

**THE ORGANISATION OF ECONOMIC COOPERATION AND DEVELOPMENT  
(OECD) TRANSFER PRICING GUIDELINES: AN EVALUATION OF THEIR  
EFFECTIVENESS IN THE KENYA'S TAX REGIME**

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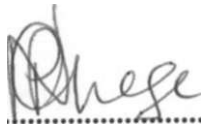
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A THESIS SUBMITTED FOR THE PART FULFILMENT OF MASTER OF LAWS  
DEGREE OF THE UNIVERSITY OF NAIROBI

## DECLARATION

This thesis is my original work and has not been presented for a degree in any other university.

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I confirm that the work reported in this thesis was carried out by the candidate under my supervision as University supervisor.

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**Date.**

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**Prof. Arthur A. Eshiwani**

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## **DEDICATION**

This work is dedicated to:

My dad, the late Samuel Chege Mirii who did not live long enough to see the complete version of this document. His words of encouragement kept my spirit high till the end of the race.

My mother Tabitha Njoki Chege for her endless encouraging words and reminding me that hard work pays.

My father in law for reminding me that my success is the success of many and my failure sounds doom to the lives of many.

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I thank KRA for granting me an opportunity to prove my worth in transfer pricing

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I recognise the support I got from the KRA transfer pricing audit team members at personal levels

I most sincerely thank my wife Anne, my children Tabby, Jennifer, Robin and Michelle for the support, patience and encouragement accorded to me during difficult times. It would not have been possible to complete such work without sacrificing precious time for the family

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Asanteni Sana

## **ABSTRACT**

The basic law governing transfer pricing in Kenya is contained in section 18(3) of the Income Tax CAP. 470. It is based on the arms length principle. This section is expressed in general terms and therefore difficult to apply. To remedy the defect, the Income tax (Transfer Pricing) rules of 2006 were issued. The rules set out methods to be employed in arriving at an arm's length price or margin for transactions between a Kenyan party and a related party in another tax jurisdiction.

The rules borrow heavily from the OECD Transfer Pricing guidelines of 1995. These guidelines are comprehensive and are widely used by both OECD and non OECD members. Specifically, Kenya applies the guidelines as soft law to augment its transfer pricing rules. The OECD Transfer Pricing guidelines were crafted for developed economies experiencing a different set of circumstances from those of Kenya. As a taxation tool, the guidelines have been applied with a lot of challenges, sometimes resulting to unwarranted loss of revenue.

It is against this backdrop that it was found necessary to examine the extent to which OECD Transfer Pricing guidelines are applicable in the Kenya's tax legal regime. To achieve this, this study identifies parts of the Guidelines that are difficult to apply, and the useful parts not yet incorporated in the Kenya's tax legislation. Appropriate recommendations are then made to the relevant authorities for a possible legislation change. The methodology applied in the study included the use of secondary data gathering and to a lesser extent structured oral interviews.

The findings of the study are that although the OECD Transfer pricing guidelines are globally accepted standards for transfer pricing, certain aspects of it cannot be applied in Kenya due to its economy's unique circumstances. This has been found to be similar to

experiences in other countries like India and Brazil where the operation of the arms length principle has been approached differently. The opposition to the OECD Transfer Pricing guidelines appears to be growing day by day which has led the OECD to acknowledge that there are indeed challenges that requires to be addressed to make the guidelines more practical.

To ensure for certainty, simplicity and relevance of the guidelines, Kenya may have to look for an alternative to the arms length principle. Top in the list is the establishment of a local data base for margins and prices, which should be applied before any other source of comparables is considered. In a situation with a range of results, the median should be the comparable price or margin. A specific penalty regime should be put in place to cover all aspects of transfer pricing especially on non submission of transfer pricing records. Training on international tax issues should be prioritized for KRA officer, the tax tribunal, the local committee and the Judiciary so as to give the Kenya's tax regime a broader, flexible and effective approach in tackling transfer pricing problems.

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## ABBREVIATIONS

ABDT	Central Board of Direct Taxes
ALP	Arm's Length Price
APA	Advance Pricing Agreements
ATAF	African Tax Administration Forum
BVD	Bureau Van Djik
<i>CARF</i>	<i>Conselho Administrativo de Recursos Fiscais</i> ("Appellate Judges)
CATA	Commonwealth Association of Tax Administrators
CCCTB	Common Consolidated Corporate Tax Base
CFA	Committee on Fiscal Affairs
CIAT	Inter-American Centre of Tax Administrations
CIT	Commissioner of Income Tax
CPM	Cost plus Method
CUP	Comparable Uncontrolled Price
DRJ	Administrative Judges
DTA	Double Tax Agreement
EAI	East African Industries Limited
EPPO	Export Processing Program Office
FOB	Free On Board
FTA	Forum on Tax Administration
GAAP	General Anti Avoidance Provision

GFI	Global Financial Integrity
IRS	Inland Revenue Service
ITA	Income Tax Act
JKIA	Jomo Kenyatta International Airport
K.R.A	Kenya Revenue Authority
LIBOR	london inter bank rate
LTO	Large Taxpayers Office
MAP	Mutual agreement procedure
MNE	Multinational Enterprise
NI	Normative Instructions
OECD	Organization of Economic Cooperation and Development
RPM	Resale Price Method
SARS	South Africa Revenue Service
TNMM	Transactional Net Margin Method
U.K	United Kingdom
U.S.	United States of America
UKL	Unilever Kenya Limited
UNCTAD	UN Conference on Trade and Development
UUL	Unilever Uganda Limited
VAT	Value Added Tax

## CHAPTER ONE

### 1.0 INTRODUCTION TO THE STUDY

*"India is actively undermining (aspects of transfer pricing rules) .... Brazil is not going to be brought around to the transfer pricing nonsense. . . . China signs the treaties, offers advance pricing agreement, and then lets local tax officials make their own decisions. . . . China wants to reclaim some of the advantages of the China price as taxes "- Lee Sheppard'*

### 1.1 Introduction

Transfer pricing is defined as the setting of prices for intra group or company transfers of goods and services<sup>2</sup> . Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or services to associated enterprises. Transfer pricing is not, in itself, illegal or necessarily abusive. What is illegal or abusive is transfer mispricing, also

<sup>1</sup> Lee A. Sheppard is a lawyer who has for the last 30 years commented on important tax issues, and frequently speaks on tax subjects for the media and at conferences. Sheppard works as contributing editor to *Tax Analyst*, *Tax Notes International* and according to *New York times* "her writings over the last two decades have become a must read for tax practitioners". Shepherd demonstrates in the quote that major economies of the world, *the BR/CS*, have drifted from the arms length principle and therefore the arms length principle is not necessarily the best. There exist practical alternatives that can deal effectively with the issue of transfer pricing.

Jonathan, L. and John, S. (2008) *Transfer pricing: A Dictionary of finance and Banking*. Oxford: Oxford University Press.

OECD. (2010). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*. OECD Publishing 2010. P. 21, Para 11

known as transfer pricing manipulation or abusive transfer pricing<sup>4</sup>. The term "mis-pricing" is used to refer in a short form to pricing that is not in accordance with the arm's length standard<sup>5</sup>. It is not intended to imply that a tax avoidance or evasion motive necessarily exists in a particular case<sup>6</sup>. The arms length principle states that the transaction between affiliated firms must be made purely on commercial basis, both firms trying to maximize their advantage and neither firm accommodating or favoring the other in any way<sup>7</sup>.

The increased integration of national economies and technological advancement especially in the area of telecommunication has boosted the role of Multinational Corporations in the Worlds trade<sup>8</sup>. About 30% of international transactions take place between related parties<sup>9</sup>. With increasing cases of mergers, takeovers and acquisitions it will be challenging to find completely independent companies from where to draw comparables.

The price of a product between unrelated parties is influenced by market forces which include demand and supply, tariffs and political conditions. However, where transactions are

<sup>4</sup> Lee Sheppard (2012): *Transfer pricing is the leading edge of what is wrong with international tax*. Available at [www.taxjustice.net/.../front-content.php...](http://www.taxjustice.net/.../front-content.php...) accessed on 5th August 2013

<sup>5</sup> U.N 2013: U.N Practical Manual on Transfer Pricing. P. ii Para 3

<sup>6</sup> U.N 2013: U.N Practical Manual on Transfer Pricing. P. ii Para 3

<sup>7</sup> Business Dictionary .com [www.businessdictionary.com](http://www.businessdictionary.com)

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OECD: (2010). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*. OECD Publishing 2010. P. 19, Para 1

<sup>9</sup> U.N 2013: U.N Practical Manual on Transfer Pricing. PI 1 Para 1.1.3



between related parties, prices may be influenced by set group objective rather than market forces. According to a report by GFI, transfer pricing contributed to illicit financial flow out of developing countries is between \$ 858.6 million and \$ 1060 million.<sup>10</sup>

The OECD developed what came to be known as "OECD Transfer Pricing guidelines for Multinational enterprise and Tax Administrations 1995" which adopted the arms length principle as a tool for determining the arms length prices and margins. OECD posits that the application of the arms-length principle has fairly succeeded in majority of cases". The principle seeks to detach tax considerations from economic considerations therefore promoting growth in international trade and investment<sup>12</sup>. An alternative to the arms length

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principle is the unitary taxation with formulary apportionment . Formulary apportionment approach allocates the world wide tax liability of an MNE based on its economic nexus in each tax jurisdiction. Yet other economies like Brazil operates with success a regime of fixed margins, safe harbours and a method akin to CUP, but avoids the use of Transactional Net Margin method and Profit Split method<sup>14</sup>.

The Chinese transfer pricing legislation although based on the arms length principle, allows the use of Customs Valuation of the intercompany purchases, a method not allowed under the

<sup>10</sup> Kar, D. & Cart, W: (2008): *Illicit Financial Flow from Developing Countries 2002-2006, Global Financial Integrity*. As quoted by Tax Justice Network, in "Tricky tax: Transfer pricing". P. 4

<sup>11</sup> OECD :( 2010): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*. OECD Publishing. P. 36, Para 1.9

" OECD: Transfer pricing guidelines 2010. P. 36, Para 1.8

<sup>13</sup> McIntyre, R. S. & McIntyre, M. Y:(1993). *On the breakdown of IRS tax enforcement regarding Multinational Corporations, revenue losses, excess litigation, and unfair burden for U.S producers*. The U.S Senate Committee on Government Affairs, march 25, 1993, U.S

<sup>14</sup> UN 2013: *UN Manual on Transfer Pricing for Developing Countries*. U.N. New York. P.362, Para. 10.2.1.2

OECD transfer pricing guidelines.<sup>15</sup> In some instances, global formulary method is allowed in china, where it is found to be more appropriate than traditional transactional or profit based approach.<sup>16</sup> Kenya adopted the arms length principle but has so far registered very limited success in dealing with transfer mispricing and capital freight.

The arms length principle as set out in the OECD transfer pricing guidelines has failed to deal effectively with transfer pricing issues. A more practical approach is therefore required based on economy's peculiar circumstances. For instance, India adopted the arms length principle in 2001, but due to the challenges encountered in the administration of the arms length principle, it embarked on numerous legislative changes that today, a hybrid model is beginning to take shape.

China, Brazil and India are expected to play a significant role in the shaping of the transfer pricing landscape in the next few years as their respective Tax Authorities become more sophisticated in transfer pricing issues, and the global economy becoming increasingly reliant on emerging markets.

## **1.2 Background**

The basic law that governs transfer pricing in Kenya can be traced back to the 1973 Income Tax Act. It is contained in section 18(3) of the said Act. For a long time this section remained untested largely because the Commissioner of Income Tax felt that this section demands

<sup>15</sup> PWC (2012): *Pricing Knowledge Network: Focusing on the Impact of Major Intercompany Pricing Issues*. P.3. Available at [www.pwc.com/tp](http://www.pwc.com/tp)

<sup>16</sup> PWC (2012): *Pricing Knowledge Network: Focusing on the Impact of Major Intercompany Pricing Issues*. P-2. Available at [www.pwc.com/tp](http://www.pwc.com/tp)

special skills to deal with large multinationals that were suspected to be involved in transfer pricing. As a result of increased demand of revenue there was need by the government to restructure departments charged with the responsibility of tax administration. In 2005, Kenya Revenue Authority (KRA) was established to operate under the Kenya Revenue Authority Act CAP 469, as a central authority for the assessment and collection of government revenue. Upon its incorporation KRA embarked on aggressive tax reforms, part of which revolved around how to deal with tax evasion through transfer pricing especially by large multinational enterprises<sup>17</sup>.

In order to deal effectively with revenue challenges posed by large multinationals enterprises, Large Taxpayers' Office (LTO) was formed in 1998 with a primary objective of promoting

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efficient tax administration and compliance among large taxpayers . Nearly all Multinational Enterprises (MNE's) happen to fall in this category. Among the first transfer pricing audits to be conducted include one on Unilever Kenya Limited (UKL)<sup>19</sup>, formally East African Industries limited (EAI).

UKL was engaged in the manufacture of various household goods which included foods, detergents and personal care items. UKL is a subsidiary of Unilever Pic a company incorporated in the United Kingdom. Unilever Uganda Limited (UUL) is also a subsidiary of

<sup>17</sup> KRA:(2006):/tevera/e *Administration Reform and Modernization Program*. Nairobi. Available at <http://www.kra.go.ke/rarmp/rannp.html>

<sup>18</sup> KRA: Large Taxpayers Office, <http://www.renenuc.go.ke/lto/lto.html>

*Unilever Kenya limited v The Commissioner of Income Tax* (2003) AP, 753

Unilever Pic and therefore a related party to UKL by virtue of common shareholding. UKL and UUL entered into a contract in 1995 whereby UKL was to manufacture for UUL and supply UUL with such goods as prescribed in their contract. UKL also manufactured and sold such products to customers in Kenya and to other unrelated customers in the export market. UKL charged lower prices to UUL as compared to prices charged to unrelated customers in the export market. Applying the principle of comparability, the price charged to related party should be benchmarked with the price charged to third parties taking into account the circumstance of the case. Pursuant to section 18(3) of ITA, the Commissioner charged tax on the price difference after adjusting for transport cost as the price was deemed not to be at arm's length. UKL appealed on the assessment in High Court on the basis that section 18(3) is ambiguous and that it had applied the OECD Transfer Pricing Guidelines in arriving at the price which the Commissioner now sought to adjust.

In upholding the appeal, the judge observed that there was no evidence of tax fraud or tax cheating on the part of the appellant. He held that Section 18(3) is obscure and the appellant is entitled to demand that his tax liability be made out of a reasonable clarity. The course of business between UKL and UUL were not so arranged to enable UKL to make no profit or less profits and that when the Act gives no guidelines other internationally acceptable guidelines may be applied. The ITA is silent on various methods of computing arms length price and that Section 18(3) does not tell taxpayers what K.R.A would accept as arms length or how to prove to them or if they are willing to negotiate pricing arrangement.

The judge was also persuaded by the Indian Income Tax (21<sup>st</sup> Amendment) Rules, 2001 Rule 108 which set out at length guidelines for the determination of arms length price under subsection 2 of section 92 C of the Indian Income Tax Act. The Rules provide for methods

similar to those of the OECD although India is not a member of OECD. The judge concluded by stating that it is his hope that Kenya would emulate India in enacting similar rules.

Following this ruling in 2005, Kenya issued the Income Tax (Transfer Pricing Rules) 2006 to guide in the application of Section 18(3) of the Income Tax Act. The Rules came into operation on the first of July 2006 vide the Finance Act 2006. Following the above developments it was necessary to dispose other on-going cases whose assessments were based on section 18(3) of the Act. One such case was *Sara Lee Household & Body Care limited*, whose appeal was already pending in high court. It was evident that the appellant would rely heavily on the Unilever decision and therefore the Commissioner and the appellant agreed to negotiate the case out- of- court. Other cases were dropped without recovery of any taxes.

The second phase of audits was conducted under the new transfer pricing rules. It was however realized that the rules were not as elaborate as anticipated. From the wordings of the rules, it was evident that they were a replica of OECD Transfer Pricing Guidelines of 1995 (OECD Guidelines). Therefore to expound on the rules, it became necessary to rely on the OECD Guidelines as soft law. Details of the application of transfer pricing methods are set out in the OECD Rules. The rules provide for four transfer pricing methods namely the Comparable Uncontrolled Price method (CUP), Resale Price method (RPM), Cost Plus method (CPM) and Transactional Net Margin Method (TNMM). Traditionally, TNMM is the most popular method. This method requires the use of commercial databases to establish comparables.

Commercial databases are developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis<sup>20</sup>. Data bases will only contain data for companies with transactions which are considered arms length, therefore giving rise to arms length results. The results of the enterprise under audit would be characterized and benchmarked with results of similar enterprises in the data base to establish whether the results reflected by the enterprise under audit are at arm's length. Where the results for the benchmarked enterprise show lower profitability than the established benchmark, then, an adjustment is made to bring the two at par. This adjustment is known as transfer pricing adjustment.

Lack of commercial database was the first challenge faced by KRA because without it, it was not possible to test statistics presented by taxpayers in support of their application of the arms length principle. Although the database was eventually procured in year 2010, KRA continued to face many other challenges ranging from the use of the database to others associated with transfer pricing legislation.

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Inherent challenges associated with the use of database were numerous and varied . First, data bases rely on publicly available information which may not be available in all countries. It therefore became evident that the information in the data base was only from some countries and that certain unique conditions in some countries could not be catered for.

<sup>20</sup> OECD, (1979) *OECD Report Transfer Pricing and Multinational Enterprises*. Paris: OECD publishing, p. 116

<sup>21</sup> See note 3 para.3.31

Secondly, even where information is publicly available, not all countries have the same amount of publicly available information about their companies. Some countries demand more detailed information than others depending on the level of disclosure intended to be achieved. Thirdly, even where the same level of details is required, sometimes the information contained therein is significantly different depending on the legal form of the company and whether the company is listed or not. Finally, many databases are compiled and presented for non transfer pricing purposes. It is not always the case that the commercial databases provide information that is detailed enough to support the chosen transfer pricing method.

The legal challenges that threatened the application of arms length principle after the enactment of the rules include: First, as pointed out in the Unilever case, the wording of section 18(3) required the Commissioner to prove intention of tax evasion by the taxpayer. Ordinarily, in taxation, the burden of proof is on the taxpayer because tax inquiries are based on the taxpayers self assessment. This interpretation by the judge necessitated legislative amendment which was effected in 2008 to relax this requirement. The two versions of the section before and after amendments are reproduced in Appendix I for ease of reference.

The phrase *so arranged* in the first version according to Visram J, suggests the presence of intention or a premeditated act which the Commissioner has to prove to sustain an assessment. The amendment brought in the word *such* in lieu of *so arranged* to lower the standard of proof required if the Commissioner is to make a case for transfer pricing. Under the second version, the Commissioner is only required to demonstrate that as a result of the commercial arrangement the transaction gave rise to less than normal tax.

Due to Kenya's stage of development, it was found that significant business is conducted between related individuals which could potentially pose a challenge to transfer pricing compliance. As a consequence, the definition of related party was expanded to include relation by blood (consanguinity) and other close relationships (affinity) by amending section 18(6) (c).<sup>22</sup>

KRA continues to face challenges in the administration of transfer pricing legislation. The reliance on the OECD Guidelines as soft law has not helped much. It is therefore necessary to carry out several other amendments geared towards customizing transfer pricing legislation to be in line with the local circumstances.

### **1.3 Statement of the Problem**

Kenya has made concerted effort in modernizing its transfer pricing legislation in recent times. Transfer pricing refers to the allocation of profits between entities that are considered related based on the relevant local legislation.<sup>23</sup> Transfer price has been defined by Tang<sup>24</sup> as intra-firm price for the sale or transfer of tangible and intangible goods between related companies in two or more countries.

Income Tax (Transfer Pricing) rules were issued in 2006, followed by a series of amendments to Section 18 of Income tax Act .The rules are a replica of the OECD Transfer pricing guidelines of 1995 which are based on the arms length principle. Despite this effort

<sup>22</sup> Finance Act no. 10 of 2010 s. 24

<sup>23</sup> Global transfer pricing consulting :(2013): *Importance of transfer pricing* .available at <http://globaltpconsulting.co.in/index.php/en/component/content/article>. (accessed on 10<sup>th</sup> January 2010)

<sup>24</sup> Tang & Roger, W.Y. (1997): *Intra-firm Trade and Global Transfer Pricing Regulations*. Connecticut.



Kenya faces serious challenges in the implementation of the law occasioning continued erosion of tax base by multinational enterprises.

The main problem emanate from the model tax legislation currently in force, which is based on the OECD Transfer pricing guidelines. Kenya's transfer pricing legislation is in skeleton form and requires to be expounded with the help of the OECD transfer pricing guidelines. For instance, Income Tax transfer pricing rules provide for methods to be applied in arriving at an arm's length result.<sup>25</sup> No effort however has been made to explain how the methods will be applied. Likewise, paragraph 6 of the rules set out transactions subject to transfer pricing. Included in the list are transactions relating to intangible assets and provision of services. These two areas are complex to administer not only for developing economies but also for developed economies. Whereas KRA merely listed the transactions without any explanation, OECD dedicated two full Chapters in the OECD Transfer pricing guidelines for the two aspects.<sup>26</sup> OECD Transfer pricing guidelines are therefore applied in Kenya as soft law. The application of the guidelines requires the availability of reliable comparables and the requisite skills in transfer pricing. These two aspects are lacking in Kenya hence the challenge. Moreover, OECD transfer pricing guidelines were formulated for developed economies with different sets of circumstances from Kenya. The guidelines are too subjective for application in the Kenya's tax environment.

<sup>25</sup> **Income Tax (transfer pricing ) rules 2006 ; at Para 7**

<sup>26</sup>OECD Report (2010): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*: OECD Publication. Chapters VI and VII

The continued reliance on the OECD transfer pricing guidelines will enhance capital flight from Kenya to other developed economies through mispricing. The tax base will continue to diminish which may ultimately give rise to increase in national debt, high levels of unemployment and low standards of living. This situation is unacceptable and urgent solution to the problem must be found as a matter of priority. In this study a case has been made upon tax authorities to take up what is relevant to them from OECD Transfer Pricing guidelines, and blending it with other practices which have worked well in other successful economies in dealing with the problem of transfer pricing. A bold step is therefore called for in terms of putting forward an alternative thinking in the application of arms length principle.

#### **1.4 Significance of the Study**

Transfer pricing law is in its infant stage in Kenya. Both KRA and tax practitioners are still grappling with this complex issue of transfer pricing. Prior to year 2006, Kenya relied on section 18(3) as the only law dealing with transfer pricing.

The relevance of the OECD guidelines was set out in the ruling of *Unilever Kenya limited v Commissioner of Income Tax*<sup>27</sup> where the court agreed with the appellant that in absence of our own guidelines, OECD guidelines could be applied as they are based on international best practice.

<sup>27</sup> Income tax appeal no.753 of 2003

/vs has been noted by OECD<sup>28</sup> "National Revenue bodies face varied environment within which to administer their taxation system. Jurisdictions differ in policies, legislative environment, administrative practices and culture. As such, a standard approach to tax administration may be neither practical nor desirable across OECD and affiliated countries".

To date, no significant jurisprudence has been developed to guide the stakeholders on the interpretation of the Income Tax transfer pricing Rules 2006. OECD guidelines therefore have been used as soft law in the interpretation of the rules. An attempt, however, to apply OECD Transfer Pricing Guidelines in their current form has been met with enormous challenges which must be addressed by customizing the guidelines to fit into the domestic situation.

Kenya hosts a number of multinationals with related parties in the neighboring countries. These include: Nakumatt holdings have a branch in Uganda and Rwanda, Fina Bank has a branch in Rwanda, Kenya Commercial Bank has subsidiaries in Tanzania, Uganda, Rwanda and The Republic of South Sudan. Others include Coca Cola East, Central and West Africa whose Head office in Kenya controlling branches in 32 African Countries, British American Tobacco (BAT) area office in Kenya controls related parties in East and Central African region. These companies have related party dealings which are subject to transfer pricing rules. It is therefore important for the country to have effective working rules on transfer pricing that strike a balance between the need to encourage investment at the same time safeguard the tax base.

<sup>28</sup> OECD (2012): *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing. Available at: [hUmJ/dx. doi.org/10.1787/9789264169463-en](https://doi.org/10.1787/9789264169463-en). P. 4

Taxation is the single largest source of government revenue with MNE's contribution to tax revenue and gross domestic product (GDP) in general considered significant . Since the formation of KRA, the ratio of tax revenue to GDP has increased from 14% in 1995/1996 to 22% in 2009/2010. This ratio is relatively high compared to other countries in the region for instance Uganda (11.1%) and Rwanda (9.2%)<sup>30</sup>. About 20% of taxpayers in Kenya contribute 80% of domestic taxes<sup>31</sup>. Most of the taxpayers in the 20% category are multinationals. Civil society is of the view that MNE's may not be contributing their fair share of taxes in developing countries as a result of transfer mispricing and other complex tax avoidance schemes<sup>32</sup>. The Government of Kenya's view is that MNE's will comply when appropriate tax legislation is put in place.<sup>33</sup>

<sup>29</sup> European Commission: (2011): *Transfer Pricing and Developing Countries. Country Study- Kenya.* Available at [www.ec.europa.eu/.../appendix p 9](http://www.ec.europa.eu/.../appendix_p_9)

<sup>30</sup> European Commission: (2011): *Transfer pricing and Developing Countries. Country Study- Kenya.* Available at [www.ec.europa.eu/.../appendix p 9](http://www.ec.europa.eu/.../appendix_p_9)

<sup>31</sup> European Commission :(2011): *Transfer Pricing and Developing Countries. Country Study- Kenya.* Available at [www.ec.europa.eu/.../appendix p 10](http://www.ec.europa.eu/.../appendix_p_10)

<sup>32</sup>

European Commission: (2011): *Transfer pricing and Developing Countries. Country Study- Kenya.* Available at [www.ec.europa.eu/.../appendix p 9](http://www.ec.europa.eu/.../appendix_p_9)

<sup>33</sup> European Commission: (2011): *Transfer pricing and Developing Countries. Country Study: Kenya.* Available at [www.ec.europa.eu/.../appendix p 11](http://www.ec.europa.eu/.../appendix_p_11)

This study has come up with suggestions which, if adopted, will contribute to improving the existing transfer pricing legal regime to make it more simple, relevant and acceptable to stakeholders. This has been done taking into account the fact that MNE's play important roles in job creation, investment, technology transfer, and corporate social responsibility.

## **1.5 Research Method**

### **1.5.1 Methods**

The research method employed in data gathering for this study was primarily the secondary method. However, some sort of primary method was applied on a limited scale in the case of Brazil. Secondary sources included international Conventions, domestic legislation, regulations and guidelines, journal articles and books. Internet sources were used where they provided information that was otherwise not available in journals and other secondary sources and where they provide current information and data. The primary method used was in the form of semi structured interviews where specific officers of the Federal Revenue Service of Brazil responded to specific inquiries on transfer pricing.

### **1.5.2 Research Objectives: The objectives of the said research were:-**

a) to evaluate the appropriateness of the OECD transfer pricing guidelines as a means of regulating transfer pricing in Kenya;

b) to find out why some countries like Brazil decided not to follow the arms length principle **enshrined** in the OECD transfer pricing guidelines, yet they have registered significant **success** in the administration of transfer pricing;

c) to establish the challenges Kenya faces in the administration of its Transfer Pricing Rules which is a product of OECD Transfer Pricing Guidelines;

d) to establish from experiences of other countries what Kenya could borrow to make the current transfer pricing legislation more effective;

e) to recommend to KRA and the Treasury legislative changes that would improve and simplify transfer pricing legislation with a view to making transfer pricing legislation less burdensome to taxpayers and easy to administer;

In some measure, these objectives underlie the purpose of this study.

## **1.6 Hypothesis**

This paper sets out on the assumption that the OECD Transfer Pricing Guidelines are largely unsuitable for Kenya. The alternative is to develop a model that approximates the principle of arms length at the same time affords the country a simple and realistic tool for curbing transfer pricing founded upon our capacities and social economic matrix.

## 1.7 Conceptual Framework

Before colonization, Kenya was divided up into a myriad of tribal based societies all with their own fixed ethnic geographical territory<sup>34</sup>. African society in pre-colonial times can be termed as a traditional society where almost all the properties were communally owned by all members<sup>35</sup>. However, in some communities, some properties especially those belonging to the king were not communal. There was no taxation as we understand it today.

In the advent of colonialism, the British introduced taxation in order to obtain cheap African labour that had to be forced upon the local Africans by moving them away from subsistence living. The Native Hut tax was put into law in 1901 through the Hut Tax Regulation 190T<sup>6</sup>. The tax was charged on all huts used for dwelling at a rate of two rupees per annum. In 1910, Poll Tax Ordinance was introduced to prevent circumvention of Native Hut Tax. This ordinance empowered the Commissioner to impose tax on anyone not covered by hut tax. All African males of the apparent age of 25 years and over were required to pay poll tax.

Historically, the classical economists were of the view that the only objective of taxation was to raise government revenue<sup>37</sup>. However, this position has changed due to ideological

<sup>14</sup> Attiya, W. (2007): *Taxation without principles: A Historical Analysis of the Kenyan Taxation System*. Kenya Law Review Vol 1: 272

<sup>35</sup> See note 5 on p.277

<sup>36</sup> Kenya Gazette: 15<sup>th</sup> march 1910

" Wiily J. (2012): *Cliffnotes.com: Fiscal Policy*. 24 march 2013. Available at <http://m.cliffnotes.com/study-guide>

and circumstantial changes. Today, taxation is used as a tool for achieving multiple objectives in line with the economic policy of a country. Primarily, taxation is used to help in the allocation of resources, for instance in directing consumption, production and distribution with a view to ensuring equitable social welfare of the people. This can be achieved by directing available resources from one sector to the other, through taxation. One sector may be taxed to discourage investors from investing in it, while the other sector may be spared to enable it attract investors. Other objectives of taxation in modern times include encouraging saving and investment, maintaining price stability, controlling inflation and consumption of harmful and luxury goods. The revenue goal however still remains the primary goal.

Many countries operate more than one tax head which includes corporate income tax; value added tax (VAT), personal income tax, withholding tax, custom duty, and other fees. Countries may base their tax on source or residence. Taxation based on residence entails taxing world- wide income earned by its nationals while taxation based on source entails taxing income accrued or derived from that country. It is also possible for a country to apply a hybrid system like the case of Kenya<sup>38</sup>.

While designing tax policies, tax designers did not contemplate the problems associated with avoidance and transfer pricing. There is a conflicting interest between the need to pay tax and the need to maximize profit by multinational corporations. It has been stated that left to its

**Section 3 of Income Tax Act provides that; Subject to , and in accordance with, this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.**



own a multinational corporation would chose a price that maximizes global profits" . One of the avenues of maximizing global profits is through aggressive transfer pricing or transfer mispricing.

The definitions of the term transfer pricing is multi disciplinary. For instance, economists define transfer pricing in business economics as the cost that a part or segment of an organization charges for a product or service that it supplies to another part or segment of the same organization<sup>40</sup>. In conventional accounting literature, 'transfer pricing' is the optimizing profits by allocating costs and revenues among divisions, subsidiaries and joint ventures within a group of related entities<sup>41</sup>

Inappropriate transfer pricing is where the pricing is not in conformity with applicable norms at international or domestic law. It is an area more properly called "mispricing", "incorrect pricing", or "unjustified pricing", and where issues of tax avoidance and evasion may arise<sup>42</sup>.

According to U.N (*supra*), about 30% of international trade takes place between related parties. A 2004 paper issued by OECD entitled "institutional approaches to policy coherence

<sup>39</sup>

**Economic and political weekly (May 12, 2001): *Transfer Pricing: Impact on Trade and Taxation: Vol. 36, Issue 19. p. 1689. Available at [www.epw.in/ejournal/show/i/1603](http://www.epw.in/ejournal/show/i/1603)***

<sup>40</sup> **United Nations. (2011): *Draft Secretariat Practical Manual on Transfer Pricing for Developing Countries*. Geneva: United Nations.**

<sup>41</sup> **Sikka, P. & Willmott, H. (2010): *The dark side of transfer pricing: its role in tax avoidance and wealth retentiveness. Critical Perspective on Accounting-*, p. 342-356. Available at [www.elsevier.com/locate/cpa](http://www.elsevier.com/locate/cpa)**

**United Nation: (2010): *Working Draft Chapter 1; An Introduction to Transfer Pricing: Financing for Development Office*. U.N. Publication, New York. Available at [www.un.org/esa/ffd](http://www.un.org/esa/ffd)**

for development" notes that intra-group transactions are not subject to the same market forces as transaction between unrelated parties operating in the free market. There is a huge potential for profit shifting through, under or over pricing of intra-group transactions. Multinational corporations just like other business enterprises have the objective of maximizing profits and minimizing costs. Tax is a major cost in business and corporations tend to arrange their affairs to result to minimum cost. Thus, corporations tend to shift profits to jurisdictions with the least tax burden through transfer mispricing which money is lent back for expansion.

Owing to profit or price manipulation, Corporations have the potential from the onset, to become very powerful. Abraham Lincoln<sup>43</sup> recognized thus: ". . . . I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country.

*Corporations have been enthroned and an era of corruption in high places will follow, and the money power of the country will endeavor to prolong its reign by working upon the prejudices of the people until all wealth is aggregated in a few hands and the Republic is destroyed.*

Adam Smith, in his famous book the Wealth of Nations, the "bible" of capitalism, was also critical of some aspects of corporate activity. He saw corporations as working to evade the laws of the market, trying to interfere with the prices and controlling trade<sup>44</sup>. This statement

Shaw, A. H. (1950). U.S President Abraham Lincoln Nov. 21,1864 (Letter to col. William F. Elkins) Ref. *The Lincoln Encyclopaedia*. New York. Macmillan.

<sup>44</sup> Anup Shah: (2013): *Global Issues, Social, Political, Economic and Environmental Issues That Affect Us All*. Available at [www.globalissues.org/print/article/26](http://www.globalissues.org/print/article/26)

was actualized by the findings that, by the year 2000, out of the 100 largest economies in the world, 51 <sup>were</sup> corporations; only 49 are countries (based on a comparison of corporate sales and countries GDP)<sup>45</sup>. According to the World Bank report Kenya's GDP for year 2000 was \$12,604 billion at the then prices<sup>46</sup>.

A comparative statistics for year 2000, (Appendix II) set out the largest 100 economies in the world. The statistics show that the Kenyan economy is many times smaller than the economies of some big multinational corporations. For example, *Wal-Mart Stores* had a turnover of \$ 67.7 billion which was over five times the Kenyan GDP. Comparing corporations with other bigger economies, it was found that Wall Mart, the biggest company measured by value added, is bigger than Pakistan, Peru and Algeria. Exxon is bigger than the Czech Republic, New Zealand, and many other small countries. It is regrettable that a more current data was not available for this analysis.

As early as 1982 in Kenya, Langdon<sup>47</sup> found that, commercial firms disguise much of their profitability in non-dividend form particularly as head office buying commissions. He observed that price movement in the international market for many products result in part

<sup>45</sup> Paul, D. G. and Filip, C.(2002 ): " *How Big are the Big Multinational Companies?*, available at <http://econ.kuleiiven.be/ew/acadernics/intecon/pdg-paper>

United Nations: (2012): *World Statistics pocket book* /United Nations Publishing. Available at <http://data.un.org/CountryProfile.aspx>. accessed on 19th January 2013

Steven, W. L. (1982): *Multinational Corporation in the Political Economy of Kenya*. Journal of Economic Issues, Vol. 16, No.3, September, 1982 p. 912. Mcmillan publishing.

from transfer pricing, and not from market factors such as resource cost, productivity, consumer incomes, tastes and preferences.

Transfer pricing aims at two objectives: first, minimizing the net liabilities of multinationals or otherwise integrated companies by limiting or increasing profit attributable to subsidiaries operating in developing countries. The shift is mainly driven by lower marginal tax rate in developed countries where the parent company operates. Corporations will shift profit to safe currency areas where remittances are not hampered by foreign exchange controls. Price manipulations reflect the attempt to shift the profit out of the country through low transfer prices for exports and high transfer prices for inputs and high capital goods. Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world<sup>48</sup>.

There is relatively weak regional trade among African countries where more than 80% of Africa's total exports go to Europe, Asia and America<sup>49</sup>. In Kenya, it is estimated that large taxpayers are dominated by MNEs and contribute over 70% of the total revenue<sup>50</sup>. Income

UN: (2010): Working draft chapter 1: *An Introduction to Transfer pricing*. p2

Economic Commission for Africa :(2010): *New Report on Assessing Regional Integration in Africa* .ABD Annual Meetings, "Press Release No.43/2010, <http://www.uneca.org/eca-resource/press-release/2010-^glgase/pressrelease4310.html>.

IMF, (2008): *Tax Administration Reforms - recent trends and development*. Compliance Management in Tax Administration Workshop, Nairobi, Kenya, November 3-7, 2008

**tax** contributes 19% of the total revenue for the period between 2005 and 2010.<sup>51</sup> Many MNEs in Kenya began their operations in the early 1990s but a significant share of them started to invest when the country attained independence in 1963. Even though MNEs have traditionally operated as full-fledged entrepreneurs in Kenya, some have recently opted to restructure their businesses by lowering the risk profile of the local entities by transferring functions and value - addition process out of Kenya.

OECD has greatly influenced the thinking of many countries in their effort to find solution to the problem occasioned by transfer pricing. Both OECD member states and non- member states find themselves adopting methodologies prescribed by the OECD in addressing transfer pricing challenges. For instance, in 2002, a Forum on Tax Administration (FTA) was created led by United Kingdom consisting of heads of Revenue bodies and their teams from 43 OECD and non-OECD countries. The FTA vision is to create a forum through which tax administrators can identify, discuss and influence relevant global trends and develop new ideas to enhance tax administration around the world.

E.U :( 2012). *Transfer pricing and Developing Countries - Kenya*. E.U Publication, Brussels.

" OECD. (2012). *Dealing Effectively with the Challenges of Transfer Pricing*: OECD Publishing. P. 4. Para 2. Available at <http://dx.doi.org/10.1787/9789264169463-en>

According to *PriceWaterHouseCoopers*,<sup>53</sup> a good number of African countries have transfer pricing legislations based on the arms length principle. These countries include: Algeria, Congo, Egypt, Kenya, Malawi, Mozambique, Nigeria, South Africa, Tunisia and Uganda. **The** PWC report showed that, other African countries that do not have comprehensive transfer pricing legislation, have provisions in their tax code that make reference to the arms length principle. The report indicated that others like Angola and Zimbabwe have draft legislation in place based on arms length principle. It is important to note that although transfer pricing legislation in Namibia does not prescribe any particular method for determining the arms length result, the understanding is that the OECD transfer pricing methods is most preferred as observed in the PWC report. Zambia too does not have transfer pricing rules, but fully adopts the OECD transfer pricing guidelines.

The above description shows that there is a broad consensus in Africa, in the adoption of arms length principle as prescribed by OECD. Significantly, these countries enacted rules that mirror the OECD Transfer Pricing guidelines. Rules are different from guidelines in that they are established and authoritative standards, mandating a conduct in a given situation.<sup>54</sup> A guideline is a recommended practice that allows some discretion or leeway in its interpretation, implementation or use.<sup>^</sup> Rules therefore are specific and have a legal force, while guidelines are broad and lack the legal force.

PWC: (2012): *Transfer Pricing Perspective: Spotlight on Africa's Transfer Pricing Landscape*. Available at: [www.pwc.com/transferpricingperspectives](http://www.pwc.com/transferpricingperspectives)

\* **Black's law dictionary; Eight Edition, P. 1357**

<sup>^^</sup> [businessdictionary.com/definitions/g...](http://businessdictionary.com/definitions/g...)

## 1.8 Literature Review

This study interrogates the extent to which OECD Transfer Pricing Guidelines are effectively applicable in the Kenya tax legal regime. First, there has been very little research done in the area of transfer pricing in Kenya and developing countries at large, mainly due to the unavailability of intra-firm trade data.<sup>56</sup>

Secondly, there lacks systematic attempt in developing countries, to collect and analyze relevant data in one information repository database, making it available for multiple uses. Also the lack of any government sponsored studies, like those in Colombo, Greece and Sri Lanka, may be the reason why not many transfer pricing studies have been undertaken in many developing countries.

In contrast, there are numerous studies on transfer pricing carried out in developed countries.<sup>59</sup> This is primarily due to the detailed statistical information on intra-firm trade made available in most developed countries and stringent laws requiring greater transparency and reporting.

**Bhagwati J. N. (1974), as quoted by Monica Singhanian in *International Research Journal of Finance and Economics* ISSN 1450-2887 Issue 40 (2010) on p.3**

<sup>57</sup> p see note 3 above

**Monica Singhanian, *International Research Journal of Finance and Economics* ISSN 1450-2887 Issue 40 (2010) on p.3**

<sup>59</sup> i ii

**Lall S. (1973), as quoted by Monica Singhanian, in *International Research Journal of Finance and Economics* ISSN 1450-2887 Issue 40 (2010) on p.3**

In Kenya, limited research has been done in related areas. Three of such studies were identified, which were carried out in part fulfillment of degree exams. Rispah<sup>60</sup> focused on the adequacy of Kenyan tax law in dealing with transfer pricing issues. Her study discussed the arms length principle in terms of why the principle should be adopted, the basis of applying the principle and the challenges faced in the application of the principle. The study further highlighted KRA's view on transfer pricing and the evaluation of transfer pricing provisions under the Income Tax Act. The author concluded by observing that the Income Tax (Transfer Pricing Rules) 2006 which were meant to supplement section 18(3) of the Income Tax Act brought more confusion for both taxpayers and tax officials. The author recommended intensive training for tax administrators in order to sharpen their skills in transfer pricing. The difference between Rispah's work and this study is that my emphasis has been on the applicability of OECD guidelines in Kenya focusing on the part of guidelines that is useful but not yet incorporated into our tax legislation on one hand and the part of the guidelines that may be difficult to adopt. This study also brings out the legislative changes that have taken place in Kenya between 2008 and 2011 relevant to the research topic which was not available to Rispah. My recommendation is therefore to customize the OECD guidelines to fit into the local circumstances.

Another study was carried out by Ann<sup>61</sup>, an employee of KRA, who dealt with the question of the inadequacy of the Kenya income tax law in regulating transfer pricing. The main focus

<sup>101</sup> Rispah, M. M: (2008): *Transfer Pricing: Does Kenya's Tax Law Provide Adequately for This?*

' Ann, J.W :(2012): *The Kenya Income Tax Law: Its Inadequacies in the Regulation of Transfer Pricing,*



**3S on** what the income tax law does not provide which makes it inadequate in regulating transfer pricing in Kenya. Her study focused on the success with which transfer pricing has been regulated especially in United Kingdom and Australia while acknowledging the challenges developing countries continue to face in terms of capital flight. The author concluded by observing that since transfer pricing is complex, evolving and fluid, transfer pricing law must likewise evolve if it is to remain relevant. The focus of my study has gone beyond this by including aspects of OECD guidelines not yet adopted by Kenya but which are helpful in resolution of transfer pricing problems. I have also attempted to outline the challenges faced by both the developed and developing countries in the application of arms length principle and suggested alternative to the arms length principle.

The other work was by Ratemo,<sup>62</sup> who did a critique on transfer pricing regulation in Kenya. The study analyses the current Transfer Pricing legal framework in Kenya, the challenges experienced by KRA in evaluating the transfer price and proposals for addressing them. Ratemo benchmarked this against international best practices provided by the OECD Transfer Pricing Guidelines, the United Nations Tax Model Convention on Transfer Pricing (UN Tax Model) and guidelines from the World Trade Organization (WTO) on customs valuation. The author concluded that the current legal framework in the area of transfer pricing is very weak and cannot withstand legal challenges. The author made recommendations for strengthening of the legal, policy and institutional framework for transfer pricing in Kenya. Although Ratemo's area of study is different from mine, it contains

Ratemo, J. M: (2012): *Transfer Pricing Regulation in Kenya: A Critique*.

erue important pointers and analysis especially in chapter four where the author sets out the nexus between OECD Transfer Pricing Guidelines and Kenya's transfer pricing legal regime. My research focused on evaluation of the OECD transfer pricing guidelines as they relate to the Kenyan transfer pricing legislation setting out the difficulties Kenya experiences by applying OECD guidelines as soft law.

Scholars from other parts of the world have written about the applicability of OECD guidelines in other tax jurisdictions. Onsando Omari analyzed the transfer pricing legislation of South Africa and compared it with the OECD Transfer Pricing Guidelines. The author concluded by observing that OECD Transfer Pricing has some inherent weaknesses in their application such that there is no right or wrong answer to a transfer pricing problem<sup>64</sup>. Onsando, however, acknowledged that South Africa has extensively borrowed from the OECD Transfer Pricing Guidelines although it is not a member of OECD. The author proposes inter alia, the improvement of South African transfer pricing legislation in terms of embracing Advance Price Arrangement (APA) as a mechanism for expedient resolution of transfer pricing disputes.

Onsando, O. A. (2007). *The OECD Transfer Pricing Guidelines: An analysis of their application in the South African Legal Regime*. Available at [omarionsando@yahoo.com](mailto:omarionsando@yahoo.com)

<sup>64</sup> see note 23 p.92

Joseph and Another<sup>65</sup> observed that even member countries of the OECD recognize that the existing system of transfer pricing under the arm's-length standard is far from perfect, particularly when applied in the context of developing economies. The OECD therefore has undertaken an active program to improve the operation of arm's-length-based transfer pricing, and in particular a number of initiatives to improve the administration thereof in the context of developing economies. As a consequence of this, Working Party No. 6 has invited the participation of a group of key developing and emerging economies in its work on intangibles. These countries include Brazil, China, Colombia, India, Malaysia, Russia, Singapore, South Africa, and others are providing a developing country perspective to the working party, raising in particular important issues in relation to location advantages, group synergies, and local intangibles<sup>66</sup>.

Joseph L. Andrus and Another,<sup>67</sup> in "*The Arm's-Length Principle and Developing Economies*"<sup>68</sup> have stated that critics have questioned whether transfer pricing rules based on

<sup>65</sup> Joseph, L. A., Mary, C. B., Caroline, S: (2011): *The Arm's-Length Principle and Developing Economies: Tax Management Transfer Pricing Report 495*. p. 14. Available at <http://www.bna.com/corp/index.html#V>

<sup>66</sup> Joseph, L. A., Mary, C. B., Caroline, S: (2011): *The Arm's-Length Principle and Developing Economies: Tax Management Transfer Pricing Report 495* .p. 15

Joseph L. Andrus heads the transfer pricing unit within the OECD's Centre for Tax Policy and Administration (CTPA). Mary C. Bennett, former head of the CTPA's tax treaty, transfer pricing, and financial transactions division, is a partner with Baker & McKenzie in Washington, D.C. Caroline Silberstein, former head of the CTPA's transfer pricing unit, is a partner with Baker & McKenzie in Paris.

Joseph, L. and Another (2011): *The Arm's-Length Principle and Developing Economies, Tax Management Transfer Pricing Report 495*. p.2

the arm's-length principle are appropriate for use in developing economies. These critics have made the following suggestions:

**The** arm's-length principle is too easily manipulated by multinational enterprises and **therefore** gives rise to a loss of tax revenues in developing economies. Effective **administration** and enforcement of transfer pricing rules based on the arm's-length principle **is not** possible for developing economies because it requires resources and knowledge of **comparable** transactions that either do not exist or exceed the capacity of many developing **economy** tax administrations to identify. Alternatives to the arm's-length principle would **protect the** tax base in developing economies more effectively and place fewer demands on **the resource**-constrained tax authorities, without detrimental consequences for adopting such alternatives.

Rick Michelle<sup>69</sup> observed that OECD Transfer Pricing Guidelines are too complex and costly for developing countries to implement and consequently risk losing tax revenues. According to David Spencer,<sup>70</sup> the problem with the arms length principle is that it is very hard to get evidence or information about comparable transactions of independent companies. In many cases, multinationals have been formed and are effective because they are in situations where there are no comparable transactions. The author cited examples from automobile and large pharmaceutical companies for which there are no independent subsidiaries from which to

<sup>69</sup> D-I

Kick, M. (2011) *OECD Tax Rules Called Too Complex, Costly to Help Developing Countries Nab Evaders: Daily Tax Report 10/06/2011*

<sup>70</sup> <sup>B</sup> David Spencer is a New York-based attorney specializing in tax and banking

tain data for benchmarking. A similar observation was made by Price Waterhouse in its report to the European Union<sup>71</sup>

Thus developing countries, including Kenya, require a simple model for addressing transfer pricing issues. Comparables from developed economies do not address development parity between developing and developed economies. The use of such comparables goes a long way in facilitating erosion of tax base and capital flight from developing to developed economies.

### **1.9 Outline of the Study**

This study comprises five chapters. Chapter one is the introduction to the study. This chapter contains as has been seen the background to the transfer pricing law, the statement of the problem, significance of the study, research methodology, research objective, conceptual framework and literature review.

Chapter two comprises the historical profile of transfer pricing, beginning with the evolution of anti avoidance legislation, the evolution of the basic transfer pricing law in Kenya contained in section 18(3), and subsequent legislation of Income Tax Transfer Pricing Rules 2006 will also be visited. The chapter concludes by analyzing transfer pricing regimes of other countries with transfer pricing challenges similar to Kenya's and contribution made by certain international organizations in dealing with transfer pricing issues.

<sup>71</sup> p

t-U: (2012): *Europe Aid- Implementing the Tax and Development Policy Agenda: Transfer Pricing and Developing Countries*. P 7. Available at [www.econbiz.de/...developing:...europeaid](http://www.econbiz.de/...developing:...europeaid)

Chapter three focuses on the OECD transfer pricing model and its influence on the Kenyan tax system. A case in point is the decision in Unilever case which was largely based on the OECD transfer pricing model. The Income Tax (Transfer Pricing Rules) 2006 have been analyzed in terms of their relationship with the OECD Transfer Pricing guidelines.

Chapter four addresses the relevance and suitability of the OECD guidelines to the Kenyan situation. Other issues contained in this chapter include: limitations of the OECD model, alternatives to the OECD model as practiced by Brazil, the effort Kenya has made to customize its transfer pricing rules to make them relevant to the Kenyan situation. Chapter five sets out conclusions and recommendations necessary which if enacted will completely transform transfer pricing law in Kenya.

## CHAPTER TWO

### 2.0 HISTORICAL PROFILE TO TRANSFER PRICING AND TRANSFER PRICING DEVELOPMENTS IN SELECTED TAX JURISDICTIONS OF THE WORLD

This part traces the historical development of transfer pricing law paying special attention to the developments in U.S., Brazil, India and South Africa. The discussion begins with the development of tax avoidance law as the general law that covered transfer pricing cases. Kenya being a member of Commonwealth countries follows common law system and therefore, transfer- pricing developments in any Common Wealth country and in particular U.K may be of great importance. The history of transfer pricing legislation in Kenya is covered in this part. The study extends to cover important institutional contribution by organizations such as the OECD and United Nations.

#### 2.1 Historical Review of Transfer Pricing

Income tax was the first tax in British history to be levied directly on people's earnings. It was introduced in 1799,<sup>72</sup> by the then Prime Minister William Pitt as a temporary measure to cover the cost of the Napoleonic Wars. Income tax was formally repealed in 1816, a year after the battle of Waterloo but was re-introduced in 1842 by Sir Robert Peel to deal with a

<sup>72</sup>John Lubbock: *The Income Tax in England*. The North American Review, Vol. 158, No. 447, Feb., 1894. diversity of North Iowa. Publishing. P. 150- 156. Available at <http://www.istor.org/stable/25103273>

massive public deficit . At this time, it was only levied on the very rich. Income Tax rose dramatically in the early 20<sup>th</sup> century.

As late as 1906, there was no significant concern for legal tax avoidance as distinct from tax evasion<sup>74</sup>- This was because rates of income tax were at an acceptably low level that it was not really worth the bother taking steps to avoid it. Lloyd George<sup>73</sup>, in his last pre- First World War budget debates stated thus:

*"it is perfectly true that you can make legal arrangements ...to evade taxes. I am perfectly well aware of that ... the moment it is done the Inland Revenue can submit a scheme which will stop all that kind of spiders web ...I considered whether it should be stopped this time and the only reason why it was not done was because I was advised that at the present moment it was not worthwhile "*

The need to finance modern warfare led to higher rates of income tax which in turn led to the desire among taxpayers to legally avoid tax by whatever means available to them . For instance, in the U.S, in 1940, the congress, faced with the increasing national defense budget

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<sup>73</sup> John Lubbock: *The Income Tax in England*. The North American Review, Vol. 158, No. 447, Feb., 1894. P-152. Available at <http://www.istor.org/stable/25103273>

David Goldberg: *The approach of the courts to tax planning schemes*. Available at [www.taxbar.com](http://www.taxbar.com)

David Lloyd George was the chancellor of exchequer during the First World War. In 1916 he became the British Prime Minister a position he held until 1922.

Edwin, R. A (1918): *Loans and Taxes in War Finance*. A journal on Annals of American Academy of Political and Social Science, Vol. 75, Jan., 1918 P. 52-82 . available at <http://www.istor.org/stable/1014009>



lowered the exemptions and increased surtax rates on personal income tax<sup>77</sup>. Surtaxes led to tax avoidance schemes founded upon distribution of income among members of the family, Income producing properties were transferred to relatives and friends in lower tax brackets resulting to less tax payment on the same income level.

The ever increasing tax rates made tax advisors to sharpen their craft and become more and more skilled at plans intended to avoid taxes, and the legislature began to introduce provisions designed to limit the scope of avoidance. In Kenya, the Tax Ordinance, prepared in 1922 by British inter-departmental committee on Income tax meant for colonies not possessing Responsible Government<sup>78</sup> was gazette in Kenya vide gazette notice of 31<sup>st</sup> may 1922. The Ordinance included a general anti- avoidance provision (GAAP)-Section 22b of the Ordinance which stated that "*where the assessing officer is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is in fact no given effect to, he may disregard any such transaction or disposition and the person concerned would be assessable accordingly.*

The general anti-avoidance provision is believed to have originated from the English Excess Profit Duty legislation of 1915 that mentioned "fictitious" or "artificial" transaction<sup>79</sup>. The

**California Law Review, (May 1941). *Fair, Feasible and in Public Interest.* Vol. 29, No. 4.**

**Oilman, A. (1946). *The Palestine Income Tax: Law and Practice.* Tel Aviv: Lapid Publishing Co.'**

**Oilman, A. (1946). *The Palestine Income Tax: Law and Practice.* Tel Aviv: Lapid Publishing Co.'**

<sup>1</sup> ya income tax ordinance of 1940 contained similar provision. In 1952 the three Ordinance governing income tax- The Income Tax Ordinance 1940, The War Taxation (Income Tax) Ordinance 1940 and the War Taxation (Income Tax) (amendment) Ordinance 1941 were combined to what came to be known as The East African Income Tax (Management) Act 1952<sup>80</sup>. The colonial government was least concerned about transfer pricing as the multinationals then were few and relatively small.

The general provision dealing with tax avoidance in Kenya today was copied from the East Africa Tax Management Act 1952 as a generic provision. In the current legislation, it is section 23 of ITA. (APPENDIX III)

This section was crafted in a manner that it has to some extent capacity to deal with both "domestic transfer pricing" and cross- border transfer pricing. The main challenge in the application of this section is that it imposes upon the tax administration a heavy burden of proof in the justification of the Commissioners' opinion that the main purpose or one of the main purposes for which a transaction was effected was the avoidance or reduction of liability to tax. In the history of income tax in Kenya, this section has been invoked only once in L.A.B International Kenya limited v K.R.A<sup>81</sup>. This case has now been disposed as an out-of-court settlement.

There are other anti avoidance sections in the Income Tax Act, dealing with specific issues as discussed below:

Attiya, W. (2007). *Taxation without principles: A Historical Analysis of the Kenyan Taxation System*. Kenya Law Review. Vol 1: 288

<sup>81</sup>L.A.B International Kenya limited v K.R.A, Petition NO. 11 of 2010

## 2 11 Section 16(2) (j)

This section restricts the interest a company can claim on loans held at any time during the year if the said loans exceed three times the equity of the company, where it is in the control of a non resident person alone or together with four or fewer other persons and where the company is not a bank or a financial institution licensed under the Banking Act. This is known as thin capitalization legislation.

This section was amended in year 2010 by introducing the concept of deemed dividends. Dividends are deemed in a situation where the company is in the control of a non-resident person alone or together with four or fewer other persons and where the company is not a bank or a financial institution licensed under the Banking Act, the Commissioner deems an interest rate on interest free loans given under such circumstances. Deemed interest rate is prescribed by the Commissioner and is not deductible for tax purposes.

The deeming provision has been criticized by Oil and gas exploration companies which by the nature of their business, no bank is willing to finance their activities as profits are seldom foreseeable. They argue that their business entail long term investment which require heavy capital outlay coupled by uncertain profits. Such businesses are normally financed by their affiliates through interest free loans which may or may not be repaid, if the exploration is unsuccessful.

Finance Act No. 10 of 2010 s.23

Kenya Oil and Gas Association (KOGA) :(2013). *Taxation of Oil and Gas in Kenya*. Workshop , Simba Lodge, Naivasha, 23<sup>rd</sup> to 25<sup>th</sup> January 2013

## **2J2 Section 24**

This section deals with a situation where a company fails to distribute dividends to its shareholders within a reasonable period, not exceeding twelve months, after the end of its accounting period. The Commissioner is empowered, after taking into account the financial needs of the company, deem part of that income as distributed on a date twelve months after the end of that accounting period. By dint of this section, KRA has recovered substantial taxes on this account.

### **2.2 F Origin of Transfer Pricing Legislation in Kenya**

The earliest form of transfer pricing legislation in Kenya is the East Africa Tax Management Act 1952, whose Article IV provided:

*Where an enterprise of one of the territories participates directly or indirectly in the management, control or capital of an enterprise of the other territory, or*

*The same person participate directly or indirectly in the management, control or capital of an enterprise of one of the territories and the enterprise of the other territory, and*

*In either case, conditions are either made or imposed between the two enterprises, in their commercial or financial relations, which differ from those of which would be made between independent enterprises,*

*Any profit 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.*

The section targeted transactions between related parties operating in different territories<sup>84</sup>

The related parties could either be incorporated or unincorporated entities including individuals. An improved version of this legislation is contained in section 18(3) of the current Income Tax Act which came into force on 1<sup>st</sup> of January 1974<sup>85</sup> It provides that:

*"Where a non-resident person carries on business with a related resident person and the course of that business is such 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 "*

There is no evidence to show that the above versions of transfer pricing legislations were invoked prior to the Unilever case. It is, however, evident that the DTA's Kenya has so far signed with other countries are based upon the principle of arms length as set out in The UN Model Tax Convention Article 9(1) which is similar to Article 9 of the OECD Model Tax Convention.

**The territories referred to here are the British territories. This was the area under the jurisdiction and sovereignty of the United Kingdom excluding U.K itself.**

<sup>85</sup> The Income Tax Act, Chapter 470

### **2.3 Developments in Transfer Pricing in Other Tax Jurisdictions and International Organizations.**

This part of the study sets out efforts that have been made by other tax jurisdictions and organizations in the area of transfer pricing. Included in the study are approaches of South Africa, Brazil, India, USA, European Union, United Nations and OECD. In Africa, South Africa is perhaps the first country to modernize its transfer pricing legislation following the recommendation by Kutz Commission in 1995. South Africa also issued Transfer Pricing Practice Notes to supplement its transfer pricing legislation. South African experience is important to the Kenya's situation as the only African country with some reasonable experience in transfer pricing.

The inclusion of Brazil is driven by the uniqueness of the Brazilian transfer pricing legislation which marks a departure from the practice in many other countries. Developing countries have in the past expressed difficulty in the administration of arms length principle due to lack of local comparables. Transfer pricing methods administered by Brazil are based on fixed margins and safe harbour and do not require the use of external comparables. These methods may offer a solution to developing countries because they are simple and easy to apply.

India has made remarkable strides in transfer pricing resulting in several amendments in the transfer pricing legislation. Due to cheap labour, India has attracted large multinationals in manufacturing and service sector. The influx of multinationals in India has resulted in ever increasing cases of transfer mispricing. The Indian experience including case law is therefore<sup>m</sup>Portant to the Kenyan taxpayers and the KRA.

USA> perhaps, has the oldest history in transfer pricing dating back to 1928. Some of the largest transfer pricing cases have been litigated in the US, for instance, *Glaxo Smithkline case*<sup>86</sup> This vast experience will enable Kenya avoid some of the pitfalls the U.S experienced while developing transfer pricing legislation. European Union, United Nations and OECD have made significant contributions in the global development of transfer pricing including coming up with rules and conventions which have been widely accepted by many tax jurisdictions.

### 2.3.1 SOUTH AFRICA

The Income tax transfer legislation in South Africa is contained in section 31 of the Income Tax Act. The section applies to the purchase and sale of commodities between related enterprises one of which is a resident in South Africa. The section empowered the Commissioner to determine the taxable income of the South African importer or exporter as if the commodity had been bought or sold at an arm's length price. This section was further limited by section 103 of the said Act which would apply, where the cost incurred on a commodity is grossly excessive. Section 103 is the general anti avoidance section. In evaluating transfer pricing legislation in South Africa, the evolution of the general anti avoidance provision is important.

*Glaxo Smithkline Holdings (Americas) Inc. v Commissioner of Internal Revenue.* | 17 TC 1, 2001

Onsando, O. A. (2007). *The OECD Transfer Pricing Guidelines: An analysis of their application in the South Wean Legal Regime.* P.38 Available at [omarionsando@yahoo.com](mailto:omarionsando@yahoo.com)

government of South Africa set up a Commission on 22<sup>nd</sup> June 1994, which came to be known as Katz Commission to inquire into and report on the desired tax reforms in South Africa. The Commission issued its first report on 18<sup>th</sup> November 1994 and the second one on 28<sup>th</sup> June 1995. In its various reports, Katz Commission dealt extensively with the question of tax avoidance and transfer pricing.

On the issue of tax avoidance, the Commission observed the difficulty in drafting an adequate and effective anti-avoidance provision and wondered whether a general anti-avoidance provision should be included in the income tax legislation at all. It was then found necessary to inquire into the U.K experience because the absence of general anti-avoidance provision had stimulated judicial activism in the guise of substance over form doctrine.<sup>89</sup> It was further observed that for over forty years, English courts followed the approach adopted by the House Of Lords in *IRC v Duke of Westminster*<sup>90</sup> that "every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. "

<sup>88</sup> Katz Commission, (1996). Third interim report of the inquiry into certain aspects of the tax structure of South Africa. *Tax Reform*. Chapter 11, Para 11.4.1

<sup>J</sup> Katz Commission, (1996). Third interim report of the inquiry into certain aspects of the tax structure of South Africa. *Tax Reform*. Chapter 11, Para 11.4.2

<sup>90</sup> *IRC v Duke of Westminster (1935) ALL ER 259 (H.L)*



ruling of *W Ramsay*<sup>91</sup> case appears to have brought a complete shift from the doctrine of the Westminster case. In this case, Lord Wilberforce laid down four general principles to be applied to tax avoidance schemes<sup>92</sup> namely that:

When **construing** fiscal legislation the courts are not confined to literal interpretation. The **taxpayer** will be taxed according to clear statutory words, but the Act itself must be placed in the **context** and purpose of the Act should be taken into account. The taxpayer can arrange **his** affairs to reduce his liability to tax. He is still to be taxed according to the legal effect of the transaction into which he entered.

**The** Commissioner will find as a matter of fact whether the transaction is the genuine one or a **sham**. If the document or transaction is genuine, the courts should not look for some **underlying** substance. When Commissioners are deciding whether the transaction is a **genuine** one, or a sham, they may look at a series of transactions and determine their effect as a **series**.

**The** uncertainty of the English jurisprudence coupled with an open invitation to judicial activism and judicial legislation, supports strongly the retention of a general anti avoidance **provision**<sup>93</sup>, but to remedy the defects identified by the Commission rather than starting

<sup>91</sup> *W T Ramsay Ltd v IRC (1981) STC, 174*

<sup>92</sup> J. Katz Commission (1995): The third interim report of the inquiry into certain aspects of the tax structure of South Africa. *Tax Reforms*. Chapter 11, Para 11.5.1 (a)

<sup>93</sup> J. Katz Commission (1995): The third interim report of the inquiry into certain aspects of the tax structure of South Africa. *Tax Reforms*. Chapter 11, Para 11.4.4

Section 73 of the VAT Act attempted to remedy these defects by empowering the Commissioner to determine the tax liability of a taxpayer involved in tax avoidance schemes as though such schemes did not exist in the first place, where the transaction has been entered into which has the effect of granting a tax benefit to any person<sup>94</sup>. Section 103 was specifically remedied in the following ways: where the transaction occurs in the context of trade a business purpose test should be substituted for normality test. Where the transactions occur in a non business context, the existing normality test should continue to apply. Section 103(1) should not apply where there is no evidence in a transaction of misuse of the provisions of the Act

In its first report, the Commission in chapter 14 had recommended the introduction of transfer pricing rules to protect the tax system from abuse as well as to prepare the system from any further relaxation of exchange controls<sup>95</sup>. The second report dealt with thin capitalization and transfer pricing rules<sup>96</sup>. In its First and Second Interim Reports Katz Commission impressed on the OECD pronouncements because of their influence in international trade and investment<sup>97</sup>. As reported by Onsando<sup>98</sup> at page 3 paragraph 5, of the

<sup>94</sup>

Katz Commission (1995): The third interim report of the inquiry into certain aspects of the tax structure of South Africa. *Tax Reforms*. Chapter 11, Para 11.5.4

Katz Commission (1995): The third interim report of the inquiry into certain aspects of the tax structure of Africa. *Tax Reforms*. Chapter 1, Para 1.1.4

<sup>95</sup> Katz Commission (1995): The third interim report of the inquiry into certain aspects of the tax structure of South Africa. *Tax Reforms*. Chapter 1, Para 1.1.4

<sup>96</sup> Onsando, O. A. (2007). *The OECD Transfer Pricing Guidelines: An analysis of their application in the South African Legal Regime*. P.37 Available at [omarionsando@yahoo.com](mailto:omarionsando@yahoo.com)

ort the Commission observed that major economies had already formulated transfer pricing rules similar to OECD transfer pricing guidelines and in order to integrate its national tax, trade and investment system into the international arena it is important for South Africa to follow the international consensus in the application of the OECD transfer pricing rules.<sup>99</sup>

South Africa adopted the OECD transfer pricing guidelines through section 31 of the Income Tax Act which makes reference to the arms length principle. The SARS Practice Note No. 7, at paragraph 3.2.2 also subscribes to the OECD transfer pricing guidelines<sup>100</sup>. It should be borne in mind that the mention of OECD transfer pricing guidelines is for guiding in the interpretation of the transfer pricing legislation and therefore does not have the force of law.

In order to make transfer pricing legislation clearer, the South Africa Revenue Service (SARS) issued guidelines which represent the Commissioners' interpretation of transfer pricing legislation. The practice notes are not binding on taxpayers but when applied by taxpayers in the prescribed manner would be binding on Commissioner. For instance, in 1996 SARS issued Practice Note. No 2 on determination of taxable income where financial assistance has been granted by a non resident of the republic to a resident of the republic.

**Onsando, O. A. (2007). *The OECD Transfer Pricing Guidelines: An analysis of their application in the South African Legal Regime*. P.37 Available at [omarionsando@yahoo.com](mailto:omarionsando@yahoo.com)**

**Onsando, O. A. (2007). *The OECD Transfer Pricing Guidelines: An analysis of their application in the African Legal Regime*. P.46 Available at [omarionsando@yahoo.com](mailto:omarionsando@yahoo.com)**

South Africa has recently amended section 31 where the amendments came into effect on the

1 July 2012<sup>101</sup>. Prior to this, this capitalization provision in South Africa did not embody the arms length principle. It was operated as an anti-avoidance provision. To bring it in line with the principle of arms length, the law now requires a test for arms length rather than a capitalization test. The latter amendment that came through section 31 concerns a situation where a taxpayer, in establishing an arm's length profit margin, where the results fall above the median, such taxpayer will not be allowed to make a downward adjustment to bring the results to the median.

The decision by South Africa to review its transfer pricing legislation through a Commission, presented a good opportunity for the people of South Africa to give their inputs on the kind of tax legislation that fits them. The Practice Notes recognizes the international importance of the OECD transfer pricing guidelines which are applicable where the domestic legislation is found to be inadequate. The guidelines will not however be applicable to the extent of their inconsistency with domestic legislation.

## **2.3.2 BRAZIL**

### **2.3.2.1 Background**

This part sets out the interviews I conducted in Brazil between 16<sup>th</sup> June and 19<sup>th</sup> June 2013, during a transfer pricing study tour. The interviewees were 9 employees of the Federal Revenue Service of Brazil with vast experience in transfer pricing. They were mainly drawn

<sup>101</sup> Gerdi.V.D. W: (2013) *South Africa Transfer Pricing System*: Available at [www.taxiustice.net](http://www.taxiustice.net)

from policy» departments. The study tour was facilitated by Inter-American Centre of Tax Administrations (CIAT), Federal Revenue Service of Brazil, and the Kenya Revenue Authority aimed at assisting KRA in transfer pricing capacity building. Kenya adopted the arms length principle in its transfer pricing legislation which has been administered with a lot of challenges. On the other hand, Brazil adopted fixed margins and safe harbours to circumvent the difficulties experienced in finding comparables. This system has worked well for Brazil which is now ranked the 7<sup>th</sup> largest economy in the world<sup>102</sup>. It was therefore found necessary to study the Brazilian transfer pricing legislation to see whether there are good lessons we could learn to assist us refine our transfer pricing. This write up captures only what I consider necessary for my thesis. The layout is based on specific questions and answers, each dealing with specific areas of my study. The full list of the officers presented by the Federal Revenue Service of Brazil for the interview are listed in

#### **APPENDIX IV**

*Question: what is the structure of the administrative and Taxation system of Brazil?*

*Response:* Brazil adopted a federal system of government with each state having political and administrative autonomy. Under the Federal Constitution of Brazil, each state has **authority** to impose tax. The administrative structure of Brazil is such that it consists of the Union (Federal Government), 26 States, 1 Federal District and approximately 5500 **Municipalities**. Federal Constitution of Brazil sets the basic guidelines, the general principles

<sup>101</sup> IMF (2012): largest economies by GDP.

**f tax** the limitation of power to tax. Therefore, the constitutionality of any Tax, in  
mUSt follow all the principles establish by the Federal Constitution.

**transactions** that are prone to transfer pricing are administered by the federal  
**ernment**. These taxes include: tax on import of goods and services, tax on export of goods  
**and services**, corporate income tax, tax on industrialized products and tax on financial  
**operations**. Federal Revenue of Brazil collects about 63% of the national revenue with a  
**workforce** of 32000 employees spread out across 580 branches.

**Question** : *Before the enactment of the current transfer pricing legislation, was there any law  
dealing with transfer pricing?*

**Answer**: Brazil did not have any kind of transfer pricing legislation before the enactment of  
the current legislation in 1996 which came into force in 1997. Akin to the transfer pricing  
legislation was the disguised profit margin legislation, which was operated on transactions  
carried on in Brazil. Thus, before 1996, Brazil only taxed income generated in Brazil. The  
idea that Brazil should enact law that taxes world-wide income stemmed from a proposal by  
the IMF to the government of Brazil.

**Question** *Which factors did you consider in adopting the current transfer pricing model?*

A number of reasons were cited as having contributed to the development of the  
**current** transfer pricing legislation as enumerated below:

\* <sup>Was</sup> explained that the Brazilian taxpayers are highly litigious and therefore the  
government sought to establish transfer pricing legislation that is certain and simple to apply.

That <sup>• p</sup> witnessed the problems the US and UK had undergone when administering the

<sup>b</sup> length principle, Brazil was not ready to follow the same path and face similar hurdles.

t Brazil is a civil law country and therefore tax laws must be very clear otherwise they  
ould attract a flood gate of litigation.

That Brazil designs its affairs based on what it finds appropriate for its people and not  
necessarily borrow what is perceived as international best practice.

The above factors, collectively reflects a law, based on Brazil experience and need. It is a  
customized form of transfer pricing legislation.

*Question: How does transfer pricing legislation in Brazil operate?*

*Answer:* The Brazillian transfer pricing legislation subjects the following transactions to the  
transfer pricing (TP) control: imports and exports of goods, rights or services (including  
interest) made by Brazilian resident to a related party resident in another tax jurisdiction.

According to the Brazilian legislation, the following are considered "related parties" to the  
Brazilian entity: parent company domiciled abroad; a branch or a subsidiary domiciled  
abroad; an individual or a legal entity resident or domiciled abroad, which is controlled by an  
affiliate of the Brazilian entity; a foreign entity, when it is, together with the Brazilian entity,  
is <sup>Unc</sup>er common control, or when at least 10% its shares belong to the same individual or  
^al entity; an individual or legal entity resident or domiciled in another tax jurisdiction that,  
°gether with the Brazilian entity, participate in a third legal entity, whose shareholding  
Prizes it as a controlled or affiliate company; an individual or legal entity, resident or

domi<sup>o</sup> in another tax jurisdiction, that is associated to the Brazilian legal entity, in the  
 ^ of **consortia**, on any enterprise; an individual resident in another tax jurisdiction relative  
 the third degree, spouse or partner of any director, member or controlled shareholder in a  
 or indirect way of the Brazilian entity; an individual or legal entity, resident or  
 domicile in another atx jurisdiction, that is an exclusive agent, distributor or concessionaire  
 f the Brazilian entity for the purchase and sale of goods, services or rights; an individual or  
 legal entity, resident or domiciled in another tax jurisdiction, of which the Brazilian entity is  
 an **exclusive** agent, distributor or concessionaire for the purchase and sale of goods, services  
 or rights.

Regardless of the existence of the "related" status, transfer pricing control is applied to  
 transactions between a legal entity in Brazil using an intermediary and another one abroad,  
 characterized as a "related person" of the Brazilian entity. This will also extend to an  
 individual or legal entity resident or domiciled in Brazil and an individual or legal entity  
 resident or domiciled in a country or jurisdiction that doe not tax income or taxes it with a  
 rate of less than 20%, or whose legislation imposes secrecy on legal entities' ownership  
 structure.

*Qjestionju Which methods do Brazil use to determine the Parameter Price on Imports ?*

dll^ver^ Brazil applies various methods to determine the parameter price on imports  
 Spending on the nature of the transaction. The methods are as set out below:

(1) *Sale price minus Profit (PRL) or (RPP);*



is the weighted arithmetic average of the sale prices, in Brazil, for goods, services or rights imported, in similar payment terms, calculated taking into account the following:

(i) net sale price minus (0 any conditional discounts, (ii) sales tax and contributions and (iii) paid commissions;

percentage share of the goods, services or rights imported on the cost of the good, service or right sold (input x output);

Profit margin, according to the legal entity's economic sector, weighted considering the share of the good, service or right imported on the good service or right sold

Parameter price: Difference between the share of the goods, right or service imported on the goods, right or service sold and the profit margin.

Example:

Considering a margin of 20%, in the sale of a product for Ksh100,000, whose total cost was of Ksh 90,000, where Ksh 60,000 of the cost relates to an import from a related party:

A. Net Sales Value	Ksh 100,000
B. Total Cost	Ksh 90,000
C. Import value from Related Person	Ksh 60,000
D- Ratio ( C/B)	66.7%
E. Sale Value Ratio ( A*D)	Ksh 66.7
F- Margin (E* 20%)	Ksh 13.33

<i>Q</i> parameter Price	(E-F)	Ksh 53.33
Adjustment	(C-G)	Ksh 6.67

In applying the *minus* Profit method, the profit margins to be considered is as set out in Appendix V

**(II ) *Independent Compared Prices (PIC) or (ICP)***

To determine the cost of goods, services or rights imported from related persons, the Independent Compared Prices method can be used and it is defined as the weighted arithmetical average of identical or similar goods, services or rights, according to Brazilian or foreign markets, in purchase or sale operations made by the legal entity or third parties, in similar payment terms.

The prices of the goods, rights or services acquired from the related person will be compared to the prices of identical or similar goods rights or services:

Sold by the same exporting legal entity to non-related parties, residents or not;

Acquired by the same importer, from non related parties, residents or not;

Purchase and sale operations between third parties non related, resident or not;

If the fee considered comparable, the operation must represent at least 5% of the total imports of that category of goods made by the legal entity. It is the cost of imports that will be adjusted and the sales value will be left intact.

Example

Product X	Total Value	Quantity	Unitary Value
From Related Party	Ksh 100,000	1000	Ksh 100
From Third Parties	Ksh 6,000	100	<u>Ksh 60</u>
Adjustment per unit purchase from related party			<u>Ksh 40</u>

### (III) Production Cost plus Profit (CPL)

The costs of goods, rights or services acquired from a related party abroad can be determined using the Production Cost plus Profit (CPL) method. The weighted average cost of production of identical or similar goods, services or rights, in the country where they were originally produced, added by the taxes charged by the exporting country and a profit margin of 20%, calculated over the determined cost. The production costs must be demonstrated by component, value and corresponding suppliers. Costs allocation by the productive unit abroad proportionally to the quantities destined to the Brazilian entity.

**Example:**

Import of product X:

Import price of product X from a related party in country Y  
Ksh100

Cost of production of one unit of product X in country Y  
Ksh (70)

20% margin on the production cost  
Ksh (H)

Adjustment per unit of product in country Y

(IV) Import Price Listing (PCI) or (IPL).

If the imported goods is a *commodity*, the taxpayer must use the Import Price Listing method (PCI), regardless of the sector or economical activity (APPENDIX VI). The prices of these imported goods will be compared to the listed prices of those same goods on internationally known commodity and futures exchange markets, adjusted for more or less by the average market premium, at the date of the transaction (VII).

**Question** ' Which methods do Brazil use in determining the Parameter Price on Exports ?

Different methods are applicable depending on the nature of exports as outlined below:

<sup>(1)</sup> Exports Sale Price (PVE<sub>x</sub>).

sales revenue in exports can be determined based on the method of the Exports Sale price (PVEx), defined as the weighted arithmetic average of the sales prices of exports made by the legal entity to non related parties, or by other national exporter of identical or similar goods rights or services, during the same tax period and in similar payment terms .This method is similar to the Independent Compared Prices (PIC) method of imports.

(II) Wholesale Price in Country of Destination, minus Profit (PVA)

This is the weighted arithmetic average selling prices of identical or similar goods, practiced in wholesale market of the destination country, in similar payment conditions, less the taxes included in the price, charged by that country, and a profit margin of 15% on the wholesale price.

(III) Retail Price in Country of Destination, minus Profit (PVV)

This is the weighted arithmetic average of the sales prices of identical or similar goods, practiced in the retail market of the destination country, in similar payment conditions, less the taxes included in the price, charged in that country, and a profit margin of 30% on the retail price.

(IV ) Production or Acquisition Costs plus Taxes and Profit (CAP)

CAP is calculated as the weighted arithmetic average of the acquisition or production costs of Sported goods, services or rights, plus the taxes levied in Brazil and a profit margin of 15% on the total cost plus taxes and contributions. The values of freight and insurance paid by the Quiring entity are considered part of the cost, related to the goods, services and rights

It is similar to the import method of Production Cost plus Profit (CPL), but with a focus on the Brazilian company.

( V ) Export Price Listing (Pecex)

Since January 2013, if the exported goods is a commodity, the taxpayer must use the Export price Listing method (Pecex), regardless of the sector or economical activity. The prices of **these** exported goods will be compared to the listed prices of those same goods on internationally known commodity and futures exchange markets, adjusted for more or less by **the** average market premium, at the date of the transaction. Same definitions of "commodities" and "internationally known commodity and futures exchange markets" applicable to the Import Price Listing (PCI) method . ( see Appendix VI & VII).

(VI) interest

The interests paid or credited to a related person will only be deductible up to the amount that does not exceed the value calculated based on a determined rate, plus a *spread* margin:

In case of dollar transactions, the U.S. dollar market rate for the sovereign bonds of **Brazil**;

In case of Reais transactions, the Reais market rate for the sovereign bonds of Brazil;

LIBOR, for a period of 6 (six) months, for the remaining cases.

*Spread* yet to be defined (recent legislation change).

**B e f o r e** change, it was of 3%.

*Question-* How are the fixed margins set?

It was explained that fixed margins are as a result of extensive research works done by the Federal Revenue Service based on taxpayers data. They approximate the arms length margins and are therefore not arbitrarily set. Taxpayers are also allowed to appeal on the applicable margins where it feels that the margins are unrealistic in light of the unique circumstance facing a taxpayer. The federal Revenue Service is committed to continue refining the transfer pricing legislation to achieve wide compliance. For instance, following wide consultation with taxpayers, beginning 2013, the highest margins were reduced from 60% to 40% and made more specific to sectors.

***Question:*** How does the Brazilian transfer pricing legislation interact with transfer pricing laws of other countries which subscribe to the arms length principle?

***Answer:*** It was noted that Brazil is an active participant in forums organized by OECD, UN, and World Bank. For instance one of their key officers in transfer pricing by the name Marcos Aurelio Pereira Valadao<sup>104</sup> is a member of the UN sub-committee on transfer pricing. Through this participation, the transfer pricing practice in Brazil is highly quoted throughout the UN manual. In fact, the UN manual has included Brazil's experience in transfer pricing to demonstrate the uniqueness of the Brazilian transfer pricing legislation<sup>104</sup>.

<sup>104</sup> Marcos Aurelio Pereira Valadao: A Brazilian Member of the UN Committee of Experts on International Cooperation in Tax Matters Chair of the 2nd Chamber of the 3rd Section of the Brazilian Administrative Court of Appeals (CARF). Tax Brazil: IIB Professor of Law at Catholic University of Brasilia (UCB-Brazil). S.J.D. (SMU, USA), L.L.M. (UnB, Brazil). See the UN Manual, at p.362 on country practice.

noted that other transfer pricing regimes similar to the Brazilian one existed elsewhere  
i bey

world as acknowledged by the UN manual on page 13. Global formulary  
in v

apportionment method was found to be applicable in some states of the US, Canada and  
Ireland. E.U has also spoken favorably about global formulary apportionment  
Switzerland

urging taxpayers to adopt it under the Common Consolidated Corporate Tax Base  
(CCCTB).

In terms of double tax treaties (DTA's), it was noted that Brazil concluded its first DTA in  
1967 and has so far concluded 29 DTA's (Appendix VIII). In addition to this the DTA with  
the U.S is in negotiation stage. Brazil and the U.K have a DTA whose operation is limited to  
air and sea transport incomes. Under the DTA's Brazil and the treaty partners agree to relieve  
from double taxation residents of their respective countries where their incomes have been  
taxed in either of the country. This is done by way of tax credits for the tax paid in foreign  
tax jurisdiction. Thus, Brazil does not adopt article 9 (2) of the model tax convention.  
Compared to countries like Kenya with 9 operational DTA's Brazil has done much better and  
has in fact attracted a lot of large multinational enterprises. As Brazil continues to refine its  
tax legislation, the result appears to converge with the arms length result. In the fullness of  
time therefore, Brazil will be able to achieve arms length results without going through  
thorough process of benchmarking undertaken by OECD member countries.

*Q<sup>i</sup>Hon: How is transfer- pricing related disputes resolved?*

The dispute resolution mechanism in Brazil is founded upon Article 5 item XXXV  
of the Federal Constitution which state that "you cannot get away from the jurisdiction" (  
Inaf  
^tabilidade da Jurisdi^ao ). In Brazil administrative litigation is done at two levels. First,



we <sup>riaVC</sup> the Administrative Judges (DRJ), and second we have the Appellate Judges (*£ riselho Administrative) de Recursos Fiscais -CARF*).

pRJ entertains appeals of the first level. They consist of officers from the Federal venue Service who are expected to be fully independent. They are different from the auditors who carried out the audit. They rely on the evidence in the audit report and may <sub>fer</sub> the case back to the assessing officers for further investigation in case there are doubts about the issue in dispute. DRJ has five (5) members, one of them being the president appointed by the secretary of the Federal Revenue Service. The members have a 3 year term renewable without limit. They must not have a legal background but are selected based on their experiences in tax administration. The taxpayer is not invited to explain its case. Currently, there are 15 judging units in Brazil. To ensure harmony in decision making, normative instructions are issued to them as a guide. If the decision is against the Revenue Service, and the tax does not exceed R \$ 1 million, the decision is final. However, if the decision is against the taxpayer, it is at liberty to appeal to the appellate court no matter the amount of tax involved. The general trend is that the DRJ tends to rule in favor of the Revenue Service.

The CARF is composed of 6 members drawn from public and private sector in equal numbers. Although the criteria for appointment are not set out in the law, the Revenue Service would nominate the most experienced auditors with a bias in law qualification to the <sub>me</sub>mbership. The members drawn from the public sector are nominated by taxpayers' <sub>Or</sub>ganizations for instance the Chamber of Commerce, Banks and Manufacturers. Although tinted by the taxpayers, the Minister for Finance and the Secretary to the Revenue <sub>Servic</sub>e has the final say.

ming Proceeding<sup>s</sup> new evidence may be admitted to support the principle of substantial  
• p or to support material facts. This court is not bound by normative instructions issued  
justice  
by the Revenue Service. However, the taxpayers are bound by the normative instructions  
issued by the Revenue Service.

Closely related to the second level court is the Superior Chamber of Tax Appeal. It is  
considered to be part of the second level appeal with the appointment being done in a similar  
manner. They entertain appeals where the second level courts have issued conflicting  
decisions. There are two remarkable difference with the second level appeal court. First, the  
hearings are open to the members of the public. Secondly, the taxpayer is allowed to be  
represented by its lawyers.

Further appeals lie at the Federal court and the Superior courts. A taxpayer who wishes to  
appeal to the courts is required to deposit the tax first and also bear in mind that judges are  
not trained in tax. It takes between 3 and 10 years to settle a tax case in court. Where the  
judgment is finally made in favor of the taxpayer, it will earn interest on the tax deposited  
with the Revenue Service.

*Qiwstion^ What are the main strength and weaknesses of the transfer pricing legislation of  
Brazil?*

*Weaknesses:*

<sup>01</sup> legislation in Brazil is expressed in general terms. This calls for a lot of clarification to  
e made in Normative Instructions (NI). This scenario does not operate well in an

• r o n m e n t where tax laws are required to be interpreted strictly. Recently, the Federal **yft of App<sup>ca</sup>l f<sup>o</sup>und** normative instruction no.243 of 2002 illegal having overstepped its **jnpetence** when it established how to calculate the 60% profit margin under the resale price method-

There are increasing cases of tax planning around commodity pricing. This is evident in **nterprises** dealing in unique products. It is difficult to find local comparable price for **instance** for iron ore which is handled by only one company, hence, the comparable price **becomes** its own price. There is therefore the need to insist on the use of international **commodity** prices in such cases.

The Federal Revenue Service lacks the capacity to deal with the increasing cases of transfer pricing. This is contributed by the fact that there is no dedicated team to deal with transfer pricing cases. Transfer pricing audits may be conducted any revenue officer contrary to the practice in many other tax jurisdictions. Currently, the Federal Revenue Service has about 33000 revenue officers.

Brazil's transfer pricing legal framework does not provide for advance pricing agreements (APA's). The Federal Revenue of Brazil is not allowed to negotiate for taxes with taxpayers by the Congress. APA enables both the taxpayer and the tax administration to agree in advance on some levels of margins. The taxpayer is required to keep to the margins which **he** Commissioner will accept without query. This arrangement accords the taxpayer certainty **hile** the tax administration is guaranteed for steady revenue.

*Strength*

ids the use of specific comparables. The application of the Resale Price, Cost plus  
thod Transactional Margin Method and Profit Split depends on the availability  
sparables. Generally, comparables are usually not easy to find.  
It provides the taxpayer with certainty as to the tax liability payable on a controlled  
saction. The imprecision of the OECD prescribed methods results to higher levels of  
uncertainty as compared to the Brazilian methods.  
It is cheaper for both the taxpayer and the tax administration in that there is less  
documentation requirement and less need for specialized skills in transfer pricing. It is also  
easier for the taxpayer to apply.

### 2.3.3 INDIA

The need to put in place transfer pricing legislation in India was driven by increasing participation of Multinational enterprises in economic activities of India following economic liberalization in 1991<sup>105</sup>. The Finance Act 2001 introduced the law of transfer pricing in India through section 92A and 92F of the Indian Income tax Act, 1961 and Rules 10A to 10E of the Income Tax Rules, 1962<sup>106</sup>. The regulations are broadly based on the OECD Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements, and contain harsh penal provisions for noncompliance.

**Tax justice network (2012): *Alternative Methods of Transfer Pricing*. The transfer pricing edition, third Huarter, Vol 7 issue 3 of 2012. Available at [www.taxiustice.net](http://www.taxiustice.net)**

**A^ta Kapur (2012). *Transfer Pricing- a journey across two centuries*. Available at [www.taxjustice.net](http://www.taxjustice.net)**

There are some critical differences between OECD TP guidelines and Indian transfer pricing

legislation.<sup>107</sup> First the definition of "associate enterprise" is quite broad under Indian TP

compared to OECD; multiple-year data of the Financial results of comparable companies is allowed in India's transfer pricing except under certain circumstances unlike OECD. The arithmetic mean of comparables is used in India's transfer pricing and not inter-file ranges; Indian TP has stringent documentation guidelines while lacking guidelines for intra-group set-offs, thin capitalization and intangibles, all of which are in contrast to the OECD guidelines.

India's transfer pricing legislation mainly applies to cross-border transactions. However, more recently, courts have taken a view that India might need to revisit the application of the code to apply to domestic transactions in view of potential tax arbitrage opportunities that may exist under the Act pursuant to tax holidays and loss situations.<sup>108</sup>

Section 92B of the Act defines the term "international transaction" to mean a transaction between two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property; provision of services; cost-sharing arrangements; lending or borrowing of money; or any other transaction having a bearing on the profits, income, losses or assets of such enterprises. The associated enterprises could be either two non-residents or a resident and a non-resident. A Permanent Establishment (PE) of a foreign enterprise also

<sup>107</sup> T

<sup>ax</sup> Justice network (2012): *Alternative Methods of Transfer Pricing*. The transfer pricing edition, third quarter, Vol 7 issue 3 of 2012. P 7

<sup>Gla</sup> oSmithKline Asia Pvt. Ltd.

qualifies as an associated enterprise. Accordingly, transactions between a foreign enterprise and its Indian PE are within the ambit of the code.

Section 94A of the Act provides that, if a taxpayer enters into a transaction in which one party is a person located in a *notified jurisdictional area* then all the parties to the transaction shall be deemed to be associated enterprises (AE) and any transaction with such AE or deemed AE shall be deemed to be an international transaction. This regulation aims to specify countries or territories outside India not having an effective exchange of information as notified jurisdictional areas.

In 2009, the Central Board of Direct Taxes (CBDT) was empowered to formulate safe harbor rules<sup>109</sup>. These rules were meant to specify the circumstances in which the Tax Authority will accept the arm's-length price as declared by a taxpayer, without detailed analysis. The objective of introducing these rules is to reduce the impact of judgmental errors in determining transfer prices of international transactions. An alternative dispute resolution mechanism was instituted by the Finance Act (2009) to facilitate expeditious resolution of disputes in all cases involving transfer pricing and foreign company taxation.<sup>110</sup>

### 2.3.4 USA

The US enacted Section 45 of the Revenue Code in 1928, which gave authority to the Secretary of the Treasury in the case of two or more organizations owned or controlled by the same interests to distribute, apportion or allocate gross income, deductions, credit or

<sup>109</sup> PWC India: (2012): *International Transfer Pricing* . p4. Available at [www.pwc.com/internationaltp](http://www.pwc.com/internationaltp)

<sup>110</sup> PWC India (2012): *International Transfer Pricing* . p6. Available at [www.pwc.com/internationaltp](http://www.pwc.com/internationaltp)

nances between or among these organizations if he determines that such a distribution, is  
ssary to prevent tax evasion or to clearly reflect the income of such organizations.<sup>111</sup>

Until 1986 section 45 remained substantially unchanged. In 1986, the U.S Treasury issued

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laborate regulations for specific types of inter-company transaction. From the early

. ^tjes concern in the IRS, the Treasury and the Congress increased about tax planning

• volving the transfer of intangibles (technology) developed in the United States to

subsidiaries of United States companies in tax havens. The Tax Reform Act of 1986

amended Sec. 482 dealing with intangibles to provide that, in case of the transfer or licensing

of intangible property the income of the transferor or licensor had to be "commensurate with

the income attributable to the intangible."<sup>113</sup>

In 1988 the IRS and the Treasury produced a discussion paper on how to implement the new

"Commensurate with Income" rule. The "White Paper" presented four methods: two based on

comparable uncontrolled prices and the other two based on profits.<sup>114</sup> These methods are:

• **United Nations :(2001): *Transfer Pricing: History and State of Art Perspectives*. Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp 10**

• **United Nations :(2001): *Transfer Pricing: History and State of Art Perspectives*. Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp**

• **United Nations :(2001): *Transfer Pricing- History and State of Art Perspectives*. Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp 10**

On **United Nations: (2001): *Transfer Pricing: History and State of Art Perspectives*. Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp**

ri!P inexact CUP, The Basic Arms length Return Method (BALRM or Ball room exact cur, method) and Profit Split Method.

ideas put forward in the White Paper met with severe criticism. In the first place, the tallroom method was considered to be in conflict with the arms length principle.<sup>116</sup> In January 1992, the IRS and the Treasury proposed Sec. 482 regulations partly replacing the 1968 Regulations. The purpose was to implement the "commensurate with income" clause of Sec 482. and to improve the litigating position of the IRS.<sup>116</sup>

In January 1993 Temporary Regulations were issued, which were much broader than the 1992 Proposed Regulations as they not only dealt with intangibles but also contain revised regulations on transfers of tangible property.<sup>117</sup> For transfers of tangible property five principal methods were given namely CUP, resale price, cost plus, CPM and profit split.

On 1 July 1994 the IRS released final regulations under Sec. 482, which were effective for tax years beginning after 6 October 1994. According to the preamble, they clarify and refine

"United Nations :(2001): *Transfer Pricing: History and State of Art Perspectives: Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting'* Geneva, Switzerland, 10 - 14 September 2001. Pp

116 .  
United Nations:(2001): *Transfer Pricing: History and State of Art Perspectives: Ad Hoc Group of Experts on Nernational Cooperation in Tax Matters Tenth meeting'* Geneva, Switzerland, 10 - 14 September 2001. Pp 11

on |United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives: Ad Hoc Group of Experts (n<sup>tern</sup>at<sup>lo</sup>nal Cooperation in Tax Matters Tenth meeting'* Geneva, Switzerland, 10 - 14 September 2001. Pp

11 \*



oris of the 1993 regulations where necessary, without fundamentally altering the basic policies reflected in the 1993 regulations.<sup>118</sup>

### 2.3.5 OECD

^r\* nnpw out of the Marshall Plan, primarily to rebuild Europe after World War II.<sup>119</sup> It as for several decades' brokered rules and standards used to tax multinational corporations worldwide, particularly transfer pricing rules which are guided by the arms length principle. The arms length principle has a long history dating back to the League of Nations Model Tax Conventions that formed the international consensus in the last half of the first century.<sup>120</sup> In 1963 the arms length principle made its way to Article 9 of the OECD Model Tax Convention. Because of the increase in the number of MNEs and transactions within MNEs since the sixties, the member states of the OECD considered it necessary to produce guidelines for their respective tax administrations on how to deal with issues of transfer pricing.<sup>121</sup>

Working Party No. 6 which is a subgroup of the Committee on Fiscal Affairs (CFA) of the OECD produced an authoritative report at the end of the seventies. The 1979 OECD Report

United Nations (2001): *Transfer Pricing: History and State of Art Perspectives*: Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10 - 14 September 2001. Pp

19 p. ,

Kick Michelle (2011) .*OECD Tax Rules Called Too Complex, Costly to Help Developing Countries* Nab waders: Daily Tax Report 10/06/2011

HeUinkie p<sup>d</sup>® R(2012): *Alternative Methods of Taxation of Multinationals*: OECD Conference 13-14 June 2012,

by .

on Int<sup>ted</sup> Nations: (2001): *Transfer Pricing - History and State of Art Perspectives*: Ad Hoc Group of Experts 7<sup>ernat</sup>ional Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp

"Multinational Enterprises" was not intended to establish a detailed standard of transfer pricing, but rather to set out the problems and the considerations to be taken into account to describe which methods and practices were acceptable from a tax point of view in determining transfer prices.<sup>122</sup> All Ministries of Finance of the OECD Member States adopted the 1979 Report without reservations and gave it a high level of authority.<sup>123</sup>

Since 1979, the OECD has developed practical guidance for the implementation of arm's length principle. The OECD Transfer Pricing Guidelines for multinational Enterprises and Tax Administration are continuously revised to cope with increasing changes brought about by globalization and technology.<sup>124</sup>

In 1984 the OECD published a second report comprising three topics: the mutual agreement procedure, transfer pricing in the banking sector, and the allocation of central costs. The

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**United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives*: Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp**

**United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives*: Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting, Geneva, Switzerland, 10-14 September 2001. Pp**

<sup>124</sup> "

**Parlies de R (2012): *Alternative Methods of Taxation of Multinationals*: OECD Conference 13-14 June 2012. Helsinki, Finland. P 1 Para 2**

<sup>125</sup>

**United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives*: Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth meeting', Geneva, Switzerland, 10 - 14 September 2001. Pp**

126 the definition of shareholders costs which are costs that may not be allocated to such subsidiaries; a description of direct and indirect methods of cost allocation, in particular cost sharing methods; and guidance on the inclusion of a profit mark-up when cost-oriented methods are used.

From a Task Force Working Party No. 6 of the CFA worked on an update and consolidation of the 1979 and 1984 Reports on Transfer Pricing. An update was necessary to reflect developments in international trade, for instance, global trading, and technology. The new Guidelines also try to bridge the differences which have arisen between the United States and other OECD member countries since the publication of the United States White Paper in 1988.<sup>127</sup>

The implementation of OECD TP guidelines however poses great challenges to both OECD and non OECD member countries<sup>128</sup>. To deal with these challenges, OECD together with non

<sup>126</sup> United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives: Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth meeting,* Geneva, Switzerland, 10 - 14 September 2001. Pp

United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives: Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth meeting,* Geneva, Switzerland, 10-14 September 2001.

<sup>127</sup> *Journal of International Taxation* (2012): *Alternative Methods of Taxation of Multinationals: OECD Conference 13-14 June 2012, Helsinki, Finland. P 1 Para 3*

Member economies and other international Organizations are committed to ensure standards and guidance are relevant and meet the needs of non OECD economies.<sup>129</sup>

recognizing the tax risk posed by intangibles, OECD, in 2011 launched a project on transfer pricing aspects of intangibles. Transfer pricing issues on intangibles were identified as a *IPV* area of concern by taxpayers and governments due to insufficient international "dance on definition, identification and valuation of intangibles for transfer pricing purposes.<sup>130</sup>

The OECD has organized a steering committee for the transfer pricing activities of the Global Forum on Transfer Pricing. The committee aims at strengthening the dialogue with non- OECD economies. The work of the steering committee is to plan the Annual International Meeting on Transfer Pricing, undertake work on important transfer pricing related topics with specific developing countries focus and to provide a forum for discussion of other transfer pricing issues important to both developing and developed countries

The OECD's Tax and Development work, guided by the Task Force on Tax and Development, has identified transfer pricing as one of its high-priority areas and has

**Marlies de R (2012): *Alternative Methods of Taxation of Multinationals: OECD Conference 13-14 June Helsinki, Finland. P 1 Para 4***

**Marlies de R (2012): *Alternative Methods of Taxation of Multinationals: OECD Conference 13-14 June 2012> Helsinki, Finland. P 2***

**Blj, . Nations: (2013) : *Practical Manual on Transfer Pricing for Developing Countries: U.N. Publishing, York. Chapter 1. P 6.***

formulated a detailed work program designed to support developing countries introduce and implement transfer pricing rules.<sup>132</sup> The program has made significant progress in delivering

- development initiatives in Colombia, Ghana, Kenya, Rwanda and Vietnam, in terms of technical training in transfer pricing. In countries like Ghana, OECD has recognized the role played by the Judiciary in development of transfer pricing by extending transfer pricing training to its members. Plans are underway to have similar training to be offered to the Kenya's Tax Tribunal and Judiciary.

In May 2012, the OECD's Task Force on Tax and Development launched the concept of "Tax Inspectors without Borders," to help developing countries improve their revenues by making their tax systems fairer and more effective.<sup>133</sup> The OECD and the African Tax Administration Forum (ATAF) signed a memorandum of co-operation agreeing to work together to improve tax system in Africa. The two bodies have planned joint activities in Africa in 2013 which include technical events for African Tax Officials, sharing knowledge and developing good tax practices.<sup>134</sup>

<sup>132</sup> OECD 2012: *Transfer Pricing- "Alternative Methods of Taxation of Multinationals"* , Helsinki, Finland 13-June 2012

<sup>133</sup> OECD 2012: *Transfer Pricing- "Alternative Methods of Taxation of Multinationals"* , Helsinki, Finland 13-

Available at [www.GLOBAL MARKETS: OECD and ATAF strengthen tax co-operation with Africa. \(November 2012\).](http://www.globalmarkets.com)  
le at [globalmarkets.com](http://www.globalmarkets.com)

### 3.6 EUROPEAN COMMISSION

European Commission has developed proposals on income allocation to members of the EU's active in European Union at the option of the taxpayer. This is to harmonize its rate taxes under the "Common Consolidated Corporate Tax Base" (CCCTB) initiative -home state taxation."<sup>136</sup> Under this, taxing rights would be allocated between countries upon the apportionment of European business activity such as formulary combinations of sales, payroll and assets.

### 2.3.7 THE UNITED NATIONS

In a multilateral context, the arms length principle was formulated for the first time in Article 6 of the League of Nations draft Convention on the Allocation of Profits and Property of International Enterprises in 1936<sup>137</sup>. This Article is substantially similar to Article 9 of the 1963 OECD Draft Convention and Article 9, paragraph 1 of the present OECD and UN Model tax treaties<sup>110</sup>.

The United Nations published a report on "International Income Taxation and Developing Countries" in 1988. The report discusses significant opportunities for transfer pricing manipulation by MNEs to the disadvantage of developing country's tax bases. It

Paragraph Nations: (2013) : *Practical Manual on Transfer Pricing for Developing Countries*: Chapter 1. P 6,

Nations: (2013) : *Practical Manual on Transfer Pricing for Developing Countries*!. Chapter 1. P 6,

on United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives*: Ad Hoc Group of Experts (International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp

<sup>131</sup> \*  
note 31 above

rectf<sup>11</sup> a number of mechanisms tailored to deal with the particular intra-group  
ations by developing countries<sup>139</sup>. Another report was issued by the UN Conference on  
W  
and Development (UNCTAD) on Transfer Pricing in 1999<sup>140</sup>.

l raue

^\_sponse to the needs often expressed by developing countries, The United Nations has  
developed a "Practical Manual on Transfer Pricing for Developing Countries"<sup>141</sup>. The manual  
meant to assist policy makers, tax administrators and taxpayers in dealing with complex  
transfer pricing issues. Countries are at liberty to enact tax legislations of their own choice,  
but the UN manual is addressed to countries seeking to apply the *arms length standard* to  
transfer pricing issues. The drafters of the manual have not taken a position on a wider debate  
about other possible standards<sup>142</sup>. The manual is a product of the United Nations Committee  
of Experts on International cooperation on Tax Matters which has a special role in reflecting  
the diversity of the United Nations Membership and placing transfer pricing in its  
developmental perspective<sup>143</sup>.

N<sup>United Nations: (2013): *Practical Manual on Transfer Pricing for Developing Countries*. Foreword; Para 13.12</sup>

( Nations: (2013) : *Practical Manual on Transfer Pricing for Developing Countries*. Foreword; Para

' United Nations (2013): *Practical Manual on Transfer Pricing for Developing Countries* - foreword; Para 1

United Nations(2013): *Practical Manual on Transfer Pricing for Developing Countries* - foreword; Para 4

nitied Nations(2013): *Practical Manual on Transfer Pricing for Developing Countries* - foreword; p.iv,  
Para3

Conclusion

Experiences from the various tax jurisdictions have been found to be relevant to the Kenyan situation in the following ways:

South Africa's use of a Commission to modernize its transfer pricing legislation perhaps presented the best opportunity for wide consultation among the stakeholders. The views of the people are likely to be brought on board in crafting transfer pricing legislation. This is contrary to the transfer pricing laws in many developing countries which were inherited from the colonial masters. Such laws are not suitable for developing economies because, they were designed to operate and address challenges faced by developed economies.

Brazil is an example of a successful non-arms-length economy. The determination to pursue its own course has steered the economy to become one of the leading economies in the world. Fixed margins and safe harbours have promoted certainty to both the taxpayers and the tax administration leading to improved compliance.

United States of America's long history in transfer pricing is a demonstration of an economy that has modernized its transfer pricing legislation through experience. From 1928 to-date, US has transformed its transfer pricing legislation to deal with increasing cases of tax planning and to capture emerging issues of intangibles. Therefore, for Transfer pricing legislation to remain relevant, it should be regularly modernized to address changing circumstances.

The experience of India is relevant to Kenya in the sense that, although India adopted the arms-length principle, over time it has made significant amendments to the transfer pricing



Legislation to suit its circumstances. Today, India's transfer pricing model represents a weak arms length principle, having embraced significantly non arms length aspects.

, OECD has developed transfer pricing guidelines widely applied by many countries in world. They however do not address individual country's unique circumstances and therefore, each country should customize the guidelines and transform them into rules to give them the force of law. European Commission has recommended some limited use of formula apportionment method, in instances where the arms length principle is burdensome to taxpayers. This is a clear admission that even among developed economies the arms length principle in some instances is difficult to operate. This being the case, developing countries should not expect to find the operation of the arms length principle any easier and must explore ways and means of addressing transfer pricing challenges suitable for their circumstances.

## CHAPTER THREE

### 3 0 TRANSFER PRICING: THE OECD APPROACH

#### 3.1 Introduction

The OECD approach to assessing transfer prices relies on the arms length principle. This Chapter therefore, focuses on the evaluation of the arms length principle, its application and underlying methodology. The arms length principle has become acceptable internationally and serves the dual objective of securing the appropriate tax base and avoiding double taxation, thereby minimizing conflict between tax administrations and promoting international trade and investment. In addition, the Chapter covers administrative approaches to avoiding and resolving transfer pricing disputes and lay special emphasis on intangible property, intra-group services and cost contribution arrangements.

The arms length principle has a long history dating back to the League of Nations Model Tax Conventions that formed the international consensus in the last half of the first century.<sup>144</sup> In 1933, the arms length principle made its way to Article 9 of the OECD Model Tax Convention. This model now forms the basis of extensive bilateral income tax treaties between OECD member countries and non member countries.<sup>145</sup> Because of the increase in

Parlies, D.R. (2012): *Alternative Methods of Taxation of Multinationals: OECD Conference 13-14 June 2012*, Helsinki, Finland.

OECD (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris.

the work of MNEs and transactions within MNEs since the sixties, the OECD Member States considered it necessary to produce guidelines for their respective tax administrations how to deal with transfer pricing.<sup>146</sup>

1979 therefore, OECD drafted what came to be known as the OECD Report *Transfer Pricing and Multinational Enterprises (1979)*.<sup>147</sup> Since their approval by the OECD in 1995, they have been supplemented by the following reports: the report on Intangible Property and Services, adopted by the Committee on Fiscal Affairs on 23 January 1996 and incorporated in Chapters VI and VII<sup>148</sup>; the report on Cost Contribution Arrangements, adopted by the Committee on Fiscal Affairs on 25 June 1997, incorporated in Chapter VIII,<sup>149</sup> the report on the Guidelines for Monitoring Procedures on the OECD Transfer Pricing Guidelines and the involvement of the Business Community, adopted by the Committee on Fiscal Affairs on 24 June 1997, incorporated in the annexes,<sup>150</sup> the report on the Guidelines for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure, adopted by the

2000 par 8 at 18

United Nations: (2001): *Transfer Pricing - History and State of Art Perspectives: Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting'* Geneva, Switzerland, 10-14 September 2001. Pp 7

OECD Report (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publishing, Paris. P3. par 1

OECD Report (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publishing, Paris, par 2 at 3

OECD Report (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publishing, Paris, par 3 at 3

OECD Report (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publishing, Paris, par 4 at 3

Committee on Fiscal Affairs on 30 June 1999, incorporated in the annexes;<sup>151</sup> and the report on the Transfer Pricing Aspects of Business Restructurings, adopted by the Committee on Fiscal Affairs on 11 June 2010, incorporated in Chapter IX.<sup>152</sup>

Interpretation of transfer pricing legislation must thus be consistent with Article 9 (the Associated Enterprises article) of the OECD, and in accordance with the Transfer Pricing Guidelines<sup>153</sup>. It is important to note that Article 9 of OECD is similar to Article 9 of the UN Model tax convention. In order to achieve the required clarity on the application of transfer pricing guidelines, various jurisdictions have formulated Practice notes which represent the tax administrators' views and practices on the methodologies of transfer pricing and related issues. Practice notes however, are only binding on the tax administrator and not the taxpayer.

<sup>151</sup> OECD Report (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publishing, Paris, par 5 at 3

<sup>152</sup> OECD Report (2000): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publishing, Paris, par 6 at 3

<sup>153</sup> MRC, INTM421010 - Transfer pricing: Methodologies: OECD Guidelines: Overview. Available at

## % 2 The Arms Length Principle

### 3.2.1 Definition of Arms-Length

**Ljijjs length** transaction is defined in Black's Law dictionary as; *a transaction between two related and unaffiliated parties. A transaction between two parties, however closely related, may be conducted as if the parties were strangers, so that no conflict of interest*

- J<sup>54</sup>

*arises* •

Black's Law dictionary elsewhere also defines Arms-length price as; *the price at which two unrelated, unaffiliated, and non desperate parties would freely agree to do business*

Arms length price is defined in the Income Tax Act<sup>156</sup> as *the price payable in a transaction between independent enterprises. "Unrelated" and "independent" in this context are synonymous.*

The OECD<sup>h7</sup> states the arms-length principle as: *the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. 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*

<sup>154</sup> Brian A. Garner, *Black's Law Dictionary* 8<sup>th</sup> Ed (2007) at 1535

Brian A. Garner, *Black's Law Dictionary* 8<sup>th</sup> Ed (2007) at 1226

The Income Tax (Transfer Pricing) Rules, 2006:

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

OECD Publication, Paris. P 35

• *I 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 them, but, by reason of those conditions, have not so accrued, may be included in profits of that enterprise and taxed accordingly "*

### 3.2.2 Historical Origins of the Arm's Length Principle

The arm's length principle plays an important role in international relations. It is therefore important to investigate its origin and how the principle developed in the treaties for the avoidance of double taxation to its current form.

According to Onsando,<sup>158</sup> there are two historical origins of the arm's length principle. The first origin, which is associated with continental European countries of Austria, Germany, and Luxembourg, Netherlands and Switzerland, applied the term for adjusting of income of shareholders who receive extra ordinary benefits from a company instead of declaring dividends. The adjustments were deemed to be dividends or hidden profits.

The second origin is traced to the United Kingdom and the United States. These two countries have an old history in transfer pricing. The U.S for example, enacted its first

<sup>158</sup>Onsando, O. A. (2007). *The OECD Transfer Pricing Guidelines: An analysis of their application in the African Legal Regime*. Available at [omarionsando@yahoo.com](mailto:omarionsando@yahoo.com)

fer pricing legislation in 1928,<sup>159</sup> to ensure that profits made by related parties are fairly  
j v^tween the parties in the respective tax jurisdictions. The two countries introduced  
•a\_c  
specn  
hanism to prevent profit shifting by associated enterprises through mispricing of cross-  
^rder transactions.

Hubert Hamaekers<sup>160</sup> gives a detailed account of how the arms length principle developed  
through the early forms of treaties especially after the First World War. The development of  
^e arms length principle was associated with the effort to contain the problem of double  
taxation which had significantly increased after the First World War following increased  
taxes in many countries.<sup>161</sup> He stated that, shortly after the war, the newly formed *The  
League of Nations* and *The International Chamber of Commerce* were commissioned to find  
ways of minimizing international double taxation. A report was made in 1927 with a Draft  
Model Treaty assigning taxing rights of business profit to the state where the enterprise had a  
Permanent Establishment (Article 5) .

United Nations: (2001) : *Transfer Pricing: History and State of Art Perspectives*. Ad Hoc Group of Experts  
International Cooperation in Tax Matters Tenth meeting' Geneva, Switzerland, 10-14 September 2001. Pp

Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. Available  
r\*te%Qks\_i<gool>le.co.ke/books?

<sup>n</sup> Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*, P 34.  
<http://books.google.co.ke/books?>

<sup>^</sup> Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 34

fiscal Committee of the League of Nations constituted thereafter under the chairmanship of Mitchell B. Carroll, carried out a survey of the legislative and administrative practice of 35 countries.<sup>163</sup> The conclusion of the survey was that for the countries reviewed, the Separate Accounting Method had been adopted as the primary method for allocating profits to local establishments of foreign enterprises. The first hint of arms length principle contained in Carroll's report reads thus:<sup>164</sup>

*this may entail the inquiry into the relation between the local branch and other establishments (subsidiaries or branches) of the parent enterprise which involved for example consideration of the price at which goods have been invoiced to the branch for the services or representing a portion of general or overhead expenses.*

Based on Carroll's findings, the Committee drafted a new multilateral treaty on the allocation of business profits in 1933. Article 3 of the said draft read "... the fiscal authorities of the contracting state shall when necessary rectify the accounts produced, notably to correct errors or omissions or re-establish the prices or remuneration entered in the books at the value which would prevail between independent persons dealing at arm's length,"<sup>166</sup>

The forerunner of Article 9 of OECD Model Convention was Article 5 of the model of 1933. This conferred the right to Tax Authorities to make adjustments in a situation where related

<sup>163</sup>Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 35

<sup>164</sup>Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 35

<sup>165</sup>Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 36

<sup>166</sup>Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 36



enterprises used conditions different from those which would have been used by independent enterprises<sup>5</sup>

Article VI of the Protocol to both Mexico and London Models confirmed the pre-eminence of the independence enterprise approach for the profit allocation to a Permanent Establishment.

It is observed that the OECD Model expressly included the arms-length in Transfer Pricing Regulations.<sup>169</sup> It is therefore clear that the arms length principle developed from the methods of determination of the profits of a Permanent Establishment based on Permanent Establishment's own accounts which involved consideration of conditions made between the related parties. It should be borne in mind that the phrase "*dealing as independent enterprises*" is in fact the arms length principle.

The principle found its way into the OECD 1979 Report, which acknowledged that, the arms length principle existed and that the report aimed at promoting its common application by Member Countries, in order to prevent double taxation and tax avoidance. The OECD Transfer Pricing Guidelines 2005 is considered to have laid the foundation for the arms length principle through the "equal treatment of MNE's and Independent Enterprise clause," as it is today.

**Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 36**

**Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 37**

**Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 38**

**Hubert Hamaekers (2002): *International Comparative Taxation: essay in honor of Klaus Vogel*. P 38**

### - 23 OECD Approach to the Arm's Length Principle

The *arm's length principle* is set out in the glossary of words of the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010).<sup>171</sup> This definition mirrors the one contained in Article 9 of the Model Tax Convention (2010). The article has been annexed as Appendix IX. It begins with setting out pre-conditions for the application of the arm's length principle. The precondition in paragraph 1 requires that for this principle to be invoked, the parties in the transaction must be associated enterprises. One of the parties must be in a position to control the other in terms of appointing the management or dominance in capital contribution. The importance of this requirement is that the controlling party is capable of influencing the decisions of the other party for instance in pricing. The arm's length principle requires associated enterprise in their business dealings to transact as though they are independent parties.

Tax Authorities of the contracting state may, while evaluating the tax matters of associated enterprises re-write the accounts of the enterprises where as a result of the relationship the accounts do not reflect the arm's length profit.<sup>172</sup>

<sup>171</sup> OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publication, Paris. P 23

<sup>172</sup> OECD (2010): *Articles of the OECD Model Tax Convention on Income and Capital*. OECD Publishing, Paris. P 138

<sup>173</sup> OECD (2003): *Model Tax Convention on Income and Capital*. Commentary on Article 9. OECD Publishing, Paris P 138

### 3 2 4 Weaknesses of the Arm's Length Principle as Set Out in the OECD Transfer Pricing Guidelines

The arm's length principle was adopted by OECD member states partly because they were perceived to be a mechanism to place the associated enterprises at par with independent enterprises therefore neutralizing tax losses that may accrue due to the relationship. The principle offers wide flexibility in determination of price and profit and has been seen to work in a situation where there are reliable comparables. However, the arm's length principle has faced serious challenges which cannot be taken for granted.

The separate entity approach poses a remarkable challenge in that, when two or more entities integrate their operation, they are likely to realize economies of scale. It has been observed that there is no scientific formula of allocating economies of scale<sup>174</sup>. Associated enterprises at times may enter into some unique transactions which independent enterprises may not undertake. This may be due to the fact that economic conditions facing associated enterprises may be different from those faced by independent enterprises. It may therefore be quite difficult to conceive how independent enterprises would behave if exposed to such conditions<sup>175</sup>.

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.  
OECD Publication, Paris. P 34

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.  
OECD Publication, Paris. P 35

The arm's length principle may also impose some unnecessary burden to both the taxpayer and the tax administration<sup>176</sup>. First, transfer pricing requires heavy documentation. It may take several years before an audit is conducted on a taxpayer. Where the audit is meant to occur several years, the taxpayer may be required to produce large volume of documents for examination by the tax administrator. Secondly, the condition that prevailed when the transaction was executed may be different from the time the records are examined. This may be perceived to be imposing unnecessary burden to the taxpayer and the tax administrator for requiring them to peddle back.<sup>177</sup> Lack of comparables is the other major challenge. For benchmarking purposes, the conditions experienced by associated enterprise should be similar to those experienced by independent parties. It may be very difficult to find similar conditions due to differences in economic circumstances, for instance, differences in taste and preference, municipal laws, distance from the market and market competitiveness.

Applying transfer pricing rules based on arm's length principle is not easy even with the help of OECD transfer pricing guidelines. It is not always possible to find comparable market transactions to set an acceptable transfer price.<sup>178</sup> The arm's length principle assumes the best

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. P 35, Para 1.12 & 1.13

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. P 35

OECD (2013): *keeping it at arm length*. Available at [www.oecdobserver.org/.../Transfer-pricing](http://www.oecdobserver.org/.../Transfer-pricing)

ossible world, where tax administrators and MNE's work together. Experience has shown that transfer pricing has gained much attention by the Tax administrator and MNE's because of the risks, for instance, shifting profits to low tax jurisdiction where little or no business activity will have taken place.<sup>179</sup>

### 3.2.5 Guidance for Applying the Arms Length Principle

In applying the arms length principle, the principle of comparability is central. We have already seen the requirements of the arm's-length principle that in a transaction between two related parties, the transaction should be executed under conditions similar to that which would prevail between unrelated parties. If conditions are different and the difference in conditions influence the profits realized from the transaction, then the difference in the profit realized would be adjusted to reflect the arms length profit. The import of this evaluation is that conditions between related parties should mirror conditions between unrelated parties hence the comparability principle.

OECD has set out five comparability factors in the OECD Transfer Pricing Guidelines . these factors are: Characteristics of property or services, Functional analysis, Contractual terms, Economic circumstances and Business strategies. The analysis of these factors amount

OECD: (2013): *keeping it at arm length*. Available at [www.oecdobserver.org/.../Transfer-pricing](http://www.oecdobserver.org/.../Transfer-pricing)

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Opri (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: Publication, Paris. P 43 paral.38

analysis of the conditions facing the taxpayer (a member of an MNE), and the conditions faced by a comparable independent party (third party). This will help in determining whether comparables as well as the method selected by the taxpayer are appropriate.

## 2.5.1 Characteristics of Property or Services

It is observed that differences in characteristics of goods or services at least in part determine the price of goods or services in an open market.<sup>181</sup> These characteristics include: Physical features, quality, reliability, availability, and volume of supply, nature and extent of services, type of property and the degree of protection (intangibles). For instance, raw produce is expected to be cheaper than manufactured produce because of differences in characteristics. These factors will have different weights depending on the method selected by the taxpayer. Where for instance Comparable Uncontrolled Method (CUP) is used, the characteristics of a product are very important. Where other methods like Transactional Net Margin Method (TNMM) or Profit Split method is selected, characteristics of a product will be of less importance.<sup>182</sup> In one of the decided cases, a plate glass was held to be similar to whole sheet of glass sold to a third party after being adjusted for the cost of cutting the glass to the correct size.<sup>183</sup>

<sup>181</sup> (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Publication, Paris. P 43 para .2.1

<sup>182</sup> (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Publication, Paris. P 44 para 1.4.0

<sup>183</sup> *Industries v Commissioner*, 55 T.C 928 (1970)

### 3.2.5.2 Functional Analysis<sup>184</sup>

Functional analysis captures activities performed by both the independent party and the related party taking into account assets used and risks assumed. The level of functions performed determines the level of compensation between parties in a transaction. It should be borne in mind that the functions referred to, are the economically significant functions performed in the transaction taking into account legal rights and obligations in performing the functions.

Some of the functions that may be considered for comparability analysis include; design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. What is relevant in determining which party in the transaction should be allocated higher compensation is the economic value of the function and not the number of functions performed by that party.<sup>185</sup>

There is however a relationship between functions performed, asset used and the risks assumed. The more the functions performed, the more the assets used and the higher the risks assumed. Examples of the risks assumed include; price fluctuation, loss of investment, credit risks and risks associated with success or failure of investment in research and development, in determining whether a party to a transaction actually assumes the purported risks, it is important to establish whether the party has control over those risks and the mechanism put in place to mitigate the risks.

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(2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*:

<sup>184</sup> OECD Publication, Paris. P 45 para1.4.2

its

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*:

<sup>185</sup> OECD Publication, Paris. P 45 para1.4.3

## 253 Contractual Terms

• mc **and** obligations of parties to a contract are expressed in the contract. In a situation The there is no written contract, the terms of the contract may be deduced from the i j t The analysis of contractual terms is thus part of the functional analysis. 186 In an • ipneth situation, there exists a relationship between obligations of a party and the risks arm's length • j assumes. It is however important to examine whether the parties kept to the terms of the ontract especially between related parties because of the risk of crafting a sham contract. The relative bargaining powers of the parties should be taken into account in arriving at the terms independent parties dealing at arm's- length would have arrived at in the allocation of risks and reward.

### 3.2.5.4 Economic Circumstances

Economic circumstances are economic factors or conditions that play a part in determining an outcome<sup>187</sup>. Economic circumstances prevailing in different markets determine their market comparability. Arm's length prices therefore may vary across different markets even # for transactions involving the same property or services.<sup>188</sup> The relevant economic circumstances for the purpose of comparability include: size of market, level of competition,

OPrn^ (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: Publication, Paris. P 47 para.5.2

<sup>117</sup>

vocabulary.com Available at: <https://www.vocabulary.com>.

in

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*'.

o E e D Publication, Paris. P a r a 2.108 to 2.149



• **competitive position** between buyers and sellers, extent of government regulation, availability of substitutes.

should be compared in comparable markets or markets facing similar economic instances. Where MNE's operate in several countries with similar economic circumstances, it may be appropriate for the group to rely on a multiple-country comparability analysis to support its transfer pricing policy towards this group of countries, where markets are not comparable, adjustments should be made to eliminate differences in the markets.

### 3.2.5.5 Business Strategies

Business strategies takes 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, duration of arrangements, and other

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factors bearing upon the daily conduct of business. Comparable enterprises should have similar business strategies because similar enterprises with different business strategies may result to different levels of profitability. For instance, an enterprise pursuing market penetration strategy tends to lower its prices or give higher discounts which have the effect of lowering profitability level.

"(2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. P 51 para1.5.9

j im business strate gy by an enterprise may pose a revenue risk and should therefore  
 be minimized. Where the price to a related enterprise is reduced on account of this claim, it  
 may be necessary to establish whether the benefits arising from the price reduction trickles  
 down to consumers. It is expected that an enterprise will seek to widen its customer base by  
 lowering the price. If the price is not lowered, then there should be some evidence of  
 enhanced marketing costs. Where such pointers are not found, a tax administrator may make  
 a case for profit shifting through transfer pricing.

### 3.3 Application of the Arm's Length Principle: OECD Proposed Methods

The OECD transfer pricing guidelines specify methods to be employed in evaluating whether  
 pricing between related parties is at arm's length. Accordingly, the arm's length price in  
 relation to pricing in an international transaction shall be determined by any of the following  
 transfer pricing methods: Comparable Uncontrolled Price (CUP) Method, Cost-plus Method,  
 Resale Price Method, Profit Split Method and Transactional Net Margin Method (TNMM).  
 The first three methods are referred to as a traditional transaction method while the last two  
 are referred to as transactional profit method.

The most appropriate method to the circumstances of the case shall be applied for the  
 determination of arm's length price<sup>190</sup>. Where, a traditional transaction method and a  
 Transactional profit method can be applied in an equally reliable manner, the traditional

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.  
 OECD Publication, Paris. Paragraph 2.108 to 2.149

• **n method** is preferable to the transactional profit method. Similarly, where, the transactional price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method will be preferred<sup>191</sup>. There is however no requirement that a taxpayer must test the suitability of each of the methods<sup>192</sup>,

## **j Comparable Uncontrolled Price method**

According to paragraph 2.13 of the OECD transfer pricing guidelines, CUP method compares the price applicable for property or services in a controlled transaction to the price charged for property or services in a comparable uncontrolled transaction in comparable circumstances. If the prices are different, an adjustment is required to make the prices comparable. For the purpose of CUP, a controlled transaction is comparable to uncontrolled transaction if none of the differences between the transactions or between the enterprises to the transaction can materially affect the price in an open market; or that such differences can be accurately adjusted. Where it is possible to locate CUP, it is the most direct method and hence the preferred method. It may be difficult to find transactions that are exactly the same to qualify for the application of CUP method because minor differences in the property

<sup>191</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. P 60 para2.3

<sup>192</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. P 59 para2.2

»  
OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*'.  
<sup>193</sup>OECD Publication, Paris. Para 2.108 to 2.149

ferred between controlled and uncontrolled transactions may have a material effect on the price. This will be the case even though the nature of business is sufficiently similar to generate the same profit level. In such a case, relatively accurate adjustments should be made in order to make the application of CUP reliable.

(CUP method also requires assessment of the effect on price of broader business functions. Even where it may not be possible to make accurate adjustment, the application of CUP should not be precluded. This may require a determination which is supplemented by other methods weighing the relative accuracy of such adjustments. CUP method is more appropriate where goods are sold between related parties in the same state or condition, without value addition.

### 3.3.2 Resale Price Method<sup>194</sup>

The resale price method compares gross profit realized when an entity resells goods to a related party to the gross profit realized by comparable entities in an uncontrolled transaction. The method starts with the resale price to the arm's length entities of goods purchased from a related party. The price is then reduced by gross profit margin of a comparable enterprise taking into account the functions performed, risks assumed and assets used. The balance is pushed back to the original seller to represent the arms length price or margin for the original transaction.

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.  
OECD Publication, Paris. Para 2.108 to 2.149

In resale price method, an uncontrolled transaction is comparable to a controlled transaction if none of the differences between the transactions being compared could materially affect resale price margin in the open market, or reasonably accurate adjustments can be made to eliminate the material effects of such differences. In making comparisons, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have material effect on profit margins as they do on price.

While performing comparability analysis in resale price method, broader product differences can be allowed but the property transferred in the controlled transaction must still be compared to that being transferred in the uncontrolled transaction. Although less product comparability may be required in using the resale price method, closer comparability of products will produce a better result. Broader differences are more likely to be reflected in differences in functions performed between the parties to the controlled and uncontrolled transactions where uncontrolled and controlled transactions are comparable in all respect except product itself; the resale price method may produce a more reliable measure of arm's length conditions than the CUP method.

Resale price method is suitable where the reseller does not add significant value to the product. It is however difficult to determine arm's length price in a situation where the reseller creates an intangible property as part of the product. It may also be the case that resale price method is more suitable where the goods are resold within a fairly short time to avoid changes in market conditions for instance changes in prices.

### 3 Cost- Plus Method

Cost plus method<sup>195</sup> starts with the cost incurred in production of goods, services or an intangible asset and then an appropriate markup is added taking into account the functions performed, asset used and risks assumed. The appropriate comparable markup is derived from comparable uncontrolled enterprises. The result is the comparable price of the original transaction. It is suitable in cases involving semi finished goods sold between associated parties, where associated enterprises have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

The arms length cost plus markup may be obtained through the establishment of internal or external comparable. Internal comparable is the cost plus markup that would be achieved by the supplier for comparable sales made to unrelated parties while external comparable constitutes the markup made by unrelated party supplier on similar transaction dealing at arm's length. For the purposes of cost plus method, fewer adjustments are required to product differences as compared to CUP method. Thus, other comparability factors should be given more weight as compared with product comparability.

<sup>TM A</sup>  
1 (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*:  
<sup>oECD</sup> Publication, Paris. Para 2.39 to 2.55

Cost plus method however presents significant challenges in its application because in certain cases there is no discernible connection between cost and market price. This would be the case where a valuable discovery has been made thereby resulting to higher profit with less cost. The cost structure upon which markup is applied should be comparable. Differences in cost that may cause differences in markup should be analyzed and adjusted. Attention should be made to classification of costs between the controlled and the uncontrolled transaction, to ensure for accounting consistency. Generally, costs are classified into three namely: direct costs, indirect cost and operating cost. Cost plus considers direct and indirect cost and absolute compensation increases with increase in costs. Thus, under cost plus method, there is the risk that inefficient enterprises which incur high costs will be rewarded for their inefficiencies.

### 3.3.4 Transactional Net Margin method

The Transactional Net Margin method (TNMM),<sup>196</sup> compares arm's length operating profit earned by one of the entities in the transaction to that earned by an independent entity in a similar transaction. It stipulates that relative operating profit (operating profit to: sales, costs, or assets) may be a more robust measure of an arm's length result when close comparables are not available as required for traditional methods. For instance, two distributors may sell different products but due to difficulty in classification of costs it may not be appropriate to

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

<sup>196</sup>OECD Publication, Paris. Para 2.108 to 2.149

cost plus or resale minus method. Misclassification of costs may lead to very different profit levels but the operating margin would not be expected to be materially different. The margin is arrived at after taking into account all costs except finance cost. Finance cost is excluded because different enterprises choose how to finance their businesses through debt and equity an aspect unrelated to transfer pricing.

**1<sup>^</sup>MM** is applicable in cases where one of the parties makes all the unique contributions Evolved in the controlled transaction, while the other party does not make any unique contribution. It is thus said to be a one sided method because one of the parties to the transaction must be tested. Ordinarily, the tested party is the least complex whose information is readily available. Once the return of the tested party is established, the residue represents the returns by the other party.

**TNMM** is said to have a number of advantages over other methods in the sense that it is possible to benchmark an enterprise which has a unique contribution relative to the other one. This will not be possible in the case of a traditional method. Equally, it may not be possible to find a comparable product for use in benchmarking. Even where products are not comparable, the operating profit of the enterprises dealing in the two products may still be comparable. It may be difficult to compare enterprises at gross level with different functional structure. Differences in functions are reflected in different operating costs therefore eliminating the difference in operating profit. Therefore, enterprises with different functions can still be comparable at operating margin level.

**1<sup>^</sup>NN** is said to suffer from several weaknesses. First, as a one sided method, it is possible to benchmark and allocate one party all the profit leaving the other one without any profit.



Method is highly dependent upon commercial databases which may be expensive, This

difficult to use and may represent different economic circumstances from the one the tested

located. Secondly, net profit may be affected by factors which have nothing to do party

with Price or Gross Margin independent enterprises therefore putting into question the

usability of TNMM. Finally, where the tested party is in a different tax jurisdiction, it may

be difficult to obtain all information required for benchmarking.

### 3.3.5 Transactional Profit Split methods<sup>197</sup>

These methods are applied when the enterprises involved in the examined transaction are too integrated to allow for a separate evaluation. The transactional profit split method first identifies the profits or loss to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. The profit is then split based on the level of contribution of each of the participants in the transaction.

Transactional profit split method is particularly important because, as a two sided method, it offers a solution for highly integrated operations for which traditional methods or TNMM would not be appropriate. Transactional profit split method may also be found to be the most appropriate method in cases where both parties to a transaction make unique and valuable contributions where allocation of profit is based on the relative contribution to the transaction. Finally, the method avoids extreme results which may be achieved by other

<sup>197</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publication, Paris. Para 2.108 to 2.149

Under this method both parties to the transaction shares out profits or losses  
on the overall results of the transaction,

methods however suffer from several defects. First, for the method to be reliably applied  
availability of massive information on the parties to the transaction. It may however  
difficult to obtain sufficient information for a party in a different tax jurisdiction.

Secondly, it may difficult to measure combined revenue and costs for all the associated  
enterprises participating in the controlled transactions, which may require writing books and  
records on a

Similar basis and making adjustments to take into account difference in accounting practices  
and currencies.

### **3.4 Issues Taken into Account in Applying the Arm's Length Principle**

#### **3.4.1 Comparability Analysis**

The general framework on comparability analysis is covered in chapter 1 of the OECD  
guidelines. At Para 1.33 of the OECD, comparability analysis involves a comparison of a  
controlled transaction with an uncontrolled transaction or transactions. The comparisons are  
only useful if the economically relevant characteristics of the situations being compared are  
sufficiently comparable. Therefore, controlled and uncontrolled transactions are comparable  
if none of the differences between the transactions being compared could materially affect  
such as price or margin being examined in the transaction, or if reasonably accurate  
adjustments can be made to eliminate the effects of any such material differences.

comparability analysis is covered in Chapter III of OECD guidelines<sup>198</sup> and involves the process of selecting the most appropriate transfer pricing method. It aims at finding the most reliable comparables and therefore eliminating less reliable comparables.

para 3.4 OECD describes the process that may be followed when performing a comparability analysis. The process is considered an accepted good practice but any other search process that may result to a reliable comparable may be adopted. It is important to note that reliability of the outcome is more important than process. The process has nine steps namely: determination of the period to be covered, analysis of the taxpayer's circumstances, functional analysis and identification of comparability factors at play, review of existing internal comparables, determination of available sources of information on external comparables, selection of the most appropriate transfer pricing method and, the relevant financial indicator, identification of potential comparables, determination of and making comparability adjustments and determination of the arm's length remuneration.

### **3.4.2 Evaluation of a Taxpayer's Separate and Combined Transactions**

Para 3.9 of the OECD guidelines provides that in order to achieve the most accurate estimate of a fair market value, the arm's length principle should be applied on a transaction by transaction basis. However, where separate transactions are so closely linked or continuous

<sup>198</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.  
OECD Publication, Paris. Para 2.108 to 2.149

[ cannot be evaluated adequately on a separate basis, the evaluation may be done on a  
that tnO  
**bin**ed transaction basis. This may be the case in the following circumstances: in case of  
I  
long<sup>ter</sup> contracts for the supply of commodities or services, rights to use intangible  
party pricing a range of closely-linked products which make it unrealistic to determine  
• no for each individual product or transaction and e-commerce transactions. Other  
t-jgmples include the licensing of manufacturing know-how and the supply of vital  
**opponents** to an associated manufacturer. It is ideal to assess together than to assess them  
**narately**. The routing of a transaction through another associated enterprise or where one  
scp  
transaction is undertaken by related parties without clear distinction of the functions  
**performed** by either of the parties.

### 3.4.3 Intentional Set-offs

intentional set-offs are covered under Para A3.2 of the OECD guidelines. This is where a  
related party provides a benefit to another related party within the group that is balanced off  
with a different benefit received from that party in return. The benefit could be in part or full  
satisfaction of the benefit received by the other party such that only the net effect is recorded.  
Para 3.13 gives an example of an enterprise which licenses the other to use a patent in  
exchange for the provision of know-how resulting to no profit or loss to either party. Each  
transaction should be assessed separately in accordance with the arm's length principle in  
<sup>o</sup>der to quantify the value of the respective benefits presented as set-offs.

#### ^ 4 Choice of the Tested Party

choice of tested party<sup>199</sup> is covered under Para A.3.3. It is relevant when applying a cost  
Jbe  
us meth<sup>0^</sup> resale price method or transactional net margin method earlier discussed. In  
• a whether the transaction is at arm's length, it is important to choose the party to the  
testing  
paction for which a financial indicator is tested. The general rule is that the tested party  
ould be the one who is least complex and whose information is readily available. In  
ractice, the tested party is the taxpayer in the tax jurisdiction of the assessing tax  
administration. This does not mean the tested party cannot be the party in the other tax  
jurisdiction. In such a case, the taxpayer must be prepared to provide all the records that the  
tax administration may request in order to test the compliance with the arms length principle.

#### 3.4.5 Information Undisclosed to Taxpayers<sup>200</sup>

Ordinarily, tax administrations are required to maintain taxpayers confidentiality for  
information obtained while examining the records of other taxpayers. Thus, such information  
should never be disclosed to other taxpayers unless the domestic legislation allows for the  
>are. Sometimes, this information in the eyes of the tax administration appears suitable for  
comparability, while dealing with other taxpayers. The use of such information may be  
Perceived as unfair to the taxpayer unless the same is also disclosed to it to enable it prepare  
dPpropiately for defense in case of a dispute.

A  
utCD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations:*  
CD Publication, Paris. Para 3.18 to 3.19

\*

0Frrl (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations:*  
u Publication, Paris. Para 3.36

However important to note that some countries such as Australia, Canada and Japan use the concept of 'secret comparables' arguing that secret comparables help achieve the closest practical degree of comparability for the application of arm's length principle. This has been dismissed by tax practitioners as being akin to saying that "we only use torture when we have no choice".<sup>11</sup> A complication arises at international levels especially during the Competent Authority's negotiations. A case in issue is the Japan - Mexico case, where domestic law in Japan prohibited disclosure of information obtained secretly for the purpose of benchmarking. During the negotiations that information could not be disclosed to the competent authority of Mexico.

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### 3.4.6 Comparability Adjustments

Paragraph 1.33 of the OECD guidelines states that for a situation to be comparable, none of the differences between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Comparables should be adjusted to achieve the required accuracy and reliability for both general applications of the arm's length principle and in the context of each method.

Some of the comparability adjustments that may be necessary to make include adjustments for accounting consistency which are designed to eliminate differences in accounting

<sup>11</sup>Michelle, M. (2005): *The Transfer Pricing Of Intangibles*. Chapter 6, P 183. Kluwer Law International, Dordrecht, The Netherlands. Available at <http://www.books.google.com/books7isbn>

<sup>12</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Publication, Paris. Para 3.47

tices between the controlled and uncontrolled transactions; segmentation of financial data<sup>10</sup> eliminate significant non-comparable transactions and adjustments for differences in functions, assets, risks. capita<sup>11</sup>

#### 2.4.7 Arm's Length Range<sup>203</sup>

It is not always the case that the arms length principle will produce a single figure that represents the arms length condition. It is acknowledged that transfer pricing is not an exact science and therefore it is possible to produce a range of figures all of which are approximately reliable. The difference in results reflected by each point in the range may be due to the fact that independent enterprises engage in comparable transactions under comparable circumstances but at different prices or margin. Where each result is considered relatively accurate, the tested party may fall anywhere within the range.

There are cases however, that even, as all the effort is made to eliminate defects in the statistics some still remain. In such a case, it may be appropriate to use measures of central tendency to determine the most appropriate point in the range in order to minimize the risk of error due to unknown or unquantifiable comparability defects. These measures include the Mean, mode median and the weighted average.

(2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: Publication*, Paris. Para A.7

### 348 Multiple Year Data<sup>204</sup>

Multiple year data presents a trend set by a controlled transaction over a period of time. It requires the user to have a complete understanding of the facts and circumstances surrounding the controlled transaction. Multiple year data should be used where they add value to the transfer pricing analysis. The analysis of such information might disclose facts that may have influenced the determination of the transfer price. For instance, multiple year data may disclose a history of loss making therefore justifying subsequent year losses. Multiple year data tends to minimize the effect of extra ordinary items which may show results that deviate from the general trend.

Comparability analysis requires full knowledge of business life cycle, product life cycle and economic life cycle. Business life cycle entails establishing whether the business is at infant stage, maturity or over-expanded with a possibility of suffering from the diseconomies of scale. Each of these stages of life faces unique circumstances and therefore, comparable enterprises should be at similar stage of life cycle. Product life cycle does not necessarily correspond with business life cycle. Under this, as the product is launched in the market the enterprise may be faced with huge promotional costs as opposed to an already existing product in the market. Economic life cycle consists of three stages namely boom, recession and recovery. Each of these stages provides the enterprise with varying opportunities and

P<sup>^</sup> (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. Para B. 5



1 \*aes which affects the performance of the enterprise. While benchmarking, it is P^ant to compare enterprises with similar economic life cycle.

### **35 Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes**

part IV of the OECD guidelines sets out administrative approaches which may be adopted to minimize and solve transfer pricing disputes either between taxpayers and tax administrations or between different tax administrations. This is informed by the fact that transfer pricing is not an exact science and either party can make genuine errors in determination of the arms length price or margin. Where different tax administrations take different positions on a matter there is a possibility of income arising being taxed in each of respective tax jurisdictions. This is called double taxation and is not desirable because it is a barrier to the development of international trade and the flow of investment. This part discusses several administrative approaches available to resolving disputes arising from transfer pricing adjustments and for avoiding double taxation. These approaches are; Mutual agreement procedure, simultaneous examinations of accounts, safe harbors, Advance Pricing Arrangement and Arbitration.

#### **35.1 Mutual Agreement Procedure (MAP)**

Mutual agreement procedure is covered in part CI of chapter IV of the OECD guidelines.

4.29 expresses mutual agreement procedure as a well-established means through administrations consult to resolve disputes regarding the application of double tax

utions. Article 25 of the OECD Model Tax Convention sets out three different areas  
\IAP'S are generally used. The first case is provided for in Paragraph 1 of Article 25  
OECD model tax convention. Under this, the process is initiated by the taxpayer who  
**y approach** the competent authority of the contracting state of which he is a resident,  
**withstanding** the remedies that may be available to him under the domestic law. Any  
**ement** reached shall be implemented notwithstanding any time limits in the domestic law  
*fr*  
of the Contracting States<sup>205</sup>.

paragraph 3 of the OECD Model Tax Convention provides for the other two cases. The first  
~~is~~ is where difficulties or doubts arise on the interpretation or application of the  
Convention and the second one covers cases not covered by the convention. The  
Commentary to the OECD model, in Article 25 provides for the use of supplementary  
dispute resolution mechanisms in addition to arbitration, including mediation and the referral  
of factual disputes to third party experts<sup>206</sup>.

The result of the mutual agreement procedure is the corresponding adjustment which may be  
~~made~~ by a contracting state either by recalculating the profits subject to tax for the associated  
enterprise in that country or by giving the related party relief for the additional tax charged  
by the adjusting State.

<sup>205</sup>OECD (2010): *Articles of the OECD Model Tax Convention on Income and Capital*: OECD Publishing,  
\*\* Article 25, Para 2.

<sup>206</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.  
OECD Publication, Paris. Para 2.108 to 2.149

paragraph 4.42 sets out concerns regarding the mutual agreement procedure and the **corresponding** adjustments. First, time limits may be provided under domestic law which may limit the availability of the corresponding adjustments if not dealt with sufficiently under the treaty. Secondly, mutual agreement procedure may take too long to complete. Due to the complexity of transfer pricing issues, it may not be possible to reach a quick settlement. This may be contributed by language barriers, difference in accounting system,

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distance between the two tax administrations and legal technicalities. Thirdly, taxpayers' participation may be limited. The request by the taxpayer to initiate a mutual agreement procedure is provided for under article 25 paragraph 1. Paragraph 29 of the Commentary to Article 25 addresses this issue by stating that tax authorities should notify the taxpayer as early as possible the intention to make a transfer pricing adjustment. In sub paragraph C, competent authorities should give the taxpayer every opportunity to present every argument and facts orally and in writing. Fourthly, Published procedures may not be readily available to inform taxpayers on how the procedure may be used.

Competent authorities should develop and publicize domestic rules and procedures for use in M 208

the mutual agreement procedure so that taxpayers may easily understand the process.

Finally, there may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure. In a situation

<sup>207</sup> OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. Para 4.52

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*'. OECD Publication, Paris. Para 2.108 to 2.149

domestic law does not provide for suspension of recovery of the principal tax and the related interest, this may be recovered before the process is over.

## **5.2 Simultaneous Tax Examinations**

part A OECD Model Agreement defines simultaneous tax examination as "an arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain"<sup>19</sup>.

A simultaneous tax examination allows two or more countries to cooperate in tax investigations. It is useful where information based in a third country is a key to a tax investigation, since they generally lead to more timely and effective exchanges of information<sup>20</sup>. It is particularly important because it facilitates availability of sufficient data to the participating tax administrations for transfer pricing analyses. The taxpayers affected are normally notified of the fact that they have been selected for a simultaneous examination. Simultaneous tax examination does not replace exchange of information but rather supplements it. During this process, information is exchanged between the two tax jurisdictions through competent authorities.

OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. Para 4.78

<sup>20</sup> OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. Para B. 5

paragraph 4.85 sets out instances where simultaneous tax examinations may be used. It is particularly useful for determination of the correct tax liability of associated enterprises where costs are shared and profits are allocated between taxpayers in different tax jurisdictions. It is also used where simultaneous tax examinations may facilitate an exchange of information on multinational business practices, complex transactions, cost contribution arrangements, and profit allocation methods in special fields such as global trading and innovative financial transactions.<sup>211</sup>

### 3.5.3 Safe Harbours

Safe harbor is defined in paragraph 4.94 as a statutory provision that applies to a given category of taxpayers which relieves eligible taxpayers of certain obligations imposed by the tax legislation by replacing it with simpler obligations. The taxpayer is required to comply with certain procedural issues as a precondition for qualification to the scheme. Certain transactions of the taxpayer may be exempted from complying with certain requirements of transfer pricing or certain rules are just simplified. Safe harbor does not, however, include advance pricing arrangement or thin capitalization. Safe harbor may be incompatible with the Principle of arms length.

<sup>211</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. Para B. 5

Safe harbor has several advantages, namely: the taxpayer under this scheme is able to have a level of certainty that as long as it complies with the conditions prescribed the tax authorities will not raise any query.

It is simple and economical for the taxpayer to comply with. It also relieves the taxpayer the burden of periodical audits thereby redirecting the effort to less compliant taxpayers.

Safe harbours have some disadvantages. They may pose significant challenges in the countries the associated enterprises operate. First, safe harbors may affect tax calculations within the jurisdiction because it may not be compatible with the arms length price or profit. The determination of tax in the other jurisdiction where associated enterprises operate may also be affected. Secondly, it may be difficult to establish with certainty the criteria for defining safe harbors. This may also result to prices or profits that may not be consistent with the arm's length principle. Thirdly, safe harbors may provide taxpayers with tax planning opportunities and other tax avoidance schemes through transfer pricing in order to shift taxable income to other jurisdictions. Finally, safe harbors may generate issues of equity because a tax jurisdiction will be operating two sets of rules, one for the enterprises under the scheme and the other for enterprises which are required to comply with the arms length principle.<sup>214</sup>

<sup>214</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: OECD Publication, Paris. Para 4.112

215

<sup>215</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publication, Paris. Para 4.115

<sup>216</sup>OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publication, Paris. Para 4.119

Advance pricing arrangements are dealt with comprehensively in Para's 4.123 to 4.165 of the

Guidelines. The term APA is defined in the annexure to chapter IV of the guidelines<sup>25</sup> as a <sup>ej</sup>jurational arrangement between a taxpayer or taxpayers and a tax administration intended to <sup>po</sup> solve potential transfer pricing disputes in advance.

Another definition is contained in paragraph 4.124 of the Transfer Pricing Guidelines as "*an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time.*"

APA is initiated by taxpayers and involves negotiations between the taxpayer, and one or more tax administrations. It supplements the administrative, judicial, and treaty mechanisms for resolving transfer pricing disputes. APAs are primarily used to avoid the risk of future income assessment adjustments, which could lead to large payments in the future. APAs may also operate retroactively to reduce tax exposure in past years<sup>216</sup>

APAs may be classified as unilateral, bilateral or multilateral. A unilateral APA is an agreement between a corporation and tax administration of the country where it is subject to taxation<sup>217</sup>. The risk associated with unilateral APA is that foreign tax administrations may not recognize it. Bilateral APAs on one hand involves an agreement between a taxpayer and

<sup>25</sup> *Guidelines for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure ("MAP APAs")*, OECD Publishing, Paris. Para 3

<sup>24</sup> UtCD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: Publication, Paris. Para 4.136

<sup>27</sup> <sup>P</sup> (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*: <sup>ij</sup>CD Publication, Paris. Para B. 5

administration while multilateral APAs on the other hand involve an agreement  
3  
between two or more tax administrations.<sup>218</sup>

Reoperation of APA's is perceived to give rise to the following advantages. First, APA's  
may assist taxpayers by eliminating uncertainty through enhancing the predictability of tax  
treatment of international transactions. The terms of APA are mutually agreed upon by the  
taxpayer and the tax administration and as long as they are adhered to by the taxpayer, the tax  
administration is not expected to raise any tax arrears from the same transactions.

Secondly, APAs provide a friendly atmosphere for negotiation and cooperation between the  
taxpayer and the tax administration thereby promoting understanding and free flow of  
information between the two parties.

Thirdly, an APA is both economical to both the taxpayer and the tax administration in terms  
of time and resources. This is informed by the fact that transfer pricing audits and litigation  
are both lengthy and resource intensive.

Fourthly, bilateral and multilateral APAs significantly reduces the possibility of juridical or  
economic double or non taxation since all the relevant parties participate in the discussions.  
However, unilateral APA may still result to double or non taxation because only the taxpayer  
and the tax administration in its tax jurisdiction are involved in discussions.

(W<sup>2010</sup>): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*:  
Publication, Paris. Para 4.130



free disclosure of information and explanations may assist tax administrations in insight into complex international transactions undertaken by the enterprise. gain<sup>3</sup>S

enterprises tend not to disclose all information necessary for proper ^standing of the business.

### **3.6 Conclusion**

•the OECD transfer pricing guidelines represent a comprehensive model for addressing uansfer pricing issues. It is an all inclusive model addressing all the aspects of transfer pricing, ranging from the determination of the arms length price or margin to the resolution of disputes. The use of the guidelines involves a complex process requiring high levels of expertise in establishing comparable prices or margin. The accuracy of the results is dependent upon the reliability of comparables. Developing countries including Kenya lack reliable data and expertise to effectively perform comparability analysis, therefore difficult to apply OECD transfer pricing guidelines. The model gives rise to very subjective results hence failure to accord taxpayers and tax administrators the required certainty.

## CHAPTER FOUR

### 4.0 TRANSFER PRICING: KENYAN APPROACH

This chapter focuses on Kenya's transfer pricing regime. The discussion will first briefly touch the history of transfer pricing law and practice in Kenya. This will be followed by a discussion on the current legislation and the Income Tax (Transfer pricing rules) 2006, the extent to which it has adopted the OECD transfer pricing guidelines. Included in the discussion is the extent to which Articles of The OECD Model Tax Convention on Income and Capital has been applied in the Double Tax Agreements (DTA) entered into between Kenya and other countries. Finally shortcomings of the current Kenya transfer pricing regime will be highlighted.

#### 4.1 The Scope of Kenya's Law on Transfer Pricing

The primary transfer pricing legislation in Kenya is contained in section 18(3) of the Income Tax Act. Section 18(3) deals with a situation where a non residence carries on a business with a related party at terms which are not arms length. This section empowers the Commissioner to make adjustment on the transaction to reflect the arms length situation. Section 18(5) deals with a case where a non resident person carries out business through a Permanent Establishment (P.E). This section requires the profit earned by the P.E to be taxed in Kenya without deductions of interest, royalties, management or professional fee payable to a related nonresident person. It further states that foreign exchange gains or losses on net assets or liabilities between the P.E and the foreign head office should also be disregarded.

As observed in Chapter two that, the arms length principle set out under section 18(3) was successfully tested in Unilever and Sara Lee cases. Thereafter, legislative reforms

enced culminating to the enactment of Income Tax (Transfer Pricing) rules, 2006.

(APPENDIX X)

#### 4.2 Income Tax (Transfer Pricing Rules), 2006

rules are based on the arms length principle. For instance, paragraph two (2) defines the

arms length price" as the price payable in a transaction between independent enterprises, the arms length principle therefore becomes a common basic building block for both the OECD transfer pricing guidelines and the income tax transfer pricing rules. Other terms defined in the rules include comparable transaction, controlled transaction and related enterprises. Although the term "comparable transaction" is not specifically defined in the OECD transfer pricing guidelines, its definition is contained in the meaning of "comparability analysis" which is found in the glossary of words of the guidelines on page 24. The term "controlled transaction" has a similar meaning in both the rules and the OECD transfer pricing guidelines.<sup>219</sup> Similarly, the term related enterprises in the rules has a similar meaning with the term associated enterprises in the OECD transfer pricing guidelines.

The scope of the guidelines is contained in paragraph five (5). The guidelines cover the associated enterprises, where one is located in and is taxable in Kenya and the other one is located in another tax jurisdiction. The other set of transactions covered by the rules are transactions between Permanent Establishment (PE) and its head office or other related branches. It is important to note that the definition of Permanent Establishment contained in section 2 of ITA is limited to a construction site and a fixed place of business while OECD

"See

Paragraph 2 of income tax transfer pricing rules and OECD transfer pricing guidelines, on p 25.

definition is broader and includes dependent agent . This is an inconsistency that requires to be corrected because the definition adopted in the DTA's between Kenya and other states to that in OECD transfer pricing guidelines. The main issue is that a DTA does not give taxing rights to a state that are not prescribed in the taxing Statute. Therefore a taxpayer operating a dependent agent, although provided in the DTA, may escape taxation in Kenya because of the narrow definition of PE that excludes a dependent agent in the income tax Act.

The transactions covered by the rules are set out in paragraph six (6) and includes the sale and purchase of tangible and intangible goods, transfer of intangible assets, provision of services, lending or borrowing of money and any other transaction capable of affecting the profitability of the enterprise. This list appears to cover every transaction between related parties similar to what is covered in the OECD transfer pricing guidelines.

Paragraph seven (7) covers the methods to be applied in determination of the arms length price. The methods included here are the Comparable Uncontrolled Price (CUP) method, Resale Price method, Cost Plus method, Profit Split method, and Transactional Net Margin method (TNMM). Sub paragraph "f" provides for an avenue where any other method may be applied with prior approval by the Commissioner. This presents a major departure from the OECD transfer pricing guidelines which only provides for the five methods. It is also important to note that the rules, since inception, did not have preference for any method (Para

This is contrary to the OECD transfer pricing guidelines which ranked transactional

<sup>A</sup> OECD (2010): *Articles of the OECD Model Tax Convention on Income and Capital*. OECD Publishing, Article 5 Para. 5

traditional methods (CUP, Cost Plus and Resale Price) higher than transactional profit methods (TNMM and Profit Split). However, the 2010 version of the OECD transfer pricing guidelines relaxed this requirement by providing for selection of the most appropriate method in the circumstance of each case.<sup>221</sup> This requirement appears to be circumvented again in para 2.3.1<sup>on P</sup> where the guidelines state that *where a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where.....the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.*

**Regarding** the application of transfer pricing methods, there is an increasing reliance on the use of the five prescribed methods by both KRA and the taxpayers in the determination of arm's length price. The first case where CUP method was indirectly used was in the Unilever case<sup>222</sup>. KRA compared the price applied between Unilever Kenya (UKL) and Unilever Uganda (UUL) on one hand and Unilever Kenya and third party customers in Uganda. The price between UKL and third party customers in Uganda was used as an internal comparable. The taxpayer in this case objected to the use of CUP method and insisted on Cost Plus method<sup>223</sup>. In Sara Lee case,<sup>224</sup> both KRA and the taxpayer in an out-of-court settlement agreed on Cost Plus method to determine the transfer pricing adjustment. In recent cases,

<sup>221</sup> OECD (2010): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD Publication, Paris, p.59

<sup>222</sup> *Unilever Kenya limited v The Commissioner of Income Tax; income tax appeal no. 753 of 2003, p5*

<sup>223</sup> *Unilever Kenya limited v The Commissioner of Income Tax; income tax appeal no. 753 of 2003, p 8*

*Household & Body Care Kenya Limited v Commissioner of Income Tax; Income tax appeal no.543 of 2003*

^Ijp method has been successfully applied in Karuturi case, which is currently pending at High Court. The Karuturi case involved the export of rose flowers to the overseas market through Flower Express, a related party situated in Dubai. Flower Express would buy all flowers produced by Karuturi on free- on- board ( F O B ) J o m o Kenya International Airport (JKIA) terms. Before the flowers leave JKIA, some of the flowers are sold to third party exporters at a significantly higher price, who then export the flowers to Europe and other markets served by Flower Express. The price between Flower Express and third party exporters was used as an internal comparable for CUP and the price between Karuturi and Flower Express adjusted appropriately.

**The** provision for a window to introduce other transfer pricing methods outside the five methods prescribed by the OECD was informed by practices in other tax jurisdictions. For instance, the same clause was found in transfer pricing legislation of Hungary, India, Israel, Taiwan and Thailand.<sup>226</sup> In Kenya, this provision has been invoked so far at least twice by taxpayers who sought to be allowed to use a transfer pricing method outside the five methods. The Commissioner however, after careful evaluation of the facts and circumstances of the cases, ruled that the cases could properly fit into one of the five methods hence not necessary to prescribe an extra method. There is a potential risk of prescribing a new method 'n that there may be insufficient details of the methodology to be followed in its application. 'ack of consensus in its application can lead to a prolonged dispute. The OECD prescribed Methods are set out in details in the OECD transfer pricing guidelines.

*Wuturi Limited v Commissioner of Domestic Taxes'*, Income Tax Appeal No. 7 of 2013

<sup>De</sup>llote & Touche Tohmatsu (2008), *Strategy Matrix for Global Transfer Pricing*, p.9

the power of the Commissioner to call for information is set out in Para 9 of the rules. This paragraph exists notwithstanding the presence of section 56 of the same Act that empowers the Commissioner to call for such records generally. The paragraph lists down the documents that the Commissioner could demand which have a direct relevance to the transfer pricing issue. These documents relate to; the selection of the transfer pricing method, the application of the method, the global organization structure of the enterprise, details of the transaction under consideration, the assumptions, strategies, and policies applied in selecting the method; and such other background information as may be necessary regarding the transaction. The summary of these documents are contained in a document known as the transfer pricing policy<sup>227</sup>. The transfer pricing policy provides the basis for determination of the arm's length price and should be prepared in advance. There has been undue delay or unwillingness by taxpayers to submit transfer pricing policies. This is contributed by the fact that under the Kenya's transfer pricing legislation, there are no special penalties for failure to submit records.

### 4.3 Legislative and Documentary Amendments

The income tax (transfer pricing) rules 2006, were enacted pursuant to the recommendation in Unilever judgment of 2005.<sup>229</sup> Section 18(3) had also been found wanting in the same judgment because, according to Visram J, the Commissioner was required to prove that the

<sup>227</sup> See Para 10 to the rules.

**P^RA, (2011):** *Kenya's approach to transfer pricing*: 32<sup>nd</sup> Annual CATA Conference, Colombo, Sri Lanka. Somber, 2011.

*Unilever Kenya limited v The Commissioner of Income Tax* income tax appeal no. 753 of 2003, p 15

se for which a transaction was entered into was to cause less or no profit. This is akin  
 purpos<sup>0b</sup>  
 to tin<sup>c</sup> **Commissioner** being required to prove *mens rea* which points to the state of mind. In a  
 tax environment, this requirement was found unsustainable and therefore, in 2008, section  
 18(3) was amended Oil to get rid of this requirement. It is now much easier to assess and  
 maintain an assessment because what the Commissioner is now required to demonstrate is that  
 as a result of the transaction, the resultant profit to the Kenya reduced.

It was recognized that a lot of businesses in Kenya are carried out between individuals other  
 than companies. To minimize tax leakage through transfer pricing, section 18(6) was  
 amended in 2010<sup>233</sup> to include transactions between individuals who are related by  
 consanguinity or affinity. This amendment did not however shed light on the limits within  
 which the two terms will be applied. It was important to limit the level of relation by blood  
 (consanguinity) in terms of degrees. For example, in Brazil relation by blood is limited to the  
 third degree. Unless such limits are defined, there is a risk that any level of relationship  
 would fall within the transfer pricing legislation hence ambiguity in the term. Affinity is  
 defined in the Black's law Dictionary<sup>234</sup> as relation by marriage or the relationship that one  
 spouse has to the blood relatives of the other spouse. Therefore, transaction between  
 individuals related by marriage is thus brought into the ambit of transfer pricing.

**10**  
*Unilever Kenya limited v The Commissioner of Income Tax* income tax appeal no. 753 of 2003, p 14

Finance Act no. 10 of 2010; at s 24  
 Finance Act no. 10 of 2010; at s 24

<sup>Br</sup>Van, A. G. (2007). *Black's Law Dictionary*. 8<sup>th</sup> Ed. p. 63



Due to the many problems encountered in the administration of arms length principle, it was found necessary to amend rule 8 of Income Tax (Transfer Pricing) Rules 2006, to empower

**Commissioner** to issue guidelines specifying conditions and procedures to guide in the the

application of the methods set out in rule 7. These changes were brought in pursuant to legal Notice No. 54 of 2012 which introduced the Income Tax (Transfer Pricing) (Amendment) Rules 2012. The Commissioner will now be able to issue guidelines and even revise them whenever it finds it necessary as challenging situations emerge.

To enable KRA to identify easily taxpayers with related party transactions, the taxpayer's annual income tax return was re-designed to facilitate disclosure of details of the transaction. The related party information that is required to be disclosed include; loans advanced or received, sales and/or purchases, payment or receipt for services, intellectual property, Head office expenses and payment towards cost contribution arrangements (CCA). These changes were effective from the year 2011. Using the Integrated Tax Management System ( now *i-tax*), taxpayers engaged in related party transactions are identified and the relevant accounting ratios computed to show the taxpayer with transactions which are *prima facie* deemed non compliant with the arms length principle. The selected taxpayers are then subjected to further manual screening and if found wanting, are subjected to transfer pricing to audit.

#### **4.4 Practice Notes**

Kenya Revenue Authority prepared Practice Notes on the application of section 18(3) of the Income Tax Act and the Income Tax (Transfer Pricing) Rules way back in 2011. The Practice Notes represents Commissioners' interpretation of the transfer pricing legislation the Income Tax Act. They are based on the OECD transfer pricing guidelines.

^pared to the rules, they are much more detailed and elaborate. The practice notes were ^fted and submitted to OECD for comments, which were incorporated in the document to ^t what would be regarded as international standard.

he final document was however not rolled out for two reasons. First, there was the fear that rihle the document is fully binding on the Commissioner, the taxpayer may only apply it if it conforms to the legislation. Secondly, under the doctrine *contra proferentem*, the practice notes would always be interpreted against the Commissioner being the author of the **document** in case of any ambiguity in the wording. Considering that transfer pricing issues are never clear- cut, and that Kenyan taxpayers are highly litigious, it was concluded that putting the notes into operation would make transfer pricing compliance audits very difficult. The document was therefore shelved until a time when KRA shall have refined transfer pricing legislation and developed sufficient capacity.

#### 4.5 The VAT Act

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In recognition of increasing cases of transfer mispricing in VAT, the new VAT Act has put in place several measures to ensure that prices applied between related parties are at arm's length. For instance, section 13(1) (b) requires, in determining the value of a supply, in case related parties, the price shall be the open market value. The open market value is the arms length price. Subsection 8 defines a related person as a person or a third party who Participates directly or indirectly in the management, control, or capital of the business of the

^Value Added Tax Act, 2013

upr  
otr  
in case of an individual the relationship extends to association by marriage,  
nsanguinity or affinity to an individual who participates in the management, control, or  
capital business other. Section 66 deals with anti-avoidance schemes. It  
empowers Commissioner to issue an assessment if it is satisfied that a scheme was  
entered into, the dominant purpose being to obtain a tax benefit. This law is new and the  
provision has not been tested.

#### 4.6 Double Tax Treaties (DTA's)

Section 41 of the Income Tax Act empowers the Minister for Finance to conclude special  
arrangements for relief from double taxation. Pursuant to this section, the minister concludes  
Double Tax Treaties with other states prescribing the taxes to be covered in the treaty.  
Related parties who are often at the risk of double taxation are therefore able to make use of  
DTA's to settle cases without being double taxed.

DTA's are modeled either along the OECD Model Tax Convention or the United Nations  
Model Convention. Kenya has concluded DTA's with nine countries. Beside this, a number  
of DTA's are either signed but not ratified, while others are in various stages of renegotiation  
(APPENDIX XI). Compared to other countries in the world, Kenya has not performed well  
in this area because there is a big risk of double taxation for Multinationals incorporated in  
Kenya or for Multinationals incorporated elsewhere but carrying on business in Kenya. Lack  
of DTA's

poses a serious challenge to transfer pricing audits because; it may not be possible  
<sup>10</sup> exchange information on a common taxpayer relating to transactions between the two  
states. DTA therefore cannot be considered to be an effective tool for transfer pricing in  
Kenya.

#### 4.6.1 Relevant Articles of the OECD Model Tax Convention

testing the effectiveness of the OECD transfer pricing guidelines in Kenya, it is important to find out how far the DTA's currently in force borrow from the OECD Model Tax Convention. This stems from the fact that most treaties are either based on the OECD Model Tax Convention or the U.N Model Double Taxation Convention. Both the models subscribe to the arms length principle similar to the OECD transfer pricing guidelines. This section therefore evaluates the extent to which key articles of the DTA's were influenced by either the OECD or the U.N model tax convention.

#### 4.6.2 Article 5 Permanent Establishment

Under the article, PE is defined as fixed place of business through which the business of an enterprise is wholly or partly carried on. Paragraph 3 introduces the concept of building or construction sites. Under the OECD model, a building or a construction site constitutes a PE if it lasts for more than 12 months. The UN model deems a building or a construction site a PE if it lasts for more than six months. The DTA's that Kenya has so far entered into adopted the UN model. This has given Kenya the right to tax an enterprise engaged in construction much earlier than it would have been if the DTA's were based on the OECD Model,

Paragraph 5 provides for taxation of a PE of a dependent agent. This is an agent who acts on behalf of an enterprise and habitually concludes contracts in the contracting state in the name

<sup>26</sup> U.N. (2010): *U.N Model Double Tax Convention between Developed and Developing Countries*. U.N. Wishing, New York. Article 5 (3) a

f the enterprise. This provision is found in all the DTA's so far concluded. However, the definition of PE under the Income Tax Act does not include a PE of a dependent agent and therefore' an enterprise operating in Kenya as a PE of a dependent agent cannot be taxed in Kenya. There is therefore need to amend the definition of PE in the Act to be in line with DTA's.

#### **4.6.3 Article 7 Business Profits**

Article 7 deals with business profits. Business profit is taxable on an enterprise of a contracting state unless that enterprise also carries on business in the other contracting state through a PE. The profit taxable in that other state shall be the profit attributable to the PE. Sub article 2 treats the PE as distinct and separate enterprise and therefore seeks to attribute to it what would be the arms length price or profit.

Sub article 3 allows deduction by the PE of executive and general administration expenses incurred in both states. The U.N Model however qualifies this statement by limiting the expenses to reimbursements of actual expenses to the head office by the P.E. The evaluation of the DTA's Kenya entered into shows that OECD version was adopted. No limit is put on the general and administration expenses and therefore it is possible for the head office to impose a markup on the actual cost.

The OECD version contains sub article 5 which is missing in the U.N version. According to sub article, no profit shall be attributable to mere purchase of goods or merchandise by PE for head office. In concluding DTA's with treaty partners, the OECD version was adopted in all respect. In a business of buying and selling, purchasing activities is a key

component business which deserves to be remunerated. Kenya stands to lose tax thanks to the provisions of the treaties signed.

#### 4.6.4 Article 9: Associated Enterprises

Article 9 of OECD model tax convention requires associated enterprises to embrace the principle of arms length while undertaking transactions among themselves. In sub article 1, conditions for enterprises to qualify as associated enterprises are set out. These conditions include a case where an enterprise participates in the management, control or capital of the other enterprise. Where conditions under which they relate in financial or commercial aspects differ from those which would be made between independent enterprises, then, any profits that would be lost as a consequence of these conditions shall be taxed on the enterprise in that tax jurisdiction.

Sub article 2 provides for corresponding adjustment. This arises where a State pursuant to sub article 1 makes a tax adjustment on an enterprise, the associated enterprise in the other state will be expected to make a corresponding adjustment equivalent to the tax adjusted in the first mentioned state. The UN model includes sub article 3, which limits the operations of sub article 2. This will be the case where judicial proceedings have been instituted against one enterprise and the final determination gave rise to a profit adjustment and one of the enterprises is penalized having been found guilty of fraud, gross negligence or willful default.

Kenya does not appear to have taken a uniform approach to the question of corresponding adjustment. For instance, the DTA with Canada adopted the UN model while all the rest except Sweden adopted the OECD model. The DTA between Kenya and Sweden does not

ave sub article 2 which means a Swedish multinational operating in Kenya may not have a legal basis for applying for a corresponding adjustment in either Kenya or Sweden. This will inevitably lead to double taxation and therefore the DTA should be updated to ensure that the multinational as a whole is not overtaxed.

#### 4 6.5 Article 21, Other Income

This Article is very important in that it gives direction on the treatment of incomes not covered in other articles. In sub article 1, such incomes shall be taxable in the source state.

**Sub** article 2 further limits the operation of sub article 1 to income from immovable property.

**The** UN model contains sub article 3 which allows the other state to tax the same income if **its** municipal laws so provide.

Kenya did not adopt a uniform approach in the DTA's entered into with other states. While **it is** generally stated in all the DTA's that incomes not specifically mentioned in the articles should be taxed by the state in which the taxpayer is resident, in accordance with article 21(1) of the OECD and UN models, the limitation under sub article two was adopted differently. The Canada<sup>237</sup> and India<sup>238</sup> DTA's provide that such incomes could also be taxed by that other state if their municipal laws allow. The Germany<sup>239</sup>, Norway<sup>240</sup>, Denmark<sup>241</sup>

<sup>1</sup> Article XXII, Para 2

<sup>31</sup> Article 24 (2)

Article 21

Article 23

' Article 23

the UK<sup>242</sup> DTA's do not limit the incomes that may be taxed by the resident state to income from immovable property. Therefore, in addressing the issue of incomes not covered by the specific articles, neither the OECD nor the UN model is fully adopted.

#### **4.6.6 Article 26; Exchange of Information**

This article provides for exchange of information on taxes imposed in contracting states. This function is carried out by Competent Authorities of the two states. Such information cannot be disclosed to other parties other than those involved in tax administration and the courts of law. The information cannot be used for any other purpose other than for tax. The UN model on exchange of information (article 26) is similar to the OECD model. All DTA's entered into by Kenya contains this article.

#### **4.7 Tax Information Exchange Agreements (TIEA's)**

Transfer pricing audits heavily rely on documentation generated in a transaction between the related parties. Some of the relevant information may be in the other tax jurisdiction and therefore not available to the party under audit. The situation is even more serious where the party under audit has no controlling interest in the other party. If the two countries have a DTA, it is possible to remedy the situation by invoking the exchange of information article. The competent authority would request for the relevant information and the competent authority of the other state will be obligated to provide the information.

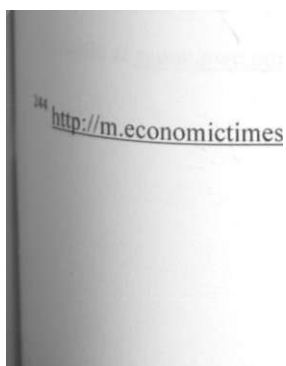


ya has very limited DTA network and therefore exchange of information through DTA only be invoked in limited cases. The Tax Information Exchange Agreements allows the parties in the agreement to exchange tax information that is foreseeable relevant to the administration for enforcement of domestic law. Kenya has initiated TIEA's with a number of countries, (APPENDIX XII) mainly from low tax jurisdictions, with information secrecy laws. Once the agreements are ratified, Kenya will be able to obtain tax information from the respective jurisdictions to test the compliance by the taxpayer for arms length principle.

#### **4.8 Multilateral Convention on Mutual Administrative Assistance in Tax Matters**

This convention was initiated by the OECD and the council of Europe to facilitate the administrative co-operation among its member countries to counter international tax evasion more effectively.<sup>243</sup> The convention goes beyond the exchange of tax information by including assistance in tax recovery, the service of documents and facilitation of joint audits. The membership to this convention is now open to all countries to reflect modern international standard of exchange of information for tax purposes. To ensure that the convention operates effectively, member countries participates in the coordinating body on an equal basis. To-date, the convention has 56 members including India and China. China was the last to join which happened on the 27 of August 2013.<sup>244</sup> Beside this, a number of

OECD and Council of Europe (2011): *The Multilateral Convention on Mutual Administrative Assistance in Tax Matters*: Amended by the 2010 Protocol, OECD Publishing. Paris. Available at: <http://dx.doi.org/10.1787/9789264115606-en>



countries including Kenya have expressed interest in signing the convention. The

benefit of this convention is that once Kenya has signed, it will be able to exchange tax information with a large network of membership. It is an easier means of exchanging information without resorting to DTA's or TIEA's.

#### **4.9 Challenges faced in Kenya in the Administration of Arms Length Principle.**

##### **1 Transfer Pricing Legislation**

The Income Tax (Transfer pricing) Rules 2006, were enacted after KRA lost the first transfer pricing case to Unilever Kenya Limited in 2005. The framework of the rules was largely based on the OECD transfer pricing guidelines 1995.<sup>24</sup> The rules however failed to include some very important aspects of transfer pricing thereby rendering the operation of the arms length principle extremely difficult. These challenges are as enumerated below.

##### **4.9.2 Scope of the Rules**

The scope of the rules is set out in paragraph 5 of the rules to cover transactions between associated enterprises and between a PE and its head office. Strictly speaking, all transactions between related parties irrespective of the value should comply with the arms length principle. Transfer pricing is inherently complex and transfer pricing audit can be expensive

<sup>24</sup> PricewaterhouseCoopers (2011): *Transfer Pricing and Developing Countries- Kenya*. P.25

Available at [www.pwc.com/en.../transfer\\_pricing.pdf](http://www.pwc.com/en.../transfer_pricing.pdf)

time consuming for both the taxpayer and the tax administration.<sup>246</sup> There is therefore need to define the minimum value of transaction that should be subjected to transfer pricing requirements. For instance, it is not economical to subject low value transactions to transfer pricing requirements.

### 93 Consanguinity and Affinity

An amendment to section 18(6) of ITA in 2010 brought parties related by blood (consanguinity) and marriage (affinity) under the transfer pricing rules. The terms are, however, not defined in the Act and therefore may be interpreted differently by different taxpayers leading to ambiguity of the terms. In an African set up, the definition of a family often extend to people remotely related. Applying this concept in a transfer pricing scenario may not be practical. Regarding transactions between such people as controlled transaction would be virtually subjecting every transaction to transfer pricing. For instance, Brazil defines related party inter alia as an individual resident in another tax jurisdiction relative to the third degree, spouse or partner of any director, member or controlled shareholder in a direct or indirect way of the Brazilian entity.

### 94 Definition of Permanent Establishment

The term Permanent Establishment is defined in section 2 of Income Tax Act. This definition is restricted to fixed place of business and a construction site. The definition of PE contained in DTA's is wider than this definition in the sense that besides fixed place of business PE and

United Nations (2013): *United Nations Practical Manual on Transfer Pricing for Developing Countries*. UN Publishing New York. P 278, Para 8.1.1

construction site PE, it also covers dependent agency PE. In principle, treaties do not confer taxing rights to a party for taxes not covered in the taxing Act. Therefore, Kenya may not succeed in enforcing taxes arising from income earned by a PE of a dependent agent in Kenya. In the reverse, a Kenyan multinational operating as a PE in a partner state will be taxed on income it earned in that other state as a PE pursuant to the DTA if the definition in its municipal law provides for it. The risk here is that it is possible for an enterprise in another state to arrange its affairs in a way to result to a PE in Kenya of a dependent nature and escape taxation in Kenya.

#### **4.95 Tax Havens**

Kenya lacks adequate transfer pricing legislation to deal with parties operating in tax havens. Section 18(3) of the ITA and the rules define controlled transaction as transaction between associated enterprises. However, there exists a challenge where one of the parties to a transaction is located in a tax haven. A party in a tax haven will disguise as a third party and transact with a related party because, the secrecy laws in tax havens make a proper identification of parties to a transaction difficult. There has been an increasing trend in Kenya where purported third party service and financial providers are located in tax havens. There is a need to amend the rules to deal with tax leakages arising from disguised third parties operating from tax havens. For instance, Brazil includes transactions with parties in tax havens as controlled transaction irrespective of their relationship (supra).

#### **4.96 Lack of safe harbour rules**

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Documentation compliance for transfer pricing purposes in Kenya is a big issue. Many payers do not maintain adequate documentation necessary for determination whether the

taxpayer complies with the arms length principle. The compliance with documentation may not only be expensive to taxpayers, but also imposing significant burden on the taxpayers. To encourage compliance, small to medium size enterprises in some tax jurisdictions are allowed to operate within specially designed safe harbour rules. Safe harbour rules are simple set of rules under which if adhered to, the transfer prices would be automatically accepted by the national tax administration. For instance, applying a simplified transfer pricing method approved by the Tax Authority, or meeting specific information reporting and documentation on controlled transactions, the taxpayer is exempted from observing full requirements of the transfer pricing legislation.

Kenya urgently needs safe harbour rules to reduce compliance cost on small to medium size taxpayers. The concept of Safe harbour has gained popularity in many countries. Under the safe harbor regime, for instance, Australia allows a mark-up of 7.5% on inter-company services; Switzerland has a safe harbor for interest charged on intercompany loans, with different rates for loans financed through equity and loans financed through debt; New Zealand accepts recharge of cost plus 7.5% for intra-group core services<sup>247</sup>

#### **49.7 Advance Pricing Agreement ("APA")**

Transfer pricing legislation in Kenya so far does not provide for APA. Under the APA regime, taxpayers may enter into an agreement with the Revenue Authorities to determine the Arm's Length Price ("ALP") in relation to its cross-border transactions for a specified period of time. This scheme is particularly important in case of small taxpayers who may be over

<sup>247</sup> Ernst & Young (2013): Transfer pricing: safe harbors on the horizon? [www.ey.com](http://www.ey.com)

burdened by the high cost and complexity of compliance with the arms length principle, the scheme specifies the manner, form and procedures of APA applications, it at the same time sets out consequences for non disclosure of material facts. APA is used in many countries as a tool for reducing litigation cases and promoting certainty to the taxpayers in respect of their transfer pricing policies. Similarly, tax administration will be certain as to revenue as long as the taxpayer keeps to the scheme. In Australia, for instance, the Australian Tax Office (ATO) promotes the use of APA by well established programs for both bilateral and unilateral APA<sup>248</sup>. Since 1<sup>st</sup> January 2011, it is possible to apply for a unilateral, binding, appealable advance ruling issued by the competent tax office on the tax treatment of a particular (but yet-to-occur) transfer pricing issue. The fee for such a unilateral APA amounts up to EUR 20,000<sup>249</sup>.

In Belgium, the 2003 corporate tax reform introduced a general ruling practice under Belgian tax law. Additional guidance in this respect is provided through various Royal Decrees. In Canada, APA dates back to July 1993. The Canadian Revenue Agency charges taxpayers only travel costs it incurs in the completion of an APA. APA's do not cover periods under transfer pricing audits<sup>251</sup>. APAs are available in China. Guidance regarding the APA process

<sup>248</sup> Ernst & Young (2011): Transfer Pricing Global Reference Guide. P. 13

<sup>249</sup> .

Ernst & Young (2011): Transfer Pricing Global Reference Guide. P. 15

<sup>250</sup> Ernst & Young (2011): Transfer Pricing Global Reference Guide. P. 19

<sup>251</sup> Ernst & Young (2011): Transfer Pricing Global Reference Guide. P. 25

**d procedures** is provided in Articles 46 through 63 of Guoshuifa (2009) No. 2.<sup>2>2</sup> Other countries embracing APA include: Colombia (2003), Czech Republic (2006), Denmark (Unilateral APA), Egypt, Finland and France (2005).

#### **498 Lack of Penalties for Non-compliance with Transfer Pricing Reporting Requirement**

**Income** tax (transfer pricing) rules 2006, provides for specific documentation to be **maintained** by the taxpayer. Paragraph 10 requires the taxpayer to develop a transfer pricing policy, determine the price and produce the document when called upon to do so by the **Commissioner**. The emerging trend in Kenya is that many taxpayers start developing transfer pricing policies when the Commissioner has called for them, to justify prices for past **transactions**. A good number of taxpayers end up developing a substandard transfer pricing policy or not submitting one at all.

Many tax jurisdictions have imposed varying levels of penalties to ensure proper maintenance of transfer pricing documentation. For instance, Indian transfer pricing regulations require the filing of a Transfer Pricing Accountant's Report annually disclosing the international transactions and select details. The penalty for non-furnishing of an Accountant's report was limited to Rs 100,000 (USD 2,000 approx). From 2012, in case of failure on the part of the taxpayer to report any transactions or maintaining or furnishing ^correct information or documents as required under transfer pricing regulations, the penalty

Ernst & Young (2011): Transfer Pricing Global Reference Guide. P. 30

...c increased to 2% of the international transaction value under review. If there is no documentation, then the 2% penalty could be levied on the total transaction value, including domestic transactions.<sup>253</sup> China has also introduced an interest levy and a special penalty regime on underpaid tax for transfer pricing adjustments.<sup>254</sup>

**Argentina** imposes penalties ranging between 100% and 400% for unpaid taxes from international transactions<sup>255</sup>. For the late filing of tax returns concerning other international transactions, the taxpayer will be fined ARS20, 000. For the application of penalties related to late filing or lack of filing, it is irrelevant whether the transactions were at arm's length. For non-compliance with the formal duties of furnishing information requested by the AFIP, the taxpayer faces fines up to ARS45, 000. The same applies to a failure to keep vouchers and evidence of prices on available files and failure to file tax returns upon request. If tax returns are not filed after the third request, and the taxpayer has income amounting to more than ARS10 m, the fine is increased from ARS90, 000 to ARS450, 000 (supra).

The current penalty regime in Kenya works well when the taxpayer is under audit. In many instances, the Commissioner will call for certain records to enable it risk profile cases long before the decision whether the case will be audited is made. A penalty regime like the one

<sup>3</sup> Transfer pricing associates (2012), *India transfer pricing updates*. P.2. available at [www.tpa-haUom/.../2012/.../india](http://www.tpa-haUom/.../2012/.../india)

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Deloitte & touche Tohmatsu CPA Ltd (2009): *New Transfer Pricing requirements in China*. Frequently  
pwd questions

' Ernst & Young (2011): *Transfer Pricing Global Reference Guide*; P 9



applicable in India will ensure maintenance and prompt production of documents whenever required by the Commissioner.

#### 4.9.9 Application of methods

Paragraph 7 of the Income Tax (transfer pricing) rules prescribe methods that may be used to determine the arms length price. In applying the methods, there is a possibility that a taxpayer may arrive at a range of arms length prices or margins from the comparable enterprises selected for benchmarking. Sometimes, the range of price or margin derived is so wide that the difference between the lowest price or margin and the highest ones translates to large figures of revenue. The taxpayer will be justified to place its business results on any point in the range. A taxpayer will always place itself at the lowest point in the range to prove that the price or margin being declared is at arm's length. This gives rise to a situation where two enterprises with similar functions, risks and assets end up with different prices or profitability levels.

The current transfer pricing legislation has not addressed this issue, and is therefore a challenge to the administration of arms length principle. Some countries have made specific legislation to specify the acceptable point in the range. For instance, in China, article 41 of the STA rules provides for a transfer pricing adjustment where the enterprises profit level is lower than the median of the inter-quartile range established by the comparables<sup>236</sup>.

<sup>236</sup>Deloitte & Touche (2009): *New Transfer Pricing Requirement in China*: frequently asked questions

#### **49.10 Capacity**

formed a fully devoted transfer pricing audit team in 2009 based at the large Taxpayers Office. Since then there has been a good attempt to increase capacity in transfer pricing by exposing transfer pricing auditors to training both at local and international levels. A limited number of tax auditors were initially selected who would be trained and in turn train the rest of the staffs both at LTO and across other departments. Due to limited resources, KRA is not able to finance expensive trainings and in most cases rely on the OECD/IFC sponsored transfer pricing workshops. This exposure is not sufficient especially as pressure to raise more revenue mounts.

**The** manner in which trainings for officers outside the main transfer pricing audit groups are coordinated is equally wanting. Best practice advocates for consistent and intensive training for a specific numbers of staff to ensure they obtain the required level of skills and competence. The K.R.A approach has been to expose a large number of staff to transfer pricing at basic level thereby failing to achieve the required levels of competence. The tragedy with this approach is that these officers may waste a good transfer pricing case due to limitation in the required level of knowledge.

Due to the complexity of transfer pricing cases, almost every additional assessment raised following transfer pricing audits ends up being objected to. Pursuant to section 86(1) b of the TA, a taxpayer may appeal to the local committee against the Commissioner's determination of the objection. All transfer pricing appeal cases ends up in the local committee. The Local Committee members are not trained in transfer pricing and in many occasions, have indicated <sup>ha\*</sup> transfer pricing issues are too complex for their current level of skills in tax. This poses a <sup>ns</sup>k in the sense that some decisions made at the local committee may not be founded upon

sound reasoning. For instance, this was the case in the Unilever case , where the Judge observed thus; *Unfortunately, I do not have the benefit of the reasoning by the local committee, and am bound therefore to consider this appeal in terms of the arguments advanced before me.* The local committee in this case had allowed an assumed Export processing Program Office (EPPO) benefit for the year of income 1995 and 1996. There is therefore need to built capacity among the local committee members because this is the only forum where facts could be exhaustively dealt with.

**Similar** capacity issue is likely to play out in the Kenya's judiciary largely contributed by the manner in which the judiciary is structured. Tax appeals are dealt with at the Commercial Court which also handles other matters of commercial nature. This court lacks specialization in tax law. It is worth to note that some of the most successful jurisdictions in transfer pricing like the U.S and Germany have specialized tax courts presided over by judges specialized in tax law. In addition to tax courts, it may be necessary to sensitize the judges on complex issues of transfer pricing.

#### **4.9.11 Comparables**

Central in the administration of the arms length principle is the comparability analysis. Comparability analysis consists of analyzing information on transactions with or between third parties to be used as comparable prices or margins for benchmarking related party transactions. So far, Kenya does not have locally generated data for benchmarking which

*Unilever Kenya limited v The Commissioner of Income Tax* income tax appeal no. 753 of 2003, p 12

calces taxpayers and KRA to rely on foreign data-bases. Transfer pricing rules do not prescribe any preferred data-base. Therefore the taxpayer is at liberty to use any. KRA subscribed to Orbis data-base in 2011 which has information of over 100 million private companies, 65 thousand listed companies and around 90 million individuals.<sup>278</sup> Many taxpayers in Kenya use Amadeus which is a sub-set of Orbis. Because of the inherent defects in **foreign** data bases, the comparables derived end up not giving desirable results due to the difficult in determination of appropriate adjustment for economic circumstance.

KRA officers come across a lot of information relevant for benchmarking in their course of work. This information is only available to the tax administration by dint of section 125(1) of ITA, ~<sup>9</sup>and if used would result to what is referred to as secret comparables. A secret comparable generally means the use of information about a taxpayer by the Tax Authority to form a basis of risk assessment of another taxpayer where the second taxpayer is not given access to that information as it may reveal confidential information about competitors operations.<sup>260</sup> Although the Income Tax transfer pricing rules is not express about secret comparables, the rules of procedure requires that *he who avers must prove* meaning that the Commissioner must provide the taxpayer with the data it has used to determine the arms length price or margin. This means that secret comparables cannot be used by the

Orbis database is compiled by Bureau van Dijk. Details are found at: <http://www.bvdinfo.com>

<sup>239</sup> Section 125. (1): An officer and any other person employed in carrying out the provisions of this Act shall regard and deal with all documents and information relating to the income of a person and all confidential instructions in respect of the administration of the Income Tax Department which may come into his possession **Jto** his knowledge in the course of his duties as secret.

United Nations 2013: United Nations Practical Manual on Transfer Pricing for Developing Countries. P 21, Par a 1.6.14

Commissioner. This being the case, comparables for use in benchmarking remains one of the nearest challenges in the administration of the arms length principle.

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Many countries have developed local data bases which are ranked first relative to other comparables for comparability purposes. A taxpayer is therefore not allowed to use any other source before demonstrating that no comparable could be found in the local database. For instance, China requires the use of Chinese comparable companies. Information and other financial data regarding Chinese public companies are available in Shanghai and Shenzhen stock markets. The BVD data base has also been cited as a possible source of comparables vide the circular Guo Shul Han (2005) No. 239.<sup>261</sup>

In Thailand, audited financial statements lodged by all registered (private and public) companies with the Thai Ministry of Commerce are available through the online data base.

In Portugal, the relatively small economy makes comparative data for independent companies unavailable. The taxpayers use SABI data base covering Portuguese and Spanish companies.<sup>263</sup> In Russia, the tax code provides that the exchange quotations and official sources of information should be used to determine the market price. Although the tax code does not define the phrase "official sources of information", the Russian Federal and

<sup>61</sup> Deloitte & Touchy (2008): Strategy Matrix for Global Transfer Pricing; Planning for Methods, Documentation and Other issues. P 57. Available at [www.deloitte.com/.../dtl-tax-str...](http://www.deloitte.com/.../dtl-tax-str...)

\*Deloitte & Touche (2008): Strategy Matrix for Global Transfer Pricing; Planning for Methods, documentation and Other issues, p 53 Available at [www.deloitte.com/.../dtl-tax-str](http://www.deloitte.com/.../dtl-tax-str)

Deloitte & Touchy (2008): Strategy Matrix for Global Transfer Pricing; Planning for Methods, Mentation and Other issues. P 58 Available at [www.deloitte.com/.../dtl-tax-str](http://www.deloitte.com/.../dtl-tax-str)

Journal Arbitrage Practice, the official sources of information may consist of data received from the State Statistical Committee, information from Newspapers, bulletins (from any international organization) and other sources of information<sup>264</sup>. Kenya may perhaps begin by adopting the Russian type of sources which are generally available at limited cost.

#### 4.9.12 Alternative Dispute Resolution (ADR)

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ADR is defined as a procedure for settling a dispute by means other than litigation<sup>65</sup>. Examples of ADR include arbitration and mediation. ADR is particularly important in countries lacking strong and independent judicial system coupled with inadequate expertise in tax matters<sup>266</sup>. The nature of transfer pricing tax assessments is that the issues are complex, contentious and time consuming and therefore not appropriate for litigation. Transfer pricing legislation in Kenya does not provide for ADR framework which makes it difficult for KRA to negotiate a settlement on contentious issues outside litigation.

<sup>264</sup>

Deloitte & Touche (2008): Strategy Matrix for Global Transfer Pricing; Planning for Methods, Documentation and Other issues. P 58 Available at [www.deloitte.com/.../dtt-tax-str](http://www.deloitte.com/.../dtt-tax-str)

<sup>265</sup> Bryan, A. G. (2007). *Black's Law Dictionary*. 8<sup>th</sup> Ed. P.86

<sup>66</sup> United Nations (2013): *United Nations Practical Manual on Transfer Pricing for Developing Countries*. U-N Publishing, New York. P 325, Para 9.1.1.2

## CHAPTER FIVE

### 5.0 CONCLUSIONS AND RECOMMENDATION

The study sought to interrogate the extent to which the OECD transfer pricing guidelines are applicable within the Kenya's tax legal regime. To address this issue, the study focused on a number of areas: First, the research looked into the history of transfer pricing in Kenya setting out the stages through which transfer pricing legislation has undergone and the challenges so far encountered in the administration of the arms-length principle. Secondly, the study focused on the content of the OECD Transfer Pricing guidelines bringing out similarities and differences with the Kenya's Income Tax (Transfer Pricing) Rules 2006 and subsequent amendments. Thirdly, all the DTA's currently in force in Kenya were evaluated to establish whether they were modeled along the OECD or UN Model Tax Convention. This was necessitated by the fact that the OECD Transfer Pricing guidelines, the OECD Model Tax Convention and the U.N model tax convention subscribe to the arms length principle. Finally, the Income Tax Transfer Pricing rules and the OECD transfer pricing guidelines were analyzed and compared to bring out the differences and similarities. The study also took a comparative perspective during which transfer pricing experiences of India, Brazil, South Africa, and the U.S were studied for derivation of useful lessons for Kenya.

#### 5.1 Conclusion

The starting conclusion is that the OECD Transfer Pricing guidelines are recognized international benchmarks widely accepted by many countries in the world as stated in the

lever case . This is contributed by the extensive work done by OECD occasioned by the challenges experienced by developed countries. The UN Manual recognized that most of the western countries at the time the initial guidelines were being crafted faced similar challenges to those being faced by developing countries . To that extent, developing countries could draw some lessons from the OECD transfer pricing guidelines. It is however noted that even the so called developed countries continue to face significant challenges due to the uncertainty in the guidelines. Moreover, it is evident that a number of those countries only allow the use of comparables from specified sources to enhance accuracy. It is therefore catastrophic for Kenya to admit comparables from all over the world in the determination of its taxes.

Sufficient evidence exists to show that some major economies have already drifted from adherence to strict arms length principle as prescribed OECD, to a system that fits their local circumstances. For instance, China, India and Brazil operate a diluted form of arms length suitable for their economies. This appears to be the only option available to Kenya in order to protect its tax base effectively. However, to achieve this objective, the following interventions are necessary:

## 5.2 Scope of the Rules

A pragmatic approach to the application of the rules should be made by defining the value above which transfer pricing requirements should be observed. Subjecting small value transaction to full transfer pricing requirements is overburdening the taxpayer involved in the

<sup>Su</sup>Pra, p. 13

<sup>S</sup> N (2013): *UN Practical Manual on Transfer pricing for developing countries*. U.N Publishing. New York.

<sup>P</sup>. Para 1.8.10



transaction. In defining this aspect, regard should be had to the potential loss of revenue and cost effectiveness to the taxpayer.

### **5.3 Consanguinity and Affinity**

The term consanguinity and affinity should be defined in a manner that limits their application to third degree relationship. Any tax planning happening beyond this point may be dealt with under the general anti avoidance provision. The definition of the terms will lead to certainty in the application of the term.

### **5.4 Definition of Permanent Establishment**

The definition of the term *Permanent Establishment* Tax under the Income Act should be amended in line with the definition in DTA's. Incidentally, the definition of PE in the DTA's is similar to the definition in both OECD and the UN model. This will ensure that MNE's do not establish PE's of dependent agent in Kenya to avoid tax in Kenya.

### **5.5 Tax Havens**

It is recognized that tax havens remain a big challenge in the effort to curb profit shifting in many parts of the world. For instance, a study by Fuest and Riedel 2010, quoted by OECD <sup>269</sup>, presents some empirical evidence which supports the view that profit shifting out of many developing countries into tax havens indeed takes place. It is therefore important to revisit some of the fundamentals of the existing standards to be able to curb profit shifting effectively.

OECD (2013). *Addressing Base Erosion and Profit Shifting*-. OECD Publishing. Paris. P. 68 Available at <https://doi.org/10.1787/9789264192744-en>

The risk of tax shifting does not only exist between related parties but also disguised independent parties in tax havens. The existence of secrecy laws in tax havens enables related parties hide their identity from the tax administration and disguise as independent parties. This has necessitated the UN Tax Committee in its eighth session held in Geneva to agree to proceed with drafting a new article for its model convention that will make provision for countries to tax payments for technical services, management and consultancy fees, made to persons resident in third party countries like tax havens.

There is an increasing tendency for many service providers to Kenya to operate from Mauritius and other low tax jurisdictions like Liechtenstein, where it is difficult to establish their capacity to provide the service. To deal with this problem, related party definition under the transfer pricing rules should be expanded to include parties operating in tax havens. A number of countries have already adopted this approach for instance Argentina, Brazil, Kazakhstan, Portugal and Poland. For this reason they define related parties for the purpose of transfer pricing to include parties operating in tax havens.<sup>270</sup>

### **5.6 Safe harbour rules**

Safe harbor rules should be put in place particularly for medium to small size taxpayers. Reasonable margins and prices should be set to be applied by enterprises wishing to operate under the safe harbor regime. Documentation requirement should also be simplified to in a manner that it does not cause unnecessary cost and time to small and medium taxpayers. Sufficient safeguards should however be put in place to ensure that the rules are not abused through tax planning.

<sup>20</sup> Deloitte & touche (2008): *Strategy Matrix for Global Transfer Pricing*. Available at [deloitte.com/...Global/...dtt...](http://deloitte.com/...Global/...dtt...)

## 5.7 Advance Pricing Agreement ("APA")

There is need to incorporate APA in the transfer pricing legislation to facilitate compliance by small and medium size taxpayers. The scheme may also cover complex transfer pricing issues across the board. This will not only promote voluntary compliance by the taxpayer but also guarantee KRA of steady revenue and less administration burden. Most OECD countries like the U.S, Canada, Germany, Australia and U.K embrace the concept of APA. Non OECD member countries like China, Taipei, Egypt, India Malaysia, Singapore, Venezuela,

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Columbia Indonesia, Peru Kazakhstan, and Romania also embrace the concept of APA . With APA, KRA will be able to direct its limited resources to more focused audits based on risk.

## 5.8 Lack of Penalties for Non-compliance with TP Reporting Requirement

There is need to design an effective transfer pricing penalty regime in line with international best practices. Besides the penalties prescribed in the Act, there should be a separate set of penalties dealing with documentation issues whether the taxpayer is under audit or not. For instance, in Germany, a penalty regime was established under section 162 of the General Tax Code in 2003 effective 2004, where, in case the taxpayer presents documentation late, penalties of up to one million Euros is applicable, with a minimum of 100 Euros for each day after the 60 day time limit<sup>272</sup>. Argentina, Brazil, China, Columbia, Ecuador, Finland,

<sup>271</sup> OECD (2012): *A draft Advance Pricing Arrangements: Approaches to legislation*. OECD Publishing. Paris.

P.3

<sup>12</sup> Transfer pricing associates (2013), *Germany transfer pricing country summary*. P 2. Available at [www.tpa-bal.com](http://www.tpa-bal.com)

Indonesia, Japan, Kazakhstan, Malaysia and Venezuela impose penalties of between 75% **and** 100% of all transfer pricing adjustments .

The current penalty and interest regime is further weakened by the fact that under section 94(4) of ITA, a taxpayer can apply for waiver of the same and usually, most of the penalties and interest is waived. Such penalties and interest should be excluded from waiver to encourage compliance with transfer pricing legislation.

### **5.9 Application of Methods**

To ensure that similar enterprises pay same levels of tax, transfer pricing rules should be amended to require enterprises return profits that is consistent with the measures of central tendency (mean mode or median). For instance, India only accepts results calculated as arithmetic mean with a 3% tolerance level.<sup>274</sup> A more flexible approach is to allow the use of inter-quartile range. Under this approach, a taxpayer can only place itself in the inter-quartile range and this will create equity for enterprises with similar functions, assets and risks.

The other issue relating to the application of the arms length range is whether a taxpayer should be allowed to adjust the profit or the price in the event that the actual price or profit

<sup>273</sup> Ernst & Young (2012): *Global Transfer Pricing Tax Authority Survey; perspective, interpretations and regulatory change*. P 11. Available at: [www.ey.com/.../2012-Global...survey](http://www.ey.com/.../2012-Global...survey)

<sup>274</sup> United Nations (2013): *United Nations Practical Manual on Transfer Pricing for Developing Countries*. U.N Publishing. New York. P 386, Para 10.4.5

achieved is above the minimum prescribed, for instance, the mean of the sample. For illustration purposes, assume the law allows the taxpayer to be at any point in the inter-**quartile** range. If the inter-quartile range of profit margin is 3% to 7%, should a taxpayer whose profit margin is 6% be allowed to adjust the margins to 4% because it would still be within the range? There should be a legal requirement that when the taxpayers' actual result is above the minimum required, no down ward adjustment should be allowed.

When selecting comparables, care should be taken to avoid comparables in perpetual losses. Whereas it is possible for enterprises to make losses, it is reasonably expected that perpetual loss making enterprises will ultimately close down. Taxpayers include loss making enterprises in their comparables to bring down the overall profit margin. Therefore where multiple year data is applied, no comparable should be allowed with more than one year of loss.

Enterprises may operate more than one unrelated business lines. While benchmarking using net profit margin, it may be difficult to determine the contribution of each business segment. If the focus is on one segment it may be necessary to establish its profitability levels using the available information. Where reliable information is not maintained it may be extremely difficult for the tax administration to establish the arms length status of the business segment. It should therefore be a legal requirement for taxpayers to maintain segment account that sufficiently explain the arms length status of the business segment.

## **5.10 Capacity**

There is need to enhance transfer pricing skills among the officers in transfer pricing audit teams. This may be done by sending transfer pricing auditors to more advanced tax authorities for on-the-job training. More advanced courses in transfer pricing may be necessary especially those designed and facilitated by OECD. A more coordinated approach to training should be adopted to ensure consistency to achieve the required levels of skills. Capacity building may also be extended to the members of the local committee to increase their understanding in transfer pricing. As more and more tax appeals are filed in court, there may be needed the establishment of a specialized tax court to deal with tax matters and in particular transfer pricing cases.

## **5.11 Comparables**

The challenges associated with the absence of comparables will be resolved when a local data base is developed. Appropriate law should be put in place to compel all companies to file annual audited accounts with the registrar of companies. A data base may be developed from such documents and made available to taxpayers and KRA.

## **5.12 Alternative Dispute Resolution (ADR)**

Transfer pricing audits are generally time and resource intensive<sup>275</sup>. It is in the interest of both the taxpayers and KRA to settle tax disputes expeditiously and in amicable manner. This can be achieved if both parties embrace ADR when resolving transfer pricing related

United Nations 2013: *United Nations Practical Manual on Transfer Pricing for Developing Countries*. U.N Publishing, Paris. P 278, Para 8.1.3

disputes. In an ADR situation there is no loser or winner and both parties are required to make compromises to resolve the issues before them. The current transfer pricing legislation does not provide for ADR and many transfer pricing cases end up in courts. Due to the complexity of transfer pricing issues courts may not have the required capacity to deal with them. Complexity of issues notwithstanding, generally, litigation is expensive and prone to laborious procedures, which sometimes results to issues being decided on technicalities. There is therefore need for ADR to be entrenched in the law to provide an alternative avenue for both the taxpayer and KRA to resolve amicably transfer pricing disputes.

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*Sara Lee Household & Body Care Kenya Limited v Commissioner of Income Tax* (2003)  
AP.543

*PPG Industries v Commissioner*, 55 T.C 928 (1970)

## APPENDIXES

### APPENDIX I- Versions of Section 18(3) Before and After Amendments

"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."

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"Where a non-resident person carries on business with a related resident person and the course of that business is such 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."<sup>276</sup>

<sup>276</sup> Finance Act no. 10 of 2010 s.24

**APPENDIX II - Countries and Corporations Classified According to Value Added/GDP**

(Billion dollars) in 2000

1 USA	9.882,8	51 Bangladesh	47,1
2 Japan	4.677,1	52 UAE	46,5
3 Germany	1.870,1	53 <i>General Motors</i>	46,2
4 United Kingdom	1.413,4	54 Hungary	45,6
5 France	1.286,3	55 <i>Ford Motor</i>	45,1
6 China	1.076,9	56 <i>Mitsubishi</i>	44,3
7 Italy	1.068,5	57 <i>Mitsui</i>	41,3
8 Canada	689,5	58 Nigeria	41,1
9 Brazil	595,5	59 <i>Citigroup</i>	39,1
10 Mexico	574, 5	60 <i>Itochu</i>	38,4
11 Spain	555,0	61 <i>DaimlerChrysler</i>	37,5
12 India	474,3	62 <i>Royal Dutch/Shell</i>	37,3
13 Korea, Rep.	457,2	63 <i>BP</i>	37,0
14 Australia	394,0	64 Romania	36,7
15 Netherlands	364,9	65 <i>Nippon T&amp;T</i>	36,1
16 Argentina	285,0	66 Ukraine	35,3
17 Russia	251,1	67 Morocco	33,5
18 Switzerland	240,3	68 <i>AXA</i>	32,5
19 Belgium	231,0	69 <i>General Electric</i>	32,5
20 Sweden	227,4	70 <i>Sumitomo</i>	31,9
21 Turkey	199,9	71 Vietnam	31,3

22 Austria	191,0	72 <i>Toyota Motor</i>	30,4
23 Hong Kong	163,3	73 Belarus	29,9
24 Poland	162,2	74 <i>Marubeni</i>	29,9
25 Denmark	160,8	75 Kuwait	29,7
26 Indonesia	153,3	76 <i>Total Fina Elf</i>	26,5
27 Norway	149,3	77 <i>Enron</i>	25,2
28 Saudi Arabia	139,4	78 <i>ING Group</i>	24,9
29 South Africa	125,9	79 <i>Allianz Holding</i>	24,9
30 Thailand	121,9	80 <i>E.ON</i>	24,3
31 Venezuela	120,5	81 <i>Nippon life insurance</i>	23,8
32 Finland	119,8	82 <i>Deutsche Bank</i>	23,5
33 Greece	112,0	83 AT&T	23,1
34 Israel	110,3	84 Verizon Comm.	22,6
35 Portugal	103,9	85 US Postal Service	22,6
36 Iran	99, 0	86 Croatia	22,4
37 Egypt	98, 7	87 <i>IBM</i>	22,1
38 Ireland	94, 4	88 CGNU	21,5
39 Singapore	92,3	89 JP Morgan Chase	21,0
40 Malaysia	89,7	90 Carrefour	21,0
41 Colombia	81,3	91 Credit Suisse	20,8
42 Philippines	74,7	92 Nissho Iwai	20,5
43 Chile	70,5	93 Bank of America Corp	20,2
44 <i>Wal-Mart Stores</i>	67,7	94 BNP Paribas	20,2
45 Pakistan	61,6	95 <i>Volkswagen</i>	19,7

46 Peru	53,5	96 Dominican Republic	19,7
47 Algeria	53,3	97 Uruguay	19,7
48 <i>Exxon</i>	52,6	98 Tunisia	19,5
49 Czech Republic	50,8	99 Slovak Republic	19,1
50 New Zealand	50,0	100 <i>Hitachi</i>	19,0

Source: World Bank and Fortune Magazine at [www.econ.kuleuven.be/pdf](http://www.econ.kuleuven.be/pdf)



## **APPENDIX III: The Current Version of Section 23 of Income Tax Act**

### Section 23 of ITA

*" Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for a year of income or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction "*

*(2) Without prejudice to the generality of the powers conferred by subsection (1), those powers shall extend -*

*(a) to the charging to tax of persons who, but for the adjustments, would not be charged to the same extent;*

*(b) to the charging of a greater amount of tax than would be charged but for the adjustments.*

*(3) A direction of the Commissioner under this section shall specify the transaction or transactions giving rise to the direction and the adjustments as respects liability to tax which the Commissioner considers appropriate.*

#### APPENDIX IV- Officers interviewed from the Federal Revenue Service of Brazil

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telephone number: +55 61 34124845

Position: *Coordinator of Tax and Customs Affairs - General Coordination of International Relations*

Work experience: *public servant at secretariat of the Federal Revenue of Brazil (Secretaria da Receita Federal do Brasil - RFB) since 1993; Tax Auditor at RFB since 1995; have worked in activities related to Income Tax Inspection, Customs, Tax Disputes, Taxation, Strategic Planning and International Relations (present); former Coordinators for Income and Property Taxation; from march 2009 to November 2011, served at school of Public Finance ( Ministry of Finance ), as Coordinator of Training Centre and Deputy General Director.*

2 Name: Ivonete Bezerra de Souza

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e-mail address: *ivonete.bezerra@jeceita.fazenda.gov.br*

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Position: Tax Auditor

Work experience: *three and a half years of experience in tax policy, specifically in transfer pricing issues.*

**3 Name:** *Flavio Texeira Barbosa*

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**Current Position:** *Advisor International Taxation Division*

**Work experience:** *Worked in International Taxation up to 1999. Coordenacao de Tributacao- Normative area- since 1993.*

**4 Name:** Flavio Antonio Goncalves Martins Araujo

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**Position:** Coordinator General of International Relations

**Work experience:** Tax Auditor at RFB since 1995; worked in Income Tax Inspection( field audits and taxpayers selection) and International Relations. Former Coordinator for studies and Programming- Coordination General of Tax Inspection . former Coordinator for Planning, Management and Control- Coordination General of Tax Inspection

**5. Name:** Lucio Flavio Arantes Esteves

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Position: Tax Auditor

Work experience: Tax Auditor at General of International Relations

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**APPENDIX V: Considered Profit Margins for the Purpose of Sale Price minus Profit**

(i) 40% for the sectors of:

Pharmochemical and pharmaceutical products;

Tobacco products;

Optical, fotografic and film instrumets and equipments;

Machines and equipment for dental and medical use;

Oil and gas extraction;

Oil products and its derivatives.

(ii) 30% for the sectors of:

Chemical products;

Glass and glass products;

Cellulose, paper and paper products;

Metalwork.

(iii) 20% for the remaining sectors.

## **APPENDIX VI: Commodities Considered for Import Price Listing**

- I. Cane or beet sugar and chemically pure sucrose, in solid ( NCM 17.01.1);
- II. Cotton (NCM 52);
- III. Aluminium and its articles ( NCM 76);
- IV. Cocoa and its preparations ( NCM 18);
- V. Coffee, whether or not roasted or decaffeinated, coffee husks and skins, coffee substitutes containing coffee in any proportion (NCM 09.01);
- VI. Meat and edible meat offal (NCM 02);
- VII. Coal ( NCM 27.01 a 27.04);
- VIII. Copper and articles thereof( NCM 74);
- IX Tin and articles thereof(NCM 80);
- X. Soybean Meal ( NCM 2304.00);
- XI. Wheat or mixing wheat with rye (meslin) ( NCM 1101.00);
- XII. Cast iron, iron and steel (NCM 72);
- XIII. Petroleum gases and other gaseous hydrocarbons (NCM 27.11);
- XIV. Manganese and articles thereof, including waste and scrap (NCM 8111.00);
- XV. Bean oil and its fractions (NCM 15.07);
- XVI. Gold (including gold plated with platinum), unwrought or in semi-manufactured or in powder form (NCM 71.08);
- XVII. Oil ( NCM 27.09 e 27.10);
- XVIII. Silver (including silver plated with gold or platinum), unwrought, semi-manufactured or in powder form ( NCM 71.06);

XIX. Soybeans, whether or not broken ( NCM 12.01);

XX. Orange juice ( NCM 2009.1);

XXI. Wheat and mixed wheat with rye (meslin) (NCM 10.01);



**APPENDIX VII : Commodities and Futures Exchange accepted for obtaining the price listing:**

- I. Chicago Board of Trade (CBOT) - Chicago - EUA;
- II. Chicago Mercantile Exchange (CME) - Chicago - EUA;
- III. New York Mercantile Exchange (NYMEX) - Nova York - EUA;
- IV. Commodity Exchange (COMEX) - Nova York - EUA;
- V. Intercontinental Exchange (ICE US) - Atlanta - EUA;
- VI. Bolsa de Mercadorias & Futuros (BM&F) - Sao Paulo - Brasil;
- VII. Life NYSE Euronext (LIFFE) - Londres - Reino Unido;
- VIII. London Metal Exchange (LME) - Londres - Reino Unido;
- IX. Intercontinental Exchange (ICE Europe) - Londres - Reino Unido;
- X. Tokio Commodity Exchange (TOCOM) - Toquio - Japao;
- XI. Tokio Grain Exchange (TGE) - Toquio - Japao;
- XII. Singapore Commodity Exchange (SICOM) - Cidade de Cingapura - Cingapura;
- XIII. Hong Kong Commodity Exchange (HKE) - Hong Kong - China;
- XIV. Multi Commodity Exchange (MCX) - Bombaim - India;
- XV. National Commodity & Derivatives Exchange Limited (NCDEX) - Bombaim - India;
- XVI. Agricultural Futures Exchange of Thailand (AFET) - Bangkok - Tailandia;
- XVII. Australian Securities Exchange (ASX) - Sidney - Australia;
- XVIII. JSE Safex APD (SAFEX) - Johannesburg - Africa do Sul;
- XIX. Korea Exchange (KRX) - Busan - Coreia do Sul;
- XX. China Beijing International Mining Exchange, (CBMX);

XXI. GlobalORE;

IBLA's so far Concluded by Brazil

XXII. London Bullion Market Association (LBMA);

Chile	China	Czech Republic	Denmark
Ecuador	India	France	Netherlands
Hungary	Korea	Israel	Italy
Japan	Philippines	Luxembourg	Mexico
Norway	South Africa	Portugal	Slovakia
Peru		Spain	Sweden
Ukraine			

## APPENDIX VIII : DTA's so Far Concluded by Brazil

Argentina	Austria	Belgium	Canada
Chile	China	Czech Republic	Denmark
Equador	Finlan	France	Netherlands
Hungary	India	Israel	Italy
Japan	Korea	Luxembourg	Mexico
Norway	Philipines	Portugal	Slovakia
Peru	South Africa	Spain	Sweden
Ukraine			

**APPENDIX IX -Article 9, Associated Enterprises**

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case 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.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

## **APPENDIX X -The Income Tax (Transfer Pricing) Rules, 2006**

1. These Rules may be cited as the Income Tax (Transfer Pricing) Rules, and shall come into operation on the 1st July, 2006)

2. In these Rules, unless the context otherwise requires-"arm's length price" means the price payable in a transaction between independent enterprises;

"comparable transactions" means transactions between which there are no material differences, or in which reasonably accurate adjustment can be made to eliminate material differences;

"controlled transaction" means a transaction which is monitored to ensure payment of an arm's length price for goods or services;

"related enterprises" means one or more enterprises whereby-

(a) one of the enterprises participates directly or indirectly in the management, control or capital of the other; or

(b) a third person participates directly or indirectly in the management, control or capital or both.

3. The purposes of these Rules are-

(a) to provide guidelines to be applied by related enterprises, in determining the arm's length prices of goods and service 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.

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

5. The guidelines referred to in rule 3 shall apply to-

(a) transactions between related 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.

Transactions subject to Rules

Methods

6. The transactions subject to adjustment of prices under these Rules shall include-

- (a) the sale or purchase of goods;
- (b) the sale, purchase or lease of tangible assets;
- (c) the transfer, purchase or use of intangible assets;
- (d) the provision of services;
- (e) the lending or borrowing of money; and
- (f) any other transactions which may affect the profit or loss of the enterprise involved

7. 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 price margin (the price 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 enterprise 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 transactions, the arm's length price cannot be determined using any of the methods contained in these guidelines.

8 (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 purposes 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.

9(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.

10 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.

11 The provisions of the Act relating to fraud, failure to furnish returns and underpayment of tax shall apply with respect to transfer pricing.

12 Any tax due and unpaid in a transfer pricing arrangement shall be deemed to be additional tax for purposes of Section 94 and 95 of the Act.



## **APPENDIX XI - Tax Treaties Concluded with Kenya**

### Ratified treaties

Zambia (27.8.1968, Legal Notice No. 10/1970)

Norway (13.12.1972, Legal Notice No. 6/1973)

Denmark (13.12.1972, Legal Notice No. 5/1973)

Sweden (28.6, 1973, Legal Notice No.14/1973)

UK. (31.7.1973, Legal Notice No. 253/1977)

Germany (17.5.1977, Legal Notice No. 20/1980)

Canada (27.4.1983, Legal Notice No.1 11/1987)

India (12.4.1985, Legal Notice No. 61/1989)

France (18.9.2009, Legal Notice No. 138 /2009)

### Signed but nor ratified

Italy (15.10.1979)

Tanzania and Uganda (31.3.1999, Legal Notice No. 45/1999)

### Treaty under negotiations

Tanzania and Uganda (re-negotiated 23.11.05)

Thailand (1<sup>st</sup> round negotiation, Nairobi, 3.2.2006)

Conventions under discussions (by the Task Force on Double Taxation & Investment Agreements under the chair of the Ministry of Finance)

Seychelles, Nigeria, South Africa, Mauritius, Finland, Russia, United Arab Emirates and Islamic Republic of Iran

**APPENDIX XII- Tax Information Exchange Agreements (TIEAS) - Initialed but not Ratified**

Isle of Man

Bermuda

Liechtenstein

Cayman Island

Malta

Jersey

Monaco

Guernsey