of the transaction or class of transactions, or class of related persons or function performed by such persons in relation to the transaction. This flexibility notwithstanding, the revenue authority still continues to make the same errors seen in the Unilever case. This in essence limits the taxpayer's flexibility in choosing the method applicable to his or her business since either way the taxpayer is bound to face an assessment from the KRA. Worst still, this discourages co-operation between the revenue authority and the taxpayer.

Fifth, Despite the fact that Rule 9(1) gives the Commissioner permission to request information, including documents relating to the transactions where transfer pricing issues arise and a non-comprehensive list of the documents which the Commissioner may request is provided in Rule 9(2), the TP Rules do not make it an express statutory requirement for taxpayers to complete supporting transfer pricing documentation. This provision does not lay down any hard and fast rules for compiling documentation or for the process that taxpayers should follow. Rule 10 similarly requires a taxpayer who avers the application of arm's length pricing to avail documentation evidencing the taxpayer's analysis upon request by the Commissioner. Therefore much as the requirement for taxpayers to complete transfer pricing documentation is not express in the Rules which should ideally be the case, it is implied in the said Rules and it is in the taxpayers' best interest to complete and maintain such documentation.

Sixth, the TP rules tend to imply that transfer pricing is static and in determining the arm's length price of a transaction, taxpayers must remain within the rules. This is an incorrect premise because transfer pricing is not an exact science and is certainly not based on fixed principles of science. It requires significant professional judgment and reasonable assessments. Furthermore, there is no provision in the law allowing for the adoption of the principles laid down in the OECD guidelines and that the OECD guidelines have preference over the existing Rules. This is the case in Namibia where through Practice Note number 2/2006, the OECD guidelines have been fully adopted in the tax legislation and have preference over the Practice Note.[49] Kenya is therefore at a disadvantage in this regard since as a consequence and unlike the case of Namibia, any changes to the OECD guidelines may not be automatically adopted in the Kenyan tax legislation unless through various legal notices.

Seventh, following the defeat of KRA in the Unilever case, the KRA proposed for the incorporation of the OECD guidelines into our tax laws. This was incorrectly done since the guidelines were simply copied and turned into Rules which must be obeyed. The Rules are therefore not just guidelines for the purpose of guiding taxpayers. They have not excluded guidelines applications from OECD and they do not even make provision for reference to other sources. In New Zealand and Australia, similar provisions to the Income Tax (Transfer Pricing) Rules 2006 are called guidelines. This is to enable the revenue authority to come together with taxpayers so at to amicably resolve issues surrounding cross-border related party transactions with regard to transfer pricing.

Eighth, beyond the requirement to produce documentation in support of an averred application of the arm's length principle, the TP Rules do not contain any guidance to taxpayers as to what to expect in the event that KRA conducts an in-depth audit of the taxpayers' books and nothing is known of such guidance communicated internally within the KRA. This certainly leaves a gap between KRA's requirement and the taxpayer's expectation and is likely to bring hostility between taxpayers and KRA officers conducting the audit.

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[49] *Supra* Note 13, page 207.

3.1.6: Conclusion

This chapter has addressed issues surrounding KRA's perception of the arm's length principle in the field of transfer pricing and particularly the cost plus method. This being one of the methods identified by the OECD guidelines in determining the arm's length price in a transaction between two or more cross-border related entities, it has been identified as the preferred method where the transaction between parties involve provision of services. The issue however has been what kind of costs should be included in establishing the cost base of the service provided. Based on the discussion, it is important that in establishing this, the direct costs are all factored in, and the appropriate allocation method is applied in allocating the indirect costs relating to the provision of those services. It is also imperative that the taxpayer maintains consistency in the process of establishing the cost base. The inclusion of total costs therefore, that is, direct and variable costs together with a mark-up is indeed a starting point in complying with the arm's length principle under the cost plus method.

A number of gaps have however been identified in the transfer pricing provisions which imply that the provisions have not adequately addressed the issue of transfer pricing in Kenya. Recommendations on addressing these identified gaps will be discussed in the following chapter.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

4.1: Introduction

Having discussed the arm's length principle and the OECD approach to the same, the reaction of KRA to the arm's length principle, the concept of transfer pricing and the Cost plus method, KRA's approach to assessment of taxpayers, and having carried out an analysis of the transfer pricing provisions of the ITA while identifying gaps in the same, it is imperative to make recommendations on what can be done to improve the application of TP rules and thereby tax compliance generally between Kenyan companies and their cross-border related parties, with the aim of encouraging international trade and investment.

4.1.1: Recap on Transfer Pricing

For every item sold, and every service provided, a price is charged by the seller and paid by the buyer. It is the total price charged and paid that determines the commercial profits (or losses) of any business. In straightforward cases, goods and services are offered for sale at a fixed price. The buyer has the choice of buying at the advertised price or not buying at all. But for transactions that are more complex, prices are negotiated between buyers and sellers.

Where goods and services are sold in open market, it is fairly easy to fix a price that buyers are prepared to pay (although the prices set will determine the volume of sales made). The size and nature of the market, the quality of the goods and services, the extent of competition, costs and desired profit margin are all factors that have a bearing on the selling price. But where parties to the transaction are connected, the conditions of their commercial relations will not be determined solely by market forces. The price will not necessarily correspond to what would have been charged if they had not been connected. Where both the seller and the purchaser are companies owned by the same person, the price charged will not itself make their common owner any richer or poorer; it will merely serve to determine the extent to which the common owner's funds or profits or financial resources are transferred or shifted from one company to another.

A transfer price is therefore the price charged in a transaction where connected parties transact with each other. There is no need or incentive to charge prices that precisely replicate what would have happened had they been dealing at arm's length. As a result, the level of their commercial profits may differ, sometimes by accident and on occasions by design from what would have arisen if they had done the same transactions with unconnected parties. The transfer pricing issue mainly arises in cross border transactions between two companies that are part of the same group. However, transfer pricing problems are not limited to company to company transactions; for example, a transaction between an individual and an overseas company he controls can be manipulated through the transfer price.

Tax authorities around the world are increasingly aware that the transfer pricing of transactions between connected parties can affect their tax yield. Moreover, this is particularly so where parties to a transaction are subject to different tax rules and rates.

The establishment of appropriate transfer pricing policies is vital to companies from both a business and tax point of view. Proper transfer pricing planning from a business perspective allows for accurate financial results, ensuring that business valuations and other financial decisions based on transfer prices are made using correct information. Proper transfer pricing planning from an investment and tax perspective allows for potential global optimisation of available incentives while ensuring compliance with applicable domestic legislation regarding documentation and reporting requirements.

To compete globally, multinational enterprises often transact with their affiliates by way of sharing products, services, intangibles and funds. When these transactions (Including an arrangement or event) are between affiliates in different tax jurisdictions they must be priced on an "arm's length" basis. The pricing of cross border related party transactions on an arm's length basis is critical to tax authorities that fear the loss of revenue to other tax jurisdictions through manipulation of intercompany prices. The arm's length concept is found in most countries' transfer pricing legislation and refers to the price, including other terms and conditions, at which third parties would have transacted. Transfer pricing is ultimately the methodology used to determine a range of acceptable prices for cross-border related party transactions. [50]

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[50] David J. Kemp, et al. 'Don't Take Transfer Pricing for Granted', Volume 11, No. 2, April 2005.

The OECD guidelines identify two key issues in the treatment of intra-group services;

- Has the service been provided?
- If so, how should the arm's length price be determined?

The central test of whether an intra-group service is provided is whether the recipient of an activity receives something that an independent enterprise in comparable circumstances would have been prepared to pay for or perform for itself in-house. The arm's length price of such a service can be determined using either:

- A direct approach, where costs are directly incurred for specific services, or
- An indirect approach, where costs are indirectly allocated against all services in determining a cost base on which charges are to be determined.

The costs attributable to a particular service will often not be able to be discerned directly, meaning that an indirect cost allocation will need to be applied. An appropriate allocation key will be used, based on facts and circumstances of each case. The key focus is a realistic allocation, not accounting perfection. KRA looks for a fair charge for the services provided and a reasonable effort into establishing a basis for future calculations.

4.1.2: How do Companies set their Transfer Pricing Policy?

There are a host of factors that potentially have a bearing on the way transfer prices are set within a group. Some groups plan their transfer pricing with great care in order to shift profit to where it should properly fall or to where they want it. Others tend to give their transfer pricing relatively little thought. In itself, it would be unlikely to constitute a significant profit generating activity unless it succeeds in lowering a group's tax bill. Inevitably, motives will vary and there may well be cases where transfer prices are manipulated other than for tax reasons.

Some of the factors that could influence the way in which transfer prices are set are as follows: -[51]

1. Groups want to know, for their own management purposes, where value is being added, and that implies having appropriate transfer pricing policies. Groups tend to be more interested in knowing how value is added between functions than between countries. A distinction between countries can sometimes be relevant only for tax purposes.
2. A group's transfer pricing policy will not necessarily be influenced by purely fiscal considerations. Group members may trade in countries which have unstable politics, high rates of inflation, rigid exchange controls or high rates of taxation. Those countries may impose high tariff barriers or otherwise restrict free movement of goods in or out of their territory. Transfer prices may be set in such a way as to extract profit from the country without falling of tax rates or controls.
3. Circumstances vary from group to group. Some may be very tightly controlled from the centre so that their subsidiaries are not permitted to take decisions of substance without reference to the parent company. In that situation, the parent's control of transfer prices and trading arrangements might enable it to determine

[51] http://www.hmrc.gov.uk/manuals/intmanual/INTM431020. Last accessed on 22 September 2008.

which of its subsidiaries makes commercial profits and how much profit individual subsidiaries are allowed to make. At this point, tax is clearly an important consideration and the tendency will be to channel profits into members of the group where it will be taxed at the lowest rate or be eligible for specific exemptions or reliefs.

4. Not all groups, however, exercise that degree of control over their members' operations. Wars, historical accidents, protective regimes and highly educated industries have made it politically expedient for subsidiaries of group companies to assume a distinct local identity. In some countries, substantial local minority (or even majority) participation is required, thus weakening the degree of control which the parent can exercise.
5. Multinational groups may prefer, for nationalistic reasons to pay tax in their home country, even though there may be no saving on their tax bill. There will be cultural considerations to bear in mind.
6. Sheer distance sometimes makes it physically impossible for the parent to do more than exercise general oversight. It is also increasingly common to find that local subsidiaries are expected to operate as cost and profit centres, exercising genuine control over costs and endeavouring to make their operations as profitable as possible. Directors and employees might be able to earn bonuses and other incentives linked to profits. Price setting may be subject to negotiation but these negotiations are unlikely to replicate what would happen between independent parties.

7. Some territories have domestic transfer pricing rules that do not conform to methods that are generally accepted at an international level for dealing with the transfer pricing problem.

4.1.3: What Does the Future Hold?

In recent years, revenue authorities across the globe have become better resourced, more sophisticated and more attentive to transfer pricing enforcement. As a result, a new wave of countries has entered the transfer pricing enforcement world. Notably, between 1997 and 2007, the number of countries having some form of transfer pricing documentation requirements rose from 6 to over 40. [52] Closer home, the majority of governments in African countries are placing increasing pressure on their own tax authorities to ensure taxable income is protected through the application and enforcement of transfer pricing laws. Despite build up in pressure, most of the countries only retain general transfer pricing provisions in their tax legislation but have not adopted the OECD principles which are internationally recognised as best standards. South Africa and Kenya have gone the extra mile of adopting this principles and enacting TP rules modeled around the said principles.

As stated in chapter three above, the main purpose of the TP Rules is to assist in the determination of correct prices in circumstances which would assure the tax position of a given country, thus the use of the arm's length principle which provides for the market

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[52] http://www.pwc.com/servlet/pwcPrintPreview?LNLoc=/extweb/manissue.nsf/docid/3. (Last accessed on 10th September 2008).

price determined by market forces and not by any underhand manoeuvres and dealings. This may be construed by the taxpayer as a positive move as compared to the total absence of the guidelines. However, a number of issues with regard to the transfer pricing legislation can be dealt with in a better way and this will be addressed in the form of specific recommendations below.

4.1.4: Conclusion

From the onset of this study, we set out with the hypotheses that:-

1. The Income Tax (Transfer Pricing) Rules 2006 are not adequate to deal with the issue of transfer pricing and it is necessary for KRA officials to be vigorously trained to enable them appreciate this field of tax law, to raise justifiable assessments.
2. The inclusion of total costs, i.e. both fixed and variable together with a mark-up will enable the taxpayer comply with the arm's length principle.

Arising from the discussion, we can now conclude that the TP rules were enacted to supplement the previously vague provision of section 18(3) of the ITA but they instead brought about more confusion for both the taxpayer and the tax authority officials. This means that the TP rules have not been adequate and more needs to be done. Furthermore, it is important for KRA officials to be sent to the World Trade Organisation (WTO) rounds and the European Community (EC) meetings in which transfer pricing is an area of discussion, or to countries such as India, The United Kingdom and South Africa, in order to gain more knowledge and enable them raise justifiable assessments.

We can also conclude that despite the fact that from a cost plus perspective, the inclusion of total costs together with a mark-up may enable the taxpayer comply with the arm's length principle, the process is indeed very complicated and there is no clear guideline to assist the taxpayer understand better, the nature of the costs that should be considered in order to attain an arm's length price.

As a way forward, I suggest that Parliament and KRA strengthen the transfer pricing law by adopting the following recommendations.

4.1.5: Recommendations

Firstly, instead of reacting to a situation by subsidiary legislation (rules) on transfer pricing like the then Finance Minister did in the year 2006, the advisable way to go in the determination of transfer pricing would have been to have substantive legislation in the national law which provides room for accommodation of transfer pricing related issues. This is because transfer pricing is a dynamic and volatile concept whose limits can only be fixed by how far the business men can go in manipulating prices to maximise profits as against complying with tax laws in Kenya.

Secondly, it would have been advisable for KRA to have prepared guidelines rather than rules since rules are monolithic and limiting. This is such as the case in New Zealand and Australia. This would lead to a lack of appreciation of transfer pricing which is indeed a dynamic and evolving area. Rules imply that provisions are cast on stone and cannot be flexible. This would not blend well with the current times and would certainly discourage potential investors thus cripple Kenya's economic growth.

Thirdly, even with the preparation of the TP Rules, Kenya should have adopted a format similar to Namibia Practice Note as mentioned above, whereby, despite the existence of TP guidelines, the OECD guidelines take precedence over the guidelines and as a consequence, any changes to the OECD guidelines are automatically effected in the rules and become part of Kenya's transfer pricing legislation.

Fourth, KRA should put in place a specialist unit to conduct transfer pricing audits. This should comprise highly skilled individuals who may have previously been employed by professional firms. In addition, besides recruiting highly skilled individuals from professional firms, KRA should invest heavily in training its own staff in the area of transfer pricing, or seeking advice and training from revenue specialists who are more advanced in this area, such as from South Africa, UK, Australia and New Zealand. KRA may also appoint representatives to regularly attend OECD conferences and training sessions. KRA should also prepare and share with the taxpayer in advance of the audit, a list of documents the KRA officers will require in order to conduct the audit. This will go a long way in increasing efficiency in conducting the audit and reducing hostility between the KRA officers and taxpayers.

Fifth, following trainings conducted for KRA officials as mentioned above, it will be important for KRA to include sessions on transfer pricing in the taxpayers' awareness days conducted by KRA's officials. This will keep taxpayers in check and more in control of their compliance record where transfer pricing issues are likely to arise.

Sixth, it is very crucial that all the gaps identified in the transfer pricing provisions are addressed as these will bring clarity and do away with ambiguous provisions that may lead to conflicts between KRA and the taxpayers. Furthermore, improved clarity will benefit KRA more since if the provisions are not clear in stating where tax is due from the taxpayer, the KRA is bound to be the looser as the contra-preferendum rule will come into play.

Last but not least, it is important that the KRA be more prudent when carrying out audits, since a judicious revenue authority is one that would adopt and embrace a revenue approach that encourages co-operation between the authority and the taxpayers in order to collect more taxes. This notwithstanding, the most important message from the TP Rules in my view should be that the taxpayer must know his or her business very well in order to be able to respond to the TP Rules and should therefore honestly co-operate with the revenue authority for their own good.

If and when the above recommendations are implemented, there will be improved compliance by the taxpayers and better cooperation between the taxpayers and the revenue authority, as disputes thrive in an environment of uncertainty. There will also be better clarity in terms of how to determine arm's length prices and what costs to be considered in arriving at this. This will translate to an improved business environment in Kenya and would-be investors will be more encouraged to invest in Kenya without the fear of being stalked and haunted by KRA. There will be no fear of protracted KRA audits that waste both the revenue authority's and taxpayers' quality time. KRA is conscious however, of the desirability of minimising compliance costs, particularly if this can be achieved without compromising the integrity of the arm's length principle.

Transfer pricing is not the only polemic issue affecting the Kenyan tax laws. Bilateral and multilateral agreements, laws on economic integration as well as laws on intellectual property affect our tax laws. From this study, it is evident that KRA was not ready to handle transfer pricing.

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APPENDIX A

Income Tax (Transfer Pricing) Rules 2006

- Rule 3 - Purpose of Rules

  The purpose of these Rules are:-

a) to provide guidelines to be applied by related enterprises, in determining the arm's length prices of goods and services in transactions involving them, and

b) to provide administrative regulations, including the types of records and documentation to be submitted to the Commissioner by a person involved in transfer pricing arrangements.

- Rule 4 – Person to choose method

  The taxpayer may choose a method to employ in determining the arm's length price from among the methods set in Rule 7.

- Rule 5 – Scope of guidelines

  These guidelines shall apply to:-

a) transactions between associated enterprises within a multinational company, where one enterprise is located in, and is subject to tax in, Kenya, and the other is located outside Kenya;

b) transactions between a permanent establishment and its head office or other related branches, in which case the permanent establishment shall be treated as a distinct and separate enterprise from its head office and related branches.

- Rule 7 – Methods

The methods referred to in rule 4 are the following:-

a) the comparable uncontrolled price (CUP) method, in which the transfer price in a controlled transaction is compared with the prices in an uncontrolled transaction and accurate adjustments made to eliminate material price differences;

b) the resale price method in which the transfer price of the produce is compared with the resale price at which the product is sold to an independent enterprise;

Provided that in the application of this method the resale price shall be reduced by the resale margin (the profit margin indicated by the reseller);

c) the cost plus method, in which costs are assessed using the costs incurred by the supplier of a product in a controlled transaction, with a mark-up added to make an appropriate profit in light of the functions performed and the assets used and risks assumed by the supplier;

d) the profit split method, in which the profits earned in very closely interrelated controlled transactions are split among the related enterprises depending on the functions performed by each enterprise in relation to the transaction, and compared with a profit split among independent enterprises in a joint venture;

e) the transactional net margin method, in which the net profit margin attained by a multinational enterprises in a controlled transaction is compared to the net profit margin that would have been earned in comparable transactions by an independent enterprise; and

f) such other method as may be prescribed by the Commissioner from time to time, where in his opinion and in view of the nature of the transaction, the arm's length price cannot be determined using any of the methods contained in these guidelines.

❖ Rule 8 – Application Methods

1) The methods set out in rule 7 shall be applied in determining the price payable for goods and services in transactions, between related enterprises for the purpose of section 18(3) of the Act.

2) A person shall apply the method most appropriate for his enterprise, having regard to the nature of the transaction, or class of transaction, or class of related persons or function performed by such persons in relation to the transaction.

❖ Rule 9 – Power of Commissioner to request for information

1) The Commissioner may, where necessary request a person to whom these Rules apply for information, including books of accounts and other documents relating to transactions where the transfer pricing is applied.

2) The documents referred to in paragraph (1) shall include documents relating to:-

   a) the selection of the transfer pricing method and the reasons for the selection;

   b) the application of the method, including the calculations made and price adjustment factors considered.

   c) the global organization structure of the enterprise:

   d) the details of the transaction under consideration;

   e) the assumptions, strategies and policies applied in selecting the method; and

f) such other background information as may be necessary regarding the transaction.

3) The books of accounts and other documents shall be prepared in, or be translated into, the English language, at the time the transfer price is arrived at.

❖ Rule 10 – Application of arm's length pricing

Where a person avers the application of arm's length pricing, such person shall:-

a) develop an appropriate transfer pricing policy;

b) determine the arm's length price as prescribed under the guidelines provided under these rules; and

c) avail documentation to evidence their analysis upon request by the commissioner.