

**TRANSFER PRICING MANAGEMENT STRATEGIES BY  
MULTINATIONAL ENTERPRISES WITHIN THE MAIN  
INVESTMENT SEGMENT OF THE NAIROBI SECURITIES  
EXCHANGE**

**BY  
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## DECLARATION

I, the undersigned, declare that this project is my original work and that it has not been presented in any other university or institution for academic credit.

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**D61/73327/2009**

Signature.....

Date.....

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This project has been submitted for examination with my approval as university supervisor.

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Date.....

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This project paper is an expression of my professional learning. No criticism is intended towards any person and organisation mentioned in this paper.

## **DEDICATION**

To my loving wife Muoti Mutua and daughter Nzisa Muingo Mutua whose constant encouragement and support drove me to this level of education.

## **ABSTRACT**

The purpose of this study was to analyze the development of transfer pricing, why it is a key concern to both MNEs and revenue authorities and the management strategies put in place by MNEs to cope with TP challenges in emerging markets. The research questions addressed were:

- (i) What is the impact of transfer pricing on MNEs?
- (ii) What are the challenges facing MNE's operating in Kenya in implementing transfer pricing policies?
- (iii) What transfer pricing management strategies have been put in place by MNEs in Kenya?

The research adopted a descriptive research design. The population comprised of 55 MNEs operating in Nairobi, Kenya. The study employed primary methods of data collection. The study recommended that MNEs should improve their efforts in their understanding of what transfer pricing means. In addition, awareness should be to comprehend the effects of transfer prices on the level of inter-company transactions with related non-resident companies. Generally MNEs should comply with the transfer pricing rules in the country.

On suggestion for further research, the researcher proposes that future researchers should focus on examining the most appropriate methods for determining transfer pricing and develop on the limited theoretical framework of the topic. Since the sample population size of the distributors was small (n=55) future research can focus on a wider scope of MNEs across East Africa.

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## **LIST OF ABBREVIATIONS**

<b>ALP:</b>	Arms length pricing
<b>CEO:</b>	Chief Executive Officer
<b>ITA:</b>	Income Tax Act
<b>KPMG:</b>	Klynveld Peat Marwick Goerdeler
<b>KRA:</b>	Kenya Revenue Authority
<b>MNE:</b>	Multinational Enterprises
<b>OECD:</b>	Organisation for Economic Co-operation and Development
<b>TP:</b>	Transfer Pricing

# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the study

The World Investment Report (2008) estimates that there are approximately 79,000 multinational enterprises (MNEs), with an average of 10 foreign affiliates each. The value added in these MNEs constitutes about 11 percent of world Gross Domestic Product, and more 82 million people work in MNEs worldwide. More than half the world's 100 largest "economies" are now estimated to be MNEs, not nation states. Upwards of half of cross-border transactions in goods, services and intangibles are now estimated to be transfers between units of multinational enterprises, with the proportions varying significantly by product type, industry and countries involved (Eden 1998).

When products (goods, services or intangibles) are transferred between affiliated units of a multinational enterprise (MNE), the flows are referred to intrafirm trade. The price of an intrafirm transfer is called a transfer price, and transfer pricing is the process by which the transfer price is determined. Transfer pricing, once an obscure area studied only by a few academics such as Hirshleifer (1956, 1957), Horst (1971) and Rugman and Eden (1985), has now become front page news – and front page news with an ugly face.

Transfer pricing is one of the most important strategic activities involved in the management of multiple business units within the firm. Transfer pricing is the process of pricing goods and services transferred between related firms of a multinational company across different tax jurisdictions. A related party transaction normally takes place between two or more companies and involves

two or more tax jurisdictions (Li, 2006). A properly designed transfer pricing strategy will enable management to make decisions congruent with the firm's goals. It will also help a company achieve its corporate-wide goals (Martinson, Englebrecht and Mitchell, 1999).

### **1.1.1 MNEs and International trade**

Multinational companies play a very large role in international trade. Not only is there a substantial amount of arm's-length trade between MNCs and unaffiliated buyers, but trade within MNCs is also quite considerable.

The pursuit of profits, cash flows, marketing goals, economies of scale and competitive advantage through divisionalization, joint ventures, subsidiaries and affiliates necessitates estimations of costs to measure performance and taxable profits. In such an environment corporations need to develop processes for allocating costs and overheads and design strategies for estimating transfer prices for goods and services. Since costs and overhead allocation mechanisms are highly subjective corporations enjoy considerable discretion in allocating them to particular products/services and geographical jurisdictions. Such discretion can enable them to minimise taxes and thereby swell profits by ensuring that, wherever possible, most profits are located in low-tax or low risk jurisdictions.

Researchers have devoted some attention to examining how intrafirm trade may be different from arm's-length trade. One essential reason intrafirm trade may differ from non intrafirm trade results from the fact that MNCs may alter their transactions in order to minimize worldwide tax burdens. It has long been

recognized, for example, that firms may employ transfer pricing techniques that allow them to shift profits to low tax locations, thus lowering their overall tax burdens (Rangan and Lawrence (1999).

Multinational firms can typically lower their overall tax burdens by shifting profits toward low-tax countries and away from high-tax countries. Horst (1971) generated a simple model that shows how MNCs choose transfer prices in order to maximize their after-tax earnings.

### **1.1.2 Concept of transfer pricing**

Intrafirm trade involves the sale or transfer of tangible and intangible goods between related companies in two or more countries. Transfer pricing is concerned with the pricing of intrafirm trade” (Tang 1997). Transfer pricing is a term used to describe all aspects of intercompany pricing arrangements between related business entities, and commonly applies to intercompany transfers of tangible and intangible property. Intercompany transactions across borders are growing rapidly and are becoming much more complex.

Any time related parties on different sides of international borders conduct business, the Taxing authorities from both countries will insist on taxing their fair share of the income. MNEs and transfer prices go hand in hand. Cross country differences in corporate income tax rates lead multinationals to find strategies in order to diminish their tax liabilities through manipulation of transfer prices (Azemar and Corcos, 2009). Thus transfer pricing continues to be one of the most pressing issues confronting tax departments of MNEs.

Revenue authorities have always perceived a potential for abusive income shifting between related taxpayers in different jurisdictions hence have viewed such intracompany transactions with suspicion. When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. On the other hand, when associated enterprises deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their dealings with each other. Such a scenario brings into play transfer pricing challenges since such related party transactions may be viewed by the revenue authorities involved as efforts to manipulate the profits subject to tax (Feinschreiber and Kent, 2008). To assist in managing this challenge, companies adopt arms-length prices in their transactions and also pass necessary adjustments to reflect the conditions of the commercial and financial relations that they would expect to find between independent enterprises in similar transactions under similar circumstances.

### **1.1.3 Transfer pricing in Kenya**

Kenya's transfer pricing regime is governed by the Income Tax (Transfer Pricing) Rules, 2006 whose principles heavily borrow from the OECD Guidelines. The Rules provide guidelines to be applied by related enterprises in determination of the arm's length prices of goods and services that is exchanged amongst them.

The underlying regulations are based on the principle that transactions between related parties should be evaluated on an arm's-length basis, i.e., how unrelated parties would structure a transaction in an uncontrolled situation. This principle creates transfer pricing issues when one of the related parties is offshore.

The arm's-length character of a transaction between related parties is best tested by comparing the results of the transaction in question with the results of unrelated taxpayers engaged in comparable transactions under comparable circumstances. The use of comparables is important in all of the arm's-length transfer pricing methods described below. Comparability of transactions to test the arm's-length nature of a related-party transfer price is established by looking at various factors including functions performed, risks assumed, contractual terms, economic conditions and the nature of the property or services, among other factors. The Rules are also meant to provide administrative guidance including the types of records and documentation to be submitted to KRA by a person involved in transfer pricing arrangements (Kenya Income Tax Act, Chapter 476 of the Laws of Kenya).

## **1.2 Research problem**

MNEs the world over are under constant competitive pressures to structure their worldwide business operations effectively and efficiently. They are always in search for tax efficient corporate structures, low cost raw materials and supply of labour to meet earnings per share targets set by shareholders and investors. They also aim at achieving the most effective global tax rate. Consequently, MNEs have to balance between focusing on the most efficient global entity structures,



operations and transactions while striving to achieve a defensible and competitive effective global tax rate. The choice of the transfer price therefore comes into play as this affects the total profit allocation among parts of the company. Transfer pricing is seen as an important channel for an MNEs tax planning.

The transfer price charged impact a company's profit, Return on Investment (ROI) and the residual income for the segments of a company. It is because these effects on a company's transfer price that MNEs employ creative transfer pricing strategies in today's global marketplace. This practice is largely due in part to the tax and other benefits that can be attained. Transfer prices used in MNEs impact various areas of operation of a company both internal and external purposes.

Transfer prices are used to monitor managers and to motivate performance in companies. They can also be used as a means to reduce taxes, duties or tariffs, reduce the foreign tax bill, avoid exchange controls, strengthen the foreign MNE and its subsidiary. Transfer pricing also reduces the foreign exchange risk and puts the company in a better position than its competitors.

Because of the impact that transfer prices have on the operations of, transfer pricing is subject to abuse and in many cases, transfer pricing manipulation is practiced. This involves shifting accounting profits from high tax to low tax jurisdictions a practice that is said to be tax evasion. Thus, the amounts involved in the transfer price of goods and services to a high-tax jurisdiction may be exaggerated in an effort to pay only minimum taxes and increase the overall

income of the corporation. In effect, this translates to the movement of one nation's tax revenue to another. In many cases, the amounts of these exaggerated transfer prices may be material at not only the transaction level, but also may be significant from a global economic perspective with respect to the total amount of intra-firm trade across national borders.

It is for this reason that many jurisdictions have introduced transfer pricing rules requiring companies with inter-company transactions to maintain transfer pricing documentation. Transfer pricing rules imposed on MNEs result in an understanding for certain MNEs that their pricing methods do not meet the arm's length standard hence they have to consider major changes in their internal pricing policies. This may result to re-allocation of profits among the group entities and, thus, a potential change of effective tax rates.

There is need for MNEs operating in Kenya to evaluate the impact that transfer pricing has on their operations and tax planning strategies. This may call for their re-evaluation of their existing practices to ensure that they are aligned to the transfer pricing rules. It may also require them to assess the challenges that are brought on by implementing transfer pricing policies and possibly identify ways to tackle such challenges.

Many authors have written about transfer pricing from a finance (Azemar and Corcos, 2009) and economics (Hyde and Choe, 2005) point of view but have not pointed out its impact from an strategic management point of view. Through empirical analysis and theoretical models, they have analysed ways in which

companies arrive at their transfer prices but have not addressed the angle of transfer pricing as an MNE strategy.

Secondly, there have been limited studies on transfer pricing in emerging markets (International Tax Review [ITR], 2006) and especially on Kenya. Based on research, relatively little empirical analysis has been done (either locally or otherwise) on TP and its relevance to developing economies. This has posed a challenge in obtaining conclusive information on the impact and extent of transfer mispricing in Kenya, and Africa as a whole (Oriwo, 2010).

The study will be based on Kenya as an emerging market. It will focus on MNEs whose headquarters are based in Nairobi, Kenya and other Kenyan companies with intercompany transactions with their affiliates outside the Kenyan tax jurisdiction. The study will be limited to companies which have been in operation in Kenya for over 5 years and with a minimum annual turnover of KShs 800million. The study will investigate the following; what is the impact of transfer pricing on MNEs in Kenya? and what transfer pricing management strategies have been put in place by MNEs in Kenya?

### **1.3 Research objectives**

The objectives of this study are;

- (i) To evaluate the impact that transfer pricing has on the operations of MNEs operating in Kenya,
- (ii) To evaluate the challenges that are brought on by implementing transfer pricing policies and;

(iii) To evaluate the TP management strategies put in place by MNEs in Kenya to address the challenges

#### **1.4 Value of the study**

The study hopes to benefit multinational enterprises by highlighting the changes brought on by the enacted Transfer Pricing Rules and the challenges that MNEs operating in Kenya face in implementing transfer pricing policies in their corporate strategies. This will assist the company management team in appreciating the role of transfer pricing in formulating and implementing their corporate goals.

The study also hopes to benefit the Kenya Revenue Authority through highlighting the challenges that companies are facing in implementing the Transfer Pricing Rules especially with regard to the loopholes that exist in the current legislation on Transfer Pricing.

The study will also hope to benefit researchers and academicians through contributing towards sealing the gap that is in existence with regard to transfer pricing in Kenya as an emerging market as well as to highlight issues of interest that need further redress by future researchers. It also hopes to assist students of globalization in appreciating the impact of transfer pricing in emerging markets and in particular Kenya.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

The aim of this chapter is to look into various literatures done on transfer pricing. For each of the 3 questions identified, the researcher looks at the findings of different authors and presents the results of their studies. The chapter will specifically address the impact of transfer pricing on MNEs operating in both mature economies and emerging markets.

It will also look at transfer pricing issues inherent in cross-border transactions of MNEs in emerging economies. The chapter will also highlight the transfer pricing challenges that companies in both the mature and emerging economies face in implementing transfer pricing policies in their jurisdictions.

### **2.2 Theories of transfer pricing**

Transfer pricing is one of the most important strategic activities involved in the management of multiple business units within the firm. Transfer pricing is the process of pricing goods and services transferred between related firms of a multinational company across different tax jurisdictions. A related party transaction normally takes place between two or more companies and involves two or more tax jurisdictions (Li, 2006). A properly designed transfer pricing strategy will enable management to make decisions congruent with the firm's goals. It will also help a company achieve its corporate-wide goals (Martinson, Englebrecht and Mitchell, 1999).

MNEs and transfer prices go hand in hand. Cross country differences in corporate income tax rates lead multinationals to find strategies in order to diminish their tax liabilities through manipulation of transfer prices (Azemar and Corcos, 2009). Thus transfer pricing continues to be one of the most pressing issues confronting tax departments of MNEs. Revenue authorities have always perceived a potential for abusive income shifting between related taxpayers in different jurisdictions hence have viewed such intracompany transactions with suspicion.

When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. On the other hand, when associated enterprises deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their dealings with each other. Such a scenario brings into play transfer pricing risks since such related party transactions may be viewed by the revenue authorities involved as efforts to manipulate the profits subject to tax (Feinschreiber and Kent, 2008). To assist in managing this risk, companies adopt arms-length prices in their transactions and also pass necessary adjustments to reflect the conditions of the commercial and financial relations that they would expect to find between independent enterprises in similar transactions under similar circumstances. The methods used to apply the arms-length principle can be categorized into two: traditional transactional methods and transactional profit methods.

What is the correct tax liability in each jurisdiction? This question highly depends on the companies' ability to structure, implement and defend their transfer pricing policies effectively. It is against this backdrop that many countries in Europe, America, Asia Pacific and Africa have instituted laws and regulations regarding transfer pricing (Dhawale, Horiguchi, Luquet, Manasuev and Slimmen, 2008).

Most of the transfer prices adopted by MNEs in developing countries find their basis in the Organisation for Economic Co-operation and Development (OECD). Some MNEs in other countries such as India, have adopted the UN tax treaty model which bears some significant differences from the OECD model. Others on the other hand have adopted their own models different from either of these two but based on their national legislations. New documentation requirements are increasingly proliferating and tax authorities have increased their level of scrutiny of companies' transfer prices. All signs point to the fact that this trend is likely to continue into the unforeseeable future as transfer-pricing enforcement regime and levying of harsh penalties continue to expand worldwide. A good example of this is China which never focused on transfer pricing but is now increasing its scrutiny of transfer pricing issues in tax audits (Felgran and Fouts, 2006).

### **2.3 Impact of Transfer Pricing on MNEs**

Since the 1970s, multinational organizations have been concerned about the potential harmful effects of abusive transfer pricing on countries, particularly developing countries (UNCTAD 1978; OECD 1979, 1984). Government

authorities have long recognized that transfer prices can be used to avoid or evade government regulations. By manipulating transfer prices (setting them above or below opportunity cost), the MNE can reduce its overall tax payments and achieve a higher after-tax global profit than can two non-related firms.

Transfer price manipulation (TPM) is the over/under invoicing of transfer prices in response to external pressures such as government regulations. The effects of this manipulation are further explained in detail below.

### **2.3.1 Inter-company transactions**

The value of transactions in inter-company trade is affected by adjustments in the transfer prices of the goods and services involved. Transfer pricing risks and opportunities arise when MNEs enter emerging markets to source for cheap sources of raw materials, cheap labour and to capitalize from new sales opportunities (Bajger, Doshi, Herr, Hong and Soh, 2006). The increase in intercompany global transactions has increased fears in MNEs of the threat of double taxation. In order to combat this, mature economies such as the USA and Japan have introduced stringent transfer pricing legislation (Anandarajan, McGhee and Curatola, 2007). Governments of emerging markets such as India and China have followed suit and have also adopted more stringent rules and aggressive international tax enforcement strategies (Paquette, 2005).

Globalization and increased cross-border transactions has increased popularity of transfer pricing. Transfer pricing is an area of great concern for both multinational enterprises and revenue authorities (Paquette, 2005). For MNEs operating in the USA, whether



American- or foreign-owned, they are supposed to pay taxes on the profits they earn in the United States and not to gain tax advantages from moving their operations or investments to low-tax offshore "tax havens. The choice of the transfer price affects the allocation of the total profit among the parts of the company. Tax authorities are concerned that multinational corporations including companies with group entities located outside its own tax jurisdiction (MNEs) may set transfer prices on cross-border transactions to reduce taxable profits in their own jurisdiction. On the other hand, MNEs are under constant competitive pressures to structure their worldwide business operations effectively and efficiently so as to reduce the threat of double taxation.

Unfavourable economic conditions normally cause a large number of multinational companies to suffer overall losses. This is mainly due to the transfer prices adopted by such organisations. However, a consolidated loss does not automatically imply that all group members are loss making during a certain period. For example, group entities performing routine service activities whereby remuneration is determined for example on a cost plus basis means that the entities being remunerated would be guaranteed profit allocation and yet in a recession period for instance, the group would be making losses.

Such a situation where all the beneficiaries of the service provider are making losses, while the service provider remains in a profitable position, may seem to be artificial and not in compliance with the arm's length principle. Therefore, entities may need to renegotiate resulting to a new mark-up that will be lower than the "conventional" markup (Stappen, Slachmuylders & Natanelov, 2009).

Such a challenge brought on by transfer pricing, can be resolved by establishing and maintaining a solid intercompany agreement. Such an agreement would provide support for the economic substance of the transactions such as detailing the responsibilities of the different parties and the risks borne by each, as well as the pricing of intercompany transactions.

### **2.3.2 Performance Management**

Transfer prices affect motivation and performance of managers of different segments of a business. Most MNEs including the ones operating in Kenya are managed globally, with a performance measurement focus at the business or product segment level. Managers of these segments may place less importance on accurately measuring transfer prices between legal entities because such pricing is often done primarily for legal and statutory purposes. In some cases, the accounting systems used do not include all of the features needed to track legal entity pricing - for example, products may go into inventory valued at standard costs without a separate tracking of intercompany markups. In other cases, the objectives of the operational transfer prices may be geared toward providing specific management incentives that have little to do with regulatory requirements. In such a case, managers may overprice products being sold to a specific jurisdiction so as to achieve their targets (Foley, Klopfer, Waldens and Wulfekuhler, 2007).

### **2.3.3 Capital and Profit Allocation**

MNEs often use transfer prices in their inter-company accounts for purposes of allocating capital and profits between headquarters and subsidiaries. Insurance

companies for instance, use intra-group reinsurance to reduce the amount of capital which is required by the local regulator and to optimize capital management at a group level. The uniqueness of each portfolio of risks under reinsurance means that it cannot be treated as a commodity for which a price can be easily established. Thus arriving at the transfer price to be used is a complex process. This complexity, together with a perceived lack of transparency, means that insufficient understanding of the role and pricing of reinsurance and a degree of scepticism are evident among some fiscal authorities. The need to prepare and maintain robust transfer pricing analysis is therefore paramount (Bergen & Seymour, 2007).

Within other financial institutions where capital is required to undertake business, the capital is held to absorb unexpected losses and regulators require financial institutions to have minimum amounts of capital, depending on the risks assumed. Financial institutions actively manage their capital and their capital requirements: for example, a bank may seek to lower its overall regulatory capital requirement by having a trader in a “high” capital country trade a portfolio held in a “low” capital country. The trader in the “high” capital country is able to trade the portfolio held in the “low” capital country because from the counterparty’s perspective, the bank as a whole has the capital necessary to support the risks arising from its trading activities. Such cross-border use of capital creates tax issues that impact directly on the profitability of each party (Howard, Neighbour, Clair, Preshaw and Martens, 2006).

From the review of the literature above, the various authors seem to concur that indeed, the rapid development of globalization and use of the internet technology has led to an increase in inter-company trade. Thus CEOs of MNEs have to look at international transfer pricing as extremely important since the prices adopted can affect their tax liability and cashflows since it is believed that the most important objective and top priority of MNEs is to allocate profit among its various subsidiaries in different countries with different tax structures hence minimize their overall tax liability. The overall effect of this is that MNEs have to take into consideration transfer pricing risks even as they develop their corporate strategies. Some of these risks are discussed in the following sections of the chapter.

## **2.4 Transfer pricing challenges facing MNEs**

The transfer pricing environment introduces a myriad of new challenges to MNEs from a growing number of tax regimes with different rules and requirements. MNEs are forced to realign their strategies so as to counter these challenges. Some of these challenges can be stipulated as follows:

### **2.4.1 Potential Tax Assessments and Fines**

Tax authorities in emerging markets have observed the potential for abuse that is presented by cross-border transactions especially by MNEs whose headquarters are in the mature and developed jurisdictions. Such revenue flight stimulates aggressive tax legislation and enforcement activity on the part of national treasuries. For this reason, the revenue authorities have become tougher and in some cases more litigious (Dhawale et al. 2008). MNEs running significant

losses in their local entities for a number of years after entry are increasingly subject to transfer pricing audits by the revenue authorities concerned (Bajger, Doshi, Herr, Hong and Soh, 2006).

As a measure to prevent loss of revenue in their jurisdictions, countries have increased their number of audits as well as the associated penalties as they “crack down” on corporate violations of nationally promulgated transfer pricing regulations. A good example of this is India have appointed specialized transfer pricing officers to ensure compliance with transfer pricing regulations (Gajaria and Kale, 2006). Kenya has also increased its levels of tax compliance enforcements especially with KRA’s acquisition of prosecutorial powers which allows the revenue authority to use criminal prosecution as a strategy to enhance compliance with tax laws (KRA, 2010). This aggressive approach by the KRA means that MNEs have no option but to comply with the transfer pricing rules. The KRA is currently undertaking investigations into the operations of various export oriented enterprises in light of the fact that a recent initiative to collect data on transfer pricing showed that over 100 of large taxpayers in Kenya engage in transactions that qualify under the transfer pricing rules (KRA, 2009).

#### **2.4.2 Threat of Double Taxation**

One of the reasons for the growing importance of international transfer prices is minimizing tax liability. Because tax rates vary widely among different countries, MNEs design their transfer pricing policies in accordance with the tax rates involved in order to minimize their overall world-wide tax liability (Martinson et al. 1999). Thus, an MNE will transfer goods at a lower transfer

price to its subsidiary located in a country with a low tax rate so as to reduce its tax liability. This will result to a high profit margin for that subsidiary. This notwithstanding, MNEs may be faced with the threat of double taxation. Double taxation arises when the same income of an MNE is subjected to tax in two separate tax jurisdictions. For example the revenue authority in the MNE origin country and the country where the MNEs subsidiary is located, may carry out inter-company and intra-company cost allocations. These cases may involve issues such as adjustments to inter-company pricing, royalty rates, interest, management fees, business expense and gross revenue allocation adjustments. Thus an MNE may end up being taxed twice on the same transactions. With transfer pricing, this risk is very high and tends to be costly to the MNE (Andarajan et al. 2007). This transfer pricing challenges facing MNEs can be solved via use of an APA (Feinschreiber and Kent, 2008). The right transfer pricing strategy can eventually generate tax savings and achieving a lower overall effective tax rate.

### **2.4.3 Increased Compliance Costs**

Transfer pricing demands have imposed additional costs on MNEs since it has forced companies to focus on their internal controls which can help them to improve processes and controls related to transfer pricing. Transfer pricing is all about compliance with tax legislation governing various jurisdictions. MNEs are required to maintain a certain level of compliance with regard to transfer pricing. A major challenge facing MNEs with regard to transfer pricing is the increase in compliance costs. This arises because of their need to satisfy several different documentation requirements (Preshaw, Trapé, Van Stappen and Vincent, 2008).

Documentation can prove to be costly since the MNE is required to regularly collect and review the sufficiency of existing transfer pricing documentation for each set of intercompany transactions, including intercompany and intra-company agreements and pricing arrangements, maintain invoices describing details and transfer pricing terms of the transactions, maintain books and records accurately reflecting and supporting the terms of the transactions and maintain prior or current year transfer pricing analyses or studies (Lam and Wright, 2010).

Transfer pricing regulations also require MNEs to regularly modify their transfer pricing policies when changes to their business environment affect the factors used in establishing the arm's length price. Such changes include changes in market conditions which affect a firm's costs, its competitors' costs and prices, or any number of other factors critical to establishing the transfer price and modifications in a firm's internal operations, regardless of whether they arise from division activities, market concentrations, or organizational structure. Modifications to such transfer pricing policies are normally costly to the organization since clear and complete documentation of the reasons for change and the details of implementation need to be properly documented (Ralph and Reimers, 2009).

The writers of various literatures on transfer pricing all agree that the challenge for MNEs confronted by this global array of transfer pricing challenges is to develop global transfer pricing strategies that help reduce the risks, while preserving as far as possible their freedom to develop competitive global supply chains. Some of the ways in which they can manage these risks include: Identifying and documenting

material intercompany transactions and related risk points, determining and documenting the transfer-pricing policies and controls in effect for each material transaction, implementing procedures to ensure that the transfer-pricing policies and controls are being applied, assessing the impact of potential transfer-pricing adjustments on different tax accounts and performing risk mitigation as appropriate (Silverman, Carmichael and Herr, 2008).

#### **2.4.4 Consistent Loss of Revenue**

According to Dhawale, Horiguchi, Luquet, Manasuev and Slimmen (2008), transfer pricing is a zero-sum game, an extra point of taxable income gained in one jurisdiction is a point lost in another. Because of this reason, revenue authorities around the world have increased their vigilance in their scrutiny of tax compliance by MNEs. They are concerned that many MNEs manipulate their transfer prices so as to avoid paying corporate income taxes (Abdalla and Murtuza, 2006). Transfer pricing rules are intended to prevent the arbitrary shifting of income, deductions, or credits among commonly owned or controlled taxpayers. This is in line with the fact that governments try to lower their tax rates so as to attract foreign MNEs (Schwarz, 2009). In line with this, is the requirement by the revenue authorities to maintain a certain level of documentation for purposes of ensuring that the correct revenue is reported for purposes of taxation.



## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter deals with the research methodology as the mode of achieving the purpose of the study. It specifically highlights the research methods used in carrying out the study in order to answer the research questions. In addition, various methodological issues discussed include population, sampling technique(s), sampling frame, sampling size, data collection and analysis of the methods adopted in conducting the study.

### **3.2 Research design**

The research will adopt a descriptive research design. A descriptive research design is best for this study as it describes characteristics associated with the subject population.

According to Cooper and Schindler (2003), descriptive design discovers and measures the cause and effect of relationships between variables. The study will use a descriptive design because it enables the researcher to collect a large quantity of in-depth information about the population being studied. A descriptive research design enables the researcher to test and measure the population needed for quantitative experimentation since it gives valuable pointers as to what variables are worth testing quantitatively.

### **3.3 Population**

Since the focus of the study is on MNEs operating in Nairobi, Kenya, the population of interest will comprise of 60 companies operating in Nairobi,

Kenya. This is an ideal number because previous studies done on MNEs have concentrated on an average of 60 companies per country (Ernst & Young, 2008). Cooper and Schindler (2003) define a population element as the subject on which the measurement is being taken and is the unit of study. The population has been categorized into four categories based on the Main Investment Market Segment of the Nairobi Stock Exchange. These categories are Agriculture, Commercial and Services, Finance and Investment and Industrial and Allied. The population selected provided ample information about the transfer pricing risks facing them and the various challenges they face in implementing transfer pricing policies. Appendix I attached provides a list of the MNEs making up the population.

**Table 3.1: Population selection**

<b>Sector</b>	<b>Number of companies</b>	<b>Percentage (%)</b>
Agriculture	7	12
Commercial and services	10	17
Financial and investments	8	13
Industrial and allied	35	58
<b>Total</b>	<b>60</b>	<b>100</b>

Source: Population selection based on Nairobi Securities Exchange website

### **3.4 Sampling**

Sampling is a means of selecting some part of a group to represent the entire group or the population of interest. It reduces the length of time needed to complete the study and cuts costs. It is also manageable and mirrors sample population. Furthermore, the use of samples enables a higher overall accuracy than a census. In addition, collecting data from fewer cases means that one can collect more detailed information (Saunders, Lewis and Thornhill, 2000).

According to Cooper and Schindler (2003), a sampling frame is a list of elements from which the sample is actually drawn and is closely related to the population. The population has been created from piecemeal information received from the KRA, the Companies Registry and the Yellow Pages. This is because there is no single database containing a list of all the companies and particularly MNEs operating in Kenya. By adopting this approach, the researcher will ensure that the sampling frame is current, complete and relevant for the attainment of the study objectives.

The study will adopt a stratified random sampling technique. Coopers and Schindler (2003) argued that stratified random sampling increases a sample's statistical efficiency and provides adequate data for analyzing the various sub-populations. This method provides a more representative sample than strictly random sampling does.

By using the stratified sampling technique, the whole population will comprise of 60 companies, which are stratified into four mutually exclusive subgroups or strata comprising of agriculture, commercial and services, financial and investment and industrial and allied sectors. A stratum is a subset of the population that share at least one common characteristic. This procedure ensures homogeneity within each stratum. Within each of the four strata, random sampling has been done to pick the sufficient number of subjects from the stratum. This ensures that the sample selected is varied and representative. In order to decide how to allocate the total sample among the various strata, a disproportionate allocation method will be used.

The total sample size was 55 and consisted of MNEs operating in Nairobi, Kenya. This is the most ideal number given the time and resources available. In addition, transfer pricing is still a sensitive area and is not well understood hence chances of getting 100% response rate may not be practical. The sampling formula used comprised of 90% of each strata. The distribution of the sample will be as follows:

**Table 3.2: Sample distribution**

<b>Sector</b>	<b>Target population</b>	<b>% Sample</b>	<b>Sample size</b>
Agriculture	7	90	6
Commercial and services	10	90	9
Financial and investments	8	90	7
Industrial and allied	35	90	33
<b>Total</b>	<b>60</b>	<b>100</b>	<b>55</b>

Source: Sample selection based on Nairobi Securities Exchange website

### **3.5 Data collection**

The study will employ primary data collection. Primary data will be collected through a self-made questionnaire a copy of which is attached in the Appendix II hereto. The Questionnaire has adopted both structured and unstructured questions. The responses in the questionnaires will help in gaining an in-depth understanding of transfer pricing as perceived by MNEs in Nairobi, Kenya. The questionnaire is structured based on the research questions. It has 4 sections: Section 1 provides the general information classified as personal information on the respondent and basic company information. This section seeks information on the respondent's knowledge and awareness of transfer pricing as a strategic issue and its importance to the company. Section 2 focuses on the development

of transfer pricing in Kenya. Section 3 addresses the transfer pricing challenges while Section 4 focuses on the TP management strategies put in place by MNEs in Kenya.

### **3.6 Data analysis**

The collected data will be cleaned, edited and entered into a computerized system to enable carrying out of descriptive statistical analysis of the data. The data will be coded and presented in a thematic manner. Thereafter, the data will be analysed using descriptive statistics and in particular, using the mean as a measure of central tendency. The data will then be tabulated and the most appropriate charts, tables and graphs chosen to present the findings. Tables will be used to enable reading of specific values while Figures will be used to facilitate ease of data representation.

## CHAPTER 4: DATA ANALYSIS, RESULTS AND FINDINGS

### 4.1 Introduction

This chapter presents the findings of the primary data collected from the field using the questionnaire as a tool. The purpose of this study was to analyse the development of transfer pricing and why it is a key concern to both MNEs and revenue authorities in emerging markets. The research questions addressed the questions: what is the impact of transfer pricing on MNEs? what are the transfer pricing risks facing MNE's operating in Kenya? And what are the challenges facing MNE's operating in Kenya in implementing transfer pricing policies?

### 4.2 Response Rate

The section presents an analysis of the information designed to respond to the research questions as outlined in the study. There are four subsections presented on the questionnaire. The first is a general section answers the respondents characteristics; the following four subsections address specific research questions. Fifty five questionnaires were distributed to the respondents, however, 35 responded thereby creating a response effective rate of 63%. The results are indicated on the following Table 4.1.

**Table 4.1 Response rate**

	Distribution					
Respondents	Response		Non response		Total	
Students	F	%	f	%	F	%
	35	63	20	27	55	100

Source: Primary data from the research

### 4.3 General Information

The general information for the study comprised of employee and customer respondents which was organized in the following areas: gender of respondents and years of service with company.

#### 4.3.1 Gender of Respondents

To find out the gender of the respondents involved in the study. It was found out that 63% of the respondents were male and 37% of the respondents were women. Gender seems not to have any effect on transfer pricing. Table 4.2 shows the response.

**Table 4.2: Gender of the respondents**

<b>Gender</b>	<b>Frequency</b>	<b>Percent</b>
Female	13	37%
Male	22	63%
Total	35	100%

Source: Primary data from the research

Table 4.2 shows that 37% of the respondents interviewed were in female with 63% the respondents being male.

#### 4.3.2 Years of service with the company

To find out the years in service with the company of the respondents involved in the study. It was found out that 63% of the respondents had between 16-20 years of service, 32% of the respondents had 6-10 years of service, and 5% had between 0-5 years of service. The results are indicated on the following Table 4.3.

**Table 4.3: Years of service**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
0 - 5 years	2	5%
6-10 years	11	32%
16 - 20 years	22	63%
Total	35	100%

Source: Primary data from the research

#### **4.4 Impact of Transfer Pricing**

The section sort to document the findings on the various impacts of transfer pricing on the various MNEs sampled in the study.

##### **4.4.1 Understanding of Transfer Pricing**

To find whether the respondents, understood what transfer pricing is, it was found that, 53% were neutral, 21% strongly agreed, 16% agreed and 11% strongly disagreed. Most of the respondents were uncertain about what they understood by transfer pricing. The results are indicated on the following Table 4.4.

**Table 4.4: Understanding of transfer pricing**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	19	53%
Strongly agree	7	21%
Agree	6	16%
Strongly disagree	4	11%
Total	35	100%

Source: Primary data from the research



#### **4.4.2 Understanding Income Tax rules on Transfer Pricing**

To find out whether the respondents, understood the income tax rules in transfer pricing, it was found that, 37% were neutral, 21% agreed, 21% disagreed, 11% strongly agreed and 11% strongly disagreed. Most of the respondents were uncertain by their understanding of income tax rules. The results are indicated on the following Table 4.5.

**Table 4.5: Understanding of Income tax rules and transfer pricing**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	13	37%
Strongly agree	4	11%
Agree	7	21%
Disagree	7	21%
Strongly disagree	4	11%
Total	35	100%

Source: Primary data from the research

#### **4.4.3 Transfer prices affecting the level of the inter-company transactions**

To find out whether the transfer prices set by the company affect the level of intercompany transactions with related non-resident companies from the respondents involved in the study. It was found out that 32% agreed, 32% disagreed, 16% strongly disagreed, 11% strongly agreed, and 11% were neutral. Most of the respondents agreed that transfer prices set by the company affect the level of inter-company transactions with related nonresident companies. The results are indicated on the following Table 4.5.

**Table 4.5: Transfer Prices Affecting Level of Inter-Company Transactions**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	4	11%
Strongly agree	4	11%
Agree	11	32%
Disagree	11	32%
Strongly disagree	5	16%
Total	35	100%

Source: Primary data from the research

#### **4.4.4 Transfer Prices based on mutual agreements**

To find out whether the transfer prices applied on inter-company transactions are based on mutually accepted inter-company agreements from the respondents involved in the study. It was found out that 37% were neutral, 32% disagreed, 11% agreed, 11% strongly agreed, and 10% strongly disagreed. Most of the respondents were uncertain that the transfer prices applied on inter-company transactions are based on mutually accepted inter-company agreements. The results are indicated on the following Table 4.6.

**Table4.6: Transfer Prices based on mutual agreements**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	13	37%
Strongly agree	4	11%
Agree	4	11%
Disagree	11	32%
Strongly disagree	3	10%
Total	35	100%

Source: Primary data from the research

#### **4.4.5 The parent company determines the level of capital**

To find out whether the parent company determines the level of capital to be maintained by each subsidiary from the respondents involved in the study. It was found out that 58% agreed, 32% were neutral, 11% disagreed. It was agreed that the parent company determines the level of capital to be maintained by each subsidiary. The results are indicated on the following Table 4.7.

**Table 4.7: Parent company determining level of capital**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	11	32%
Agree	20	58%
Disagree	4	11%
Total	35	100%

Source: Primary data from the research

#### **4.4.8 The parent company determines the profit allocation in each subsidiary**

To find out whether the parent company determines the level of profit allocation to each subsidiary of the respondents involved in the study. It was found out that 32% agreed, 26% were neutral, 21% disagreed, 11% strongly agreed, and 11% strongly disagreed. It was agreed that the parent company determines the profit allocation in each subsidiary. The results are indicated on the following Table 4.8.

**Table 4.8: Profit allocation in each subsidiary**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	9	26%
Strongly agree	4	11%
Agree	11	32%
Disagree	7	21%
Strongly disagree	4	10%
Total	35	100%

Source: Primary data from the research

## **4.5 Transfer Pricing Risks**

The section sort to document the findings on the various TP risks as perceived by the various MNEs sampled in the study.

### **4.5.1 The Kenya Revenue Authority has in the recent past conducted transfer pricing audits**

To find out whether the Kenya Revenue has in the past conducted transfer audits and assessments from the respondents involved in the study. 42% disagreed, 21% strongly agreed, 16% strongly disagreed, 11% agreed, and 11% were neutral. It was disagreed by the majority of the respondents that KRA has in the past conducted transfer audits. The results are indicated on the following Table 4.9.

**Table 4.9: Recently conducted Transfer pricing audits and assessments**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	4	11%
Strongly agree	4	21%
Agree	7	11%
Disagree	15	42%
Strongly disagree	6	16%
Total	35	100%

Source: Primary data from the research

#### **4.5.2 The Kenya Revenue Authority imposing penalties**

To find out whether the Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies from the respondents involved in the study. It was found out that 42% strongly disagreed, 32% were neutral, 16% disagreed, 11% strongly agreed. The respondents disagreed that Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies. The results are indicated on the following Table 4.10.

**Table 4.10: Kenya Revenue Authority Imposing Penalties**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	11	32%
Strongly agree	4	11%
Disagree	6	16%
Strongly disagree	15	42%
Total	35	100%

Source: Primary data from the research

#### **4.5.5 The company has faced the threat of double taxation**

To find out whether, company has faced the threat of double taxation due to its presence in more than one jurisdiction from the respondents involved in the study. It was found out that 42% agreed, 26% were neutral, 21% strongly disagreed, 11% disagreed. Majority of the respondents agreed that company has faced the threat of double taxation due to its presence in more than one jurisdiction. The results are indicated on the following Table 4.11.

**Table 4.11: Threat of Double Taxation**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	9	26%
Agree	15	42%
Disagree	4	11%
Strongly disagree	7	21%
Total	35	100%

Source: Primary data from the research

#### **4.5.6 The costs involved in preparing a Transfer Pricing policy are high**

To find out whether the costs involved in preparing a transfer pricing policy are high. It was found out that 53% were neutral, 16% disagreed, 11% agreed, 11% strongly agreed, and 11% strongly disagreed. Most of the respondents were uncertain of whether the costs involved in preparing a transfer pricing policy are high. The results are indicated on the following Table 4.12.

**Table 4.12: High costs of preparing a transfer pricing policy**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	19	53%
Strongly agree	4	11%
Agree	4	11%
Disagree	6	16%
Strongly disagree	4	11%
Total	35	100%

Source: Primary data from the research

#### **4.6 Challenges in Implementing Transfer Pricing Policies**

The section sort to document the findings on the various challenges brought about when MNEs are implementing transfer pricing policies as perceived by the various MNEs sampled in the study.

#### **4.6.1 Understanding Transfer pricing documentation in Kenya**

To find out whether the respondents, understand maintaining a transfer pricing policy document in Kenya, it was found that 63% were neutral, 21% disagreed, 11% strongly agreed, and 5% agreed. Most of the respondents were neutral that maintaining a transfer pricing policy document in Kenya is a legal requirement for MNEs. The results are indicated on the following Table 4.12.

**Table 4.13: Maintaining a Transfer pricing document**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	22	63%
Strongly agree	4	11%
Agree	2	5%
Disagree	7	21%
Total	35	100%

Source: Primary data from the research

#### **4.6.2 Company's Transfer pricing policy**

To find out whether the company's transfer policy is mirrored along the Kenyan income, it was found out that 36% agreed, 26% were neutral, 16% disagreed, 11% strongly disagreed, and 11% strongly agreed. Majority of the respondents agreed that the company's transfer pricing policy is mirrored along the Kenyan Income Tax (Transfer Pricing) Rules for 2006. The results are indicated on the following Table 4.14.

**Table 4.14: Transfer Policy Mirrored along the Kenyan Income**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	9	26%
Strongly agree	4	11%
Agree	13	36%
Disagree	4	11%
Strongly disagree	6	16%
Total	35	100%

Source: Primary data from the research

### **4.6.3 Company's Transfer Pricing Policy Mirrored along the OECD Guidelines**

To find out whether the company's transfer pricing policy is mirrored along the OECD guidelines, it was found out that 42% were neutral, 21% disagreed, 21% agreed, and 16% strongly disagreed. Most of the respondents were not sure whether company's transfer policy is mirrored along the Kenyan income. Most of the respondents were uncertain company's transfer pricing policy is mirrored along the OECD guidelines. The results are indicated on the following Table 4.22.

**Table 4.15: Company's Transfer Pricing policy mirrored along the OECD Guidelines**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	15	42%
Agree	7	21%
Disagree	7	21%
Strongly disagree	6	16%
Total	35	100%

Source: Primary data from the research



#### **4.6.4 The Company aligns its Business Objectives with the Kenyan transfer pricing rules**

To find out whether the company aligns its business objectives with the Kenyan transfer pricing, it was found out that 47% disagreed, 21% neutral, 21% agreed, and 11% strongly disagreed. Most of the respondents disagreed that the company aligns its business objectives to the Kenyan transfer pricing regulations. The results are indicated on the following Table 4.16.

**Table 4.16: Business objectives aligned with Kenyan Transfer Pricing rules**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	7	21%
Agree	7	21%
Disagree	16	47%
Strongly disagree	4	11%
Total	35	100%

Source: Primary data from the research

#### **4.6.5 The Company applies the Arm-Length Principle in its transactions**

To find out whether the company applies the arm-length principle in its transactions, it was found out that 32% strongly disagreed, 21% were neutral, 23% strongly agreed, 16% agreed, and 8% disagreed. Most of the respondents disagreed that the company applies the Arms-Length Principle in its transactions with related parties. The results are indicated on the following Table 4.17.

**Table 4.17: Arm-Length in its Transactions**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>
Neutral	7	21%
Agree	6	16%
Disagree	3	8%
Strongly agree	8	23%
Strongly disagree	11	32%
Total	35	100%

Source: Primary data from the research

## **4.7 Discussions**

Based on the impact of transfer pricing from the findings it was established that most of the respondents did not understand transfer pricing. In addition, most of the respondents agreed that transfer prices set by the company affect the level of inter-company transactions with related non-resident companies. Further, most of the respondents were uncertain that the transfer prices applied on inter-company transactions are based on mutually accepted inter-company agreements. It was established that majority of the respondents were uncertain whether the performance management is measured by the level of sales made by the company. Some also disagreed by most of the respondents that transfer pricing affected the sales level achieved by the company. Other respondents agreed that the parent company determines the level of capital to be maintained by each subsidiary. In addition, the respondents agreed that the parent company determines the profit allocation in each subsidiary.

On transfer pricing challenges facing MNE's operating in Kenya though KRA has never conducted transfer audits in the past, there is now an increased level of tax compliance enforcements where KRA shall be forced to conduct transfer audits and assessments on MNEs that fail to comply with the rule. In addition, the respondents disagreed that Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies. Most of the respondents were uncertain of whether the costs involved in documenting a transfer pricing policy are high. The respondents disagreed that the company is required to modify its transfer prices on an annual basis. If transfer pricing regularly modified, it would affect the factors used in establishing the arm's length price.

Most of the respondents were neutral that maintaining a transfer pricing policy document in Kenya is a legal requirement for MNEs. Other respondents disagreed that the company aligns its business objectives to the Kenyan transfer pricing regulations. For those who agreed, establishing the arm's length price affects a firm's costs. It was disagreed that transfer prices applied in the company are not comparable to other independent companies. This could be due to lack of regional databases for benchmarking purposes and inconsistencies may occur because of the lack of global benchmarking initiatives.

## **CHAPTER 5: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Introduction**

This chapter addresses the results and findings on the development of transfer pricing and why it is a key concern to both MNEs and revenue authorities in emerging markets. The findings are outlined according to specific objectives of the study. The findings are based on the responses from the questionnaires filled and information gathered on the research questions. The researcher provides a discussion on the findings of the research as compared to the findings in the literature review based on the specific objectives.

### **5.2 Summary of the findings**

The research questions to be addressed will include. what is the impact of transfer pricing on MNEs? What are the transfer pricing risks facing MNE's operating in Kenya? What are the challenges facing MNE's operating in Kenya in implementing transfer pricing policies?

The research adopted a descriptive research design. The population comprised of MNEs operating in Nairobi, Kenya. The study employed primary methods of data collection. Before embarking on the actual research, a pre-test of the questionnaire was done. Five small MNEs were considered for the pilot test of the questionnaire. The collected data was cleaned, edited and entered into a computerized system to enable carrying out of descriptive statistical analysis of the data. The data was then tabulated and the most appropriate charts, tables and

graphs chosen to present the findings. Tables and Tables were used to present the data and also facilitate the ease of data representation.

Based on the impact of transfer pricing, it was established that most of the respondents did not understand transfer pricing. In addition, most of the respondents agreed that transfer prices set by the company affect the level of inter-company transactions with related non-resident companies. Further, most of the respondents were uncertain that the transfer prices applied on inter-company transactions are based on mutually accepted inter-company agreements. It was established that majority of the respondents were uncertain whether the performance management is measured by the level of sales made by the company. Some also disagreed by most of the respondents that transfer pricing affected the sales level achieved by the company. Other respondents agreed that the parent company determines the level of capital to be maintained by each subsidiary. In addition, the respondents agreed that the parent company determines the profit allocation in each subsidiary.

Though KRA has never conducted transfer audits in the past, there is now an increased level of tax compliance enforcements where KRA shall be forced to conduct transfer audits and assessments on MNEs that fail to comply with the rule. In addition, the respondents disagreed that Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies. For those who agree, there is an increased level of tax compliance enforcements by KRA to prosecute those who are not compliant.

In addition, the findings are consistent with MNEs fears of double taxation. Most of the respondents were uncertain of whether the costs involved in documenting a transfer pricing policy are high. The respondents disagreed that the company is required to modify its transfer prices on an annual basis. If transfer pricing regularly modified, it would affect the factors used in establishing the arm's length price.

Most of the respondents were neutral that maintaining a transfer pricing policy document in Kenya is a legal requirement for MNEs. The Kenyan transfer pricing rules are found to be complex and technical on the issue. In addition, most of the respondents were uncertain company's transfer pricing policy is mirrored along the OECD guidelines.

Other respondents disagreed that the company aligns its business objectives to the Kenyan transfer pricing regulations. For those who agreed, establishing the arm's length price affects a firm's costs. It was disagreed that transfer prices applied in the company are not comparable to other independent companies. This could be due to lack of regional databases for benchmarking purposes and inconsistencies may occur because of the lack of global benchmarking initiatives.

### **5.3.1 The impact of transfer pricing on MNEs**

Based on the understanding of what transfer pricing is, it was found that most of the respondents were uncertain about what they understood by transfer pricing. Some MNEs may not be unaware that the transfer pricing policies they have do not adhere to local transfer pricing standards (Silverman et al. 2008). This may

present a challenge to such MNEs. The Kenyan transfer pricing rules for instance requires a company with related inter-company transactions to determine transfer prices for tax purposes according to the arm's length principle and is expected to prepare and keep documentation concerning how prices and conditions for the controlled transactions are set.

To examine whether the transfer prices set by the company affect the level of intercompany transactions with related non-resident companies from the respondents involved in the study. It was found out that most of the respondents agreed that transfer prices set by the company affect the level of inter-company transactions with related non-resident companies. This confirms Bajger, Doshi, Herr, Hong and Soh (2006) findings that the value of transactions in inter-company trade is affected by adjustments in the transfer prices of the goods and services involved. Transfer pricing risks and opportunities arise when MNEs enter emerging markets to source for cheap sources of raw materials, cheap labour and to capitalize from new sales opportunities.

In regard to whether the transfer prices applied on inter-company transactions are based on mutually accepted inter-company agreements from the respondents involved in the study. It was found out that most of the respondents were uncertain that the transfer prices applied on inter-company transactions are based on mutually accepted intercompany agreements.

The study sought to find out whether the performance management is measured by the level of sales made by the company from the respondents involved in the

study. It was established that majority of the respondents were uncertain whether the performance management is measured by the level of sales made by the company.

In relation to whether the transfer prices affect the sales level achieved by the company from the respondents involved in the study. It was found out that 47% disagreed, 32% agreed, 21% were neutral. Therefore, it was disagreed by most of the respondents that transfer pricing affected the sales level achieved by the company.

To investigate whether the parent company determines the level of capital to be maintained by each subsidiary from the respondents involved in the study. It was found out that 58% agreed, 32% were neutral, 11% disagreed. It was agreed that the parent company determines the level of capital to be maintained by each subsidiary.

To find out whether the parent company determines the level of profit allocation to each subsidiary from the respondents involved in the study. It was found out that 32% agreed, 26% were neutral, 21% disagreed, 11% strongly agreed, and 11% strongly disagreed. It was agreed that the parent company determines the profit allocation in each subsidiary.



### **5.3.2 Transfer pricing challenges facing MNE's operating in Kenya**

In examining whether the Kenya Revenue has in the past conducted transfer audits and assessments from the respondents involved in the study. It was found out that 42% disagreed, 21% strongly agreed, 16% strongly disagreed, 11% agreed, and 11% were neutral. It was disagreed by the majority of the respondents that Kenya Revenue has in the past conducted transfer audits and assessments. Though KRA has never conducted transfer audits in the past, there is now an increased level of tax compliance enforcements where KRA shall be forced to conduct transfer audits and assessments on MNEs that fail to comply with the rule.

In determining if the Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies from the respondents involved in the study. It was found out that 42% strongly disagreed, 32% were neutral, 16% disagreed, 11% strongly agreed. The respondents disagreed that Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies. For those who agree, there is an increased level of tax compliance enforcements especially with KRA's acquisition of prosecutorial powers which allows the revenue authority to use criminal prosecution as a strategy to enhance compliance with tax laws.

To find out whether Kenya Revenue Authority has in the past conducted a transfer pricing audit on the operations of the company from the respondents involved in the study. It was found out that 37% were neutral, 21% disagreed,

21% strongly disagreed, 21% agreed. Most of the respondents were neutral that Kenya Revenue Authority has in the conducted a transfer pricing audit/assessments on the operations of the company. For those who agreed, there seems to be a consensus that KRA is taking an aggressive approach to make sure companies comply with the transfer pricing rules.

In regards if Kenya Revenue Authority has imposed penalties to the company because of failure to comply with transfer pricing regulations from the respondents involved in the study. It was found out that 53% were neutral, 32% disagreed, 11% strongly agreed, 5% strongly agreed. Most of the respondents were uncertain whether Kenya Revenue Authority has in the recent past imposed penalties to the company because of failure to comply with transfer pricing regulations. For those who agreed, it is true that KRA is currently undertaking investigations into the operations of various export oriented enterprises so that it can impose penalties for failing to comply with transfer pricing policies (KRA, 2009).

To determine whether the company has faced the threat of double taxation due to its presence in more than one jurisdiction from the respondents involved in the study. It was found out that 42% agreed, 26% were neutral, 21% strongly disagreed, 11% disagreed. Majority of the respondents agreed that company has faced the threat of double taxation due to its presence in more than one jurisdiction. The findings are consistent with MNEs fears of double taxation. Double taxation arises when the same income of an MNE is subjected to tax in two separate tax jurisdictions.

To examine if the costs involved in preparing a transfer pricing policy are high. It was found out that 53% were neutral, 16% disagreed, 11% agreed, 11% strongly agreed, and 11% strongly disagreed. Most of the respondents were uncertain of whether the costs involved in preparing a transfer pricing policy are high. The findings do not confirm whether this since there is a major risk facing MNEs with regard to transfer pricing is the increase in compliance costs. This arises because of their need to satisfy several different documentation requirements (Preshaw, Trapé, Van Stappen and Vincent, 2008).

In analyzing if the costs involved in documenting a transfer pricing policy are high. It was found out that 47% were neutral, 42% disagreed, and 11% agreed. Most of the respondents were uncertain of whether the costs involved in documenting a transfer pricing policy are high causes this involves identifying and documenting material intercompany transactions and related risk points, determining and documenting the transfer-pricing policies and controls in effect for each material transaction, implementing procedures to ensure that the transfer-pricing policies and controls are being applied.

In response to whether the company is required to modify its transfer prices on an annual basis. It was found out that 42% disagreed, 21% were neutral, 21% strongly disagreed, 11% strongly agreed, and 5% agreed. Most of the respondents disagreed that the company is required to modify its transfer prices on an annual basis. If transfer pricing regularly modified, it would affect the factors used in establishing the arm's length price.

To find out whether the company has been facing losses due to high costs allocated to the company, it was found out that 21% of the respondents were neutral, 53% strongly disagreed, 5% strongly agreed, and 21% agreed. Most of the respondents disagreed that the company has been facing losses due to high costs allocated to the company.

Unfavourable economic conditions normally cause a large number of multinational companies to suffer overall losses. This is mainly due to the transfer prices adopted by such organisations. However, a consolidated loss does not automatically imply that all group members are loss making during a certain period (Stappen, Slachmuylders and Natanelov, 2009).

### **5.3.3 Challenges facing MNE's in implementing transfer pricing policy**

To investigate whether the respondents, understand maintaining a transfer pricing policy document in Kenya, it was found that 63% were neutral, 21% disagreed, 11% strongly agreed, and 5% agreed. Most of the respondents were neutral that maintaining a transfer pricing policy document in Kenya is a legal requirement for MNEs. Sometimes, the local authority requires MNEs to regularly collect and review the sufficiency of existing transfer pricing documentation for each set of intercompany transactions, including intercompany and intra-company agreements and pricing arrangements, maintain invoices describing details and transfer pricing terms of the transactions, maintain books and records accurately reflecting and supporting the terms of the transactions and maintain prior or current year transfer pricing analyses or studies (Lam and Wright, 2010).

In determining whether the company's transfer policy is mirrored along the Kenyan income, it was found out that 36% agreed, 26% were neutral, 11% strongly disagreed, and 11% strongly agreed. Majority of the respondents agreed that the company's transfer pricing policy is mirrored along the Kenyan Income Tax (Transfer Pricing) Rules for 2006. The Kenyan transfer pricing rules, in their current form for instance, provide guidance only on the technical aspects, that is, the acceptable methods for determining arm's-length pricing, and the theoretical fundamentals underlying these methods.

In finding out whether the company's transfer pricing policy is mirrored along the OECD guidelines, it was found out that 42% were neutral, 21% disagreed, 21% agreed, and 16% strongly disagreed. Most of the respondent was not sure whether company's transfer policy is mirrored along the Kenyan income. Most of the respondents were uncertain company's transfer pricing policy is mirrored along the OECD guidelines. OECD transfer pricing guidelines have been criticized for not discussing practical and administrative issues which may arise when applying these guidelines in practice. In addition, although most of the tax authorities adhere to the transfer pricing guidelines as provided by the OECD, interpretation of the guidelines vary from country to country (Dhawale et al. 2008) in which the respondent are uncertain that it mirrors the Kenyan income .

In relation to whether the company aligns its business objectives with the Kenyan transfer pricing, it was found out that 47% disagreed, 21% neutral, 21% agreed, and 11% strongly disagreed. Most of the respondents disagreed that the company aligns its business objectives to the Kenyan transfer pricing regulations. May be

this could be because transfer pricing is could be one of the most complex areas in tax since at the very least, it involves compliance with the rules of at least two tax jurisdictions usually involving different and not always consistent transfer pricing rules. This is further exacerbated by the various business realities.

In regard to whether the company applies the arm-length principle in its transactions, it was found out that 32% strongly disagreed, 21% were neutral, 16% agreed, and 8% strongly disagreed. Most of the respondents disagreed that the company applies the Arms-Length Principle in its transactions with related parties. For those who agreed, establishing the arm's length price affects a firm's costs, its competitors' costs and prices, or any number of other factors critical to establishing the transfer price and modifications in a firm's internal operations, regardless of whether they arise from division activities, market concentrations, or organizational structure. Modifications to such transfer pricing policies are normally costly to the organization since clear and complete documentation of the reasons for change and the details of implementation need to be properly documented (Ralph and Reimers, 2009).

Analyzing how transfer prices applied in the company are comparable to other independent companies, it was found out that 24% disagreed, 24% were neutral, 13% strongly disagreed, 8% strongly agreed, and 8% agreed. It was disagreed that transfer prices applied in the company are not comparable to other independent companies. This could be due to lack of regional databases for benchmarking purposes and inconsistencies may occur because of the lack of global benchmarking initiatives.

## **5.4 Conclusion**

The conclusions arrived at are as follows;

### **5.4.1 The impact of transfer pricing on MNEs**

Based on the understanding of what transfer pricing is, it was found that most of the respondents were uncertain about what they understood by transfer pricing. In addition, most of the respondents agreed that transfer prices set by the company affect the level of inter-company transactions with related non-resident companies. Further, most of the respondents were uncertain that the transfer prices applied on inter-company transactions are based on mutually accepted inter-company agreements. It was established that majority of the respondents were uncertain whether the performance management is measured by the level of sales made by the company. Some also disagreed by most of the respondents that transfer pricing affected the sales level achieved by the company. Other respondents agreed that the parent company determines the level of capital to be maintained by each subsidiary. In addition, the respondents agreed that the parent company determines the profit allocation in each subsidiary.

### **5.4.2 Transfer pricing risks facing MNE's operating in Kenya**

Though KRA has never conducted transfer audits in the past, there is now an increased level of tax compliance enforcements where KRA shall be forced to conduct transfer audits and assessments on MNEs that fail to comply with the rule. In addition, the respondents disagreed that Kenya Revenue has in the recent years imposed penalties to companies without transfer pricing policies. For those who agree, there is an increased level of tax compliance enforcements especially with KRA's acquisition of prosecutorial powers which allows the revenue

authority to use criminal prosecution as a strategy to enhance compliance with tax laws. For those who agreed, there seems to be a consensus that KRA is taking an aggressive approach to make sure companies comply with the transfer pricing rules. It is true that KRA is currently undertaking investigations into the operations of various export oriented enterprises so that it can impose penalties for failing to comply with transfer pricing policies. The findings are consistent with MNEs fears of double taxation. Most of the respondents were uncertain of whether the costs involved in documenting a transfer pricing policy are high. The respondents disagreed that the company is required to modify its transfer prices on an annual basis. If transfer pricing regularly modified, it would affect the factors used in establishing the arm's length price.

#### **5.4.3 Challenges facing MNE's in implementing transfer pricing policy**

Most of the respondents were neutral that maintaining a transfer pricing policy document in Kenya is a legal requirement for MNEs. Sometimes, the local authority requires MNEs to regularly collect and review the sufficiency of existing transfer pricing documentation. Majority of the respondents agreed that the company's transfer pricing policy is mirrored along the Kenyan Income Tax (Transfer Pricing) Rules for 2006. The Kenyan transfer pricing rules, in their current form for instance, provide guidance only on the technical aspects, that is, the acceptable methods for determining arm's-length pricing, and the theoretical fundamentals underlying these methods. In addition, most of the respondents were uncertain company's transfer pricing policy is mirrored along the



OECD guidelines. Other respondents disagreed that the company aligns its business objectives to the Kenyan transfer pricing regulations. Most of the respondents disagreed that the company applies the Arms-Length Principle in its transactions with related parties. For those who agreed, establishing the arm's length price affects a firm's costs, its competitors' costs and prices, or any number of other factors critical to establishing the transfer price and modifications in a firm's internal operations, regardless of whether they arise from division activities, market concentrations, or organizational structure. It was disagreed that transfer prices applied in the company are not comparable to other independent companies. This could be due to lack of regional databases for benchmarking purposes and inconsistencies may occur because of the lack of global benchmarking initiatives.

## **5.5 Recommendation for Improvement**

The following are the recommendations on how the research work can be improved on in future research work.

### **5.5.1 The impact of transfer pricing on MNEs**

MNEs should understanding of what transfer pricing means. In addition, awareness should be to comprehend the effects of transfer prices on the level of inter-company transactions with related non-resident companies. Alertness should also be emphasized on the application of transfer prices on inter-company transactions are based on mutually accepted inter-company agreements. In addition, it should be established how performance management is measured by the level of sales made by the company in relations to transfer pricing. Further, the employees of MNEs should understand transfer pricing affects the sales level

achieved by the company, how the parent company determines the level of capital to be maintained by each subsidiary and the determination of profit allocation in each subsidiary.

### **5.5.2 Transfer pricing risks facing MNE's operating in Kenya**

Though KRA has never conducted transfer audits in the past, but MNEs should be aware of the increased level of tax compliance enforcements in which KRA is enforcing to conduct transfer audits and assessments on MNEs that fail to comply with the rule. In addition, the MNEs should be aware of the penalties to companies that fail to implement transfer pricing policies. Generally, the MNEs should also be aware of the increased level of tax compliance enforcements especially with KRA's acquisition of prosecutorial powers which allows the revenue authority to use criminal prosecution as a strategy to enhance compliance with tax laws. In regard to this, they should know that KRA is taking an aggressive approach to make sure companies comply with the transfer pricing rules since there are investigations into the operations of various export oriented enterprises.

### **5.5.3 Challenges facing MNE's in implementing transfer pricing policy**

The legal requirement for MNEs to document transfer pricing should come out very clearly. In addition, the local authority that requires MNEs to regularly collect and review should come up with a clear documentation of existing transfer pricing. In addition, transfer pricing should be mirrored along the Kenyan Income Tax. The Kenyan transfer pricing rules should also be less complex and technical. Most MNEs should be aligned to the business objectives

to the Kenyan transfer pricing regulations to avoid any legal penalties. Other factors that are affected by transfer such as costs and sales should be taken into consideration. In addition, there should be a global benchmark of transfer pricing.

#### **5.5.4 Suggestions for Further Research**

The researcher proposes that future researchers should focus on examining the most appropriate methods for determining transfer pricing and develop on the limited theoretical framework of the topic. Since the sample population size of the distributors was small (n=55) future research can focus on a wider scope of MNEs across East Africa.

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## APPENDIX I: QUESTIONNAIRE

### “TRANSFER PRICING MANAGEMENT STRATEGIES BY MULTINATIONAL ENTERPRISES WITHIN THE MAIN INVESTMENT SEGMENTS OF THE NAIROBI SECURITIES EXCHANGE”

This questionnaire is designed to collect information on the Transfer pricing risk management strategies among multinational enterprises in Kenya.

The information obtained will only be used for academic purposes and shall be treated in confidence.

This questionnaire is to be completed by the Chief Finance Officer, Finance Manager, Finance Director or persons in similar positions only.

#### SECTION I: GENERAL INFORMATION

##### Personal Information:

1. Personal  
Name:.....

2. Job  
Level/Position:.....

3. Gender:      Male ( )      Female ( )

4. Age Category:  
    20 – 30 ( )      51 – 60 ( )  
    31 – 40 ( )      Above 60 ( )  
    41 – 50 ( )

5. Years of service with the company:  
    0 – 5 ( ) 16 – 20 ( )  
    6 – 10 ( ) Over 25  
    11 – 15 ( )

6. Name of Company/Entity:  
.....

7. Company/Entity industry:  
.....

8. Company/Entity ultimate holding company:  
.....

9. Country in which the company/entity's ultimate holding company is located

.....  
 .....

10. Country (ies) in which the company/entity's other related parties are located  
 (Attach a separate schedule if need be).....

.....  
 .....

**SECTION II: IMPACT OF TRANSFER PRICING**

Please indicate the extent to which you agree with the following statements by using a scale of 1 to 4 where 1= strongly disagree, 2= disagree, 3= neither agree nor disagree, 4=agree, 5 = strongly agree. Tick (√) which best describes your opinion of the statement in reference to impact of transfer pricing.

		<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>
1.	I understand what transfer pricing is					
2.	I understand what the Income Tax (Transfer Pricing) Rules, 2006 provides with regard to transfer pricing					
3.	The transfer prices set by the company affect the level of inter-company transactions with related non-resident companies					

4.	The transfer prices applied on inter-company transactions are based on a mutually accepted intercompany agreements					
5.	Performance management is measured by the level of sales made					
6.	Transfer prices affect the sales level achieved by the company					
7.	The parent company determines the level of capital to be maintained by each subsidiary					
8.	The parent company determines the profit allocation in each subsidiary					

### SECTION III: TRANSFER PRICING RISK

Please indicate the extent to which you agree with the following statements by using a scale of 1 to 4 where 1= strongly disagree, 2= disagree, 3= neither agree nor disagree, 4=agree, 5 = strongly agree. Tick (✓) which best describes your opinion of the statement in reference to transfer pricing risks.

		<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>
1.	The Kenya Revenue Authority has in the recent past been conducting transfer pricing audits and assessments					
2.	The Kenya Revenue Authority has in the recent past imposed penalties to companies without transfer pricing policies					
3.	The Kenya Revenue Authority has in the conducted a transfer pricing audit/assessments on the operations of the company					
4.	The Kenya Revenue Authority has in the recent past imposed penalties to the company because of failure to comply with transfer pricing regulations					

5.	The company has faced the threat of double taxation due to its presence in more than one jurisdiction					
6.	The costs involved in preparing a transfer pricing policy are high					
7.	The costs involved in documenting a transfer pricing policy are high					
8.	The company is required to modify its transfer prices on an annual basis					
9.	The company has been facing losses due to high costs allocated to the company					

**SECTION IV: TRANSFER PRICING RISK MANAGEMENT STRATEGIES PUT INTO PLACE**

Please indicate the extent to which you agree with the following statements by using a scale of 1 to 4 where 1= strongly disagree, 2= disagree, 3= neither agree nor disagree, 4=agree, 5 = strongly agree. Tick (√) which best describes your opinion of the statement in reference the challenges in implementing transfer pricing policies.

		<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>
1.	I understand that maintaining a					



	transfer pricing policy document in Kenya is a legal requirement for MNEs					
2.	The company's transfer pricing policy is mirrored along the Kenyan Income Tax (Transfer Pricing) Rules, 2006					
3.	The company aligns its business objectives to the Kenyan transfer pricing regulations					
4.	The company's transfer pricing policy is mirrored along the OECD guidelines					

THANK YOU FOR YOUR TIME AND CONTRIBUTION