Aggressive Tax Avoidance by Multinational Corporations: A study on the sufficiency of the Response Mechanisms provided by the Kenya Tax Laws.

UNIVERSITY OF NAIROBI
COLLEGE OF HUMANITIES & SOCIAL SCIENCES
SCHOOL OF LAW

A Dissertation Submitted in Partial Fulfillment of the Requirements for the Award of a Master of Laws (L.L.M) Degree of the University of Nairobi

JUSTUS OBUYA REG. NO: G62/10294/2018

TABLE OF CONTENTS

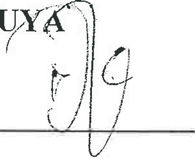
TABLE OF CONTENTS i
DECLARATION iii
ACKNOWLEDGEMENT iv
LIST OF CASES v
LIST OF STATUTES v
LIST OF INTERNATIONAL INSTRUMENTS vi
LIST OF ABBREVIATIONS vi
ABSTRACT vii
CHAPTER ONE: INTRODUCTION 1
1.1 Introduction 1
1.2 Statement of the problem 8
1.3 Research 9
1.3.1 Research Methodology 9
1.3.2 Research Questions 9
1.3.3. Objectives 10
1.3.4. Hypothesis 10
1.4 Theoretical Framework 10
1.5 Literature review 11
1.6 Chapter breakdown 15
CHAPTER TWO: THE MEANING OF AGGRESSIVE TAX AVOIDANCE AND THE PROFILE OF AGGRESSIVE TAX AVOIDANCE STRATEGIES USED IN KENYA. 17
2.1 Definition of Aggressive Tax Avoidance 17
2.2 Transfer pricing 22
2.3 Thin Capitalization 26
2.4 Accounting Methods 28
2.5 Controlling the Tax Year of Income 29
2.6 Leasing Property and Equipment. 30
2.7 Use of Tax Havens 31
CHAPTER 3: KENYA LEGAL AND INSTITUTIONAL REGIME ADDRESSING AGGRESSIVE TAX AVOIDANCE. 35
3.1 LEGAL FRAMEWORK 35

3.1.1. Transfer pricing Legal Regime in Kenya 35
3.1.2. Thin capitalization 38
3.1.3. General Anti-Avoidance Rule 39
3.1.4. Restriction on Deduction of Interest, Royalties, Management & Professional Fees and Forex Losses. 40
3.1.5. Offences and Penalties under the Tax Procedures Act 41
3.1.6. Offences by Accountants 42
3.1.7. Chapter 6 of the Constitution of Kenya on Leadership and Integrity. 44
3.1.8. Income Tax (Transfer Pricing) Rules 2006. 45
3.1.9. Double Tax Agreements (DTA's) 46
3.9.10. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters 47
3.2. INSTITUTIONAL FRAMEWORK. 49
3.2.1. Rewards for whistle blowers by the Kenya Revenue Authority. 49
3.2.2. Use of technology by The Kenya Revenue Authority 49
3.2.3. Taxpayer Education and training by the Kenya Revenue Authority. 50
3.2.4. Taxpayer surveillance and investigations by the Kenya Revenue Authority. 50
CHAPTER 4: CONCLUSION AND RECOMMENDATIONS 51
4.1. Proposed Reforms on the Legal Framework. 51
4.1.1 Review Harmful Double Taxation Agreements (DTAs). 51
4.1.2 Establish Public Beneficial Ownership Registries 54
4.1.3 Enhance Disclosure of Tax Planning Measures. 56
4.2. Proposed Reforms on the Institutional Framework. 57
4.2.1 Curb Tax Competition by Ending Issuance of Harmful Tax Incentives by the National Treasury. 57
4.2.2. Strengthen Tax Administration by the Kenya Revenue Authority. 58
4.2.3. Undertake frequent KRA Taxpayer engagement fora and seminars. 61
4.2.4. Enhance taxpayer compliance awards and recognition. 62
5.0 SOURCED REFERENCES 63
5.1 Books 63
5.2 Journals and Articles 63

DECLARATION

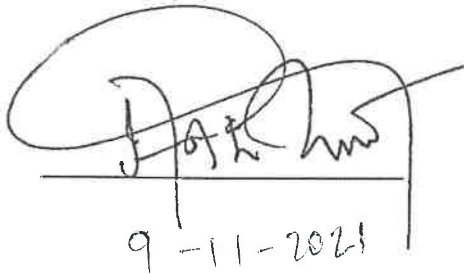
I **JUSTUS OBUYA** do declare that this dissertation is my original work and has not been submitted elsewhere for examination, award of a degree or publication. Where other people's work, or my own work has been used, this has properly been acknowledged and referenced in accordance with the University of Nairobi's requirements.

JUSTUS OBUYA

Signed: 

Date: 9th November 2021.

This research project has been submitted for examination with my approval as a University supervisor.

Signed: 

9-11-2021

PROF:ARTHUR ESHIWANI, JSD (U.C. Berkely)

ACKNOWLEDGEMENT

I thank God for His grace which gave me the energy, perseverance and focus to carry on with this research.

I acknowledge the guidance from my Supervisor, Prof. Arthur Eshiwani, who was strict and pushed me consistently throughout the study. He taught me the art of research and attention to detail which significantly shaped my research.

To my mother Millicent Obuya, my siblings Maureen, Vivian Beryl, Linda, Eunice and Walter, thank you for the belief you had in me which gave me the morale to further my education. Thank you for standing by me and encouraging when balancing between work and this project almost took a toll on me.

To my colleagues at TripleOKLaw Advocates led by the Senior Partner, Mr. James Ochieng' Oduol, thank you for stepping in whenever I had to be away to work on this research. Your constant support gave me the courage to accomplish this.

LIST OF CASES

Ayrshire Pullman Motor Services & Ritchie v Inland Revenue Commissioners [1929] 14 TC 754.

Gregory v. Commissioner [1932] 27 B.T.A. 223.

Halifax plc v Commissioner of Customs and Excise [2006] ECJ 21.

HMRC V Pedragon Plc & 5 Others [2015] UKSC 37.

Keroche Industries Limited v Kenya Revenue Authority & 5 Others [2007] Eklr.

MacNiven-v-Westmoreland Investments [2001] UKHL 6.

Mathew Okwanda v Minister of Health and Medical Services & 3 others [2013] eklr.

Mangin v Inland Revenue Commissioner [1971] AC 739.

Mitu-Bell Welfare Society v Attorney General & 2 others [2013] eklr.

MMM v Permanent Secretary, Ministry of Education & 2 others [2013] eklr.

Republic vs. Kenya Revenue Authority, ex parte Bata Shoe Company (Kenya) Limited [2014] eklr.

Tax Justice Network- Africa v Cabinet Secretary for National Treasury & 2 others [2019] eklr.

Unilever Kenya Ltd v Commissioner of Income [2005] eklr.

LIST OF STATUTES

Constitution of Kenya 2010.

Foreign Account Tax Compliance Act 2010.

Income Tax Act CAP 470 Laws of Kenya.

Income Act Transfer Pricing Rules 2006.

Proceeds of Crime and Anti-Money Laundering Act 2009.

Tax Procedures Act 2015.

LIST OF INTERNATIONAL INSTRUMENTS

OECD Report, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' 2017.

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters, ETS No.127

LIST OF ABBREVIATIONS

DTA	Double tax agreement
ITA	Income Tax Act.
KRA	Kenya Revenue Authority.
OECD	The Organization for Economic Cooperation and Development.
PE	Permanent establishment.
PSM	Profit split method.
RPM	Resale price method.
TNMM	Transactional net margin method
TP	Transfer pricing.

ABSTRACT

This study explores the definition of aggressive tax avoidance and the different strategies employed by multinational companies which include, transfer pricing, thin capitalization, accounting methods and the use of tax havens. It analyses how these methods are misused by multinational companies by stretching the legal limits to achieve tax avoidance.

In addition, the study evaluates the existing legal and institutional framework for addressing aggressive tax avoidance in Kenya. In this regard, it looks into various statutes including the Constitution of Kenya, Income Tax Act, Income Tax Transfer Pricing Rules, Accountants Act and Tax Procedures Act. It evaluates the effectiveness of the different statutes in sealing loopholes used by multinational companies to further aggressive tax avoidance.

The key finding made is the fact that there is an increase in aggressive tax avoidance in Kenya owing to inadequacies in the legal regime. The loopholes are exploited by the multinational companies to engage in practices that beat the purposes of the statutes.

The study reaches a conclusion that the current legal and institutional framework in Kenya does not effectively address aggressive tax avoidance. In this regard, suggestions are made for strengthening the legal and institutional framework to entrench transparency and strengthen tax administration in line with international best practices advanced by the OECD.

CHAPTER ONE: INTRODUCTION

1.1 Introduction

Multinational companies are firms that have economic activities and operations in more than one jurisdiction.[1] These companies undertake complex structured transactions aimed at achieving tax savings due to the cross-border nature of their transactions.[2] This is done by pushing the legal limits or by circumventing the existing laws with the aim of avoiding due taxes. While structuring transactions to achieve tax savings is not illegal, the aggressive use of the strategies portend significant ramifications to the tax collections in the country.[3]

Active exploitation of the tax regime by multinational companies especially in cross border trade effectively reduces the collectable tax because transactions which could otherwise be taxable can be disguised and structured to either make them non-taxable or significantly reduce the tax payable.[4] In Kenya, aggressive tax avoidance perpetuated by multinational companies has led to revenue losses amounting to approximately 151 million US dollars annually[5], arguably hampering economic growth. The practice has become lucrative for multinational companies which now invest heavily in research and expertise to achieve tax savings.[6]

---

[1] Eric Rugraff and Michael Hansen, *Multinational Corporations and Local Firms in Emerging Economies* (Amsterdam University Press 2011) 21.
[2] Hansrudi Lenz, 'Aggressive Tax Avoidance by Managers of Multinational Companies as a Violation of their Moral Duty to Obey the Law: A Kantian Rationale' [2018] Journal of Business Ethics 2.
[3] Ibid 3.
[4] Clemens Fuest, Mathieu Parenti, Farid Toubal, 'International corporate taxation: What reforms? What impact?'[2019] In Notes du conseil d'analyse économique Volume 54, Issue 6, 8.
[5] Benard Kirui, 'Tax Practitioners: Advocates of Compliance or Avoidance?' [2016] African Tax Research Network Working Paper No. 04. 6
[6] ibid 15.

The question that begs is therefore how to differentiate tenable tax avoidance from aggressive tax avoidance and further, whether aggressive tax avoidance should be classified as tax evasion. The difference between aggressive tax avoidance and tax evasion has grown very thin considering the effects of both concepts to the economy.[7] It is acknowledged that tax evasion is outright illegal and attracts penal sanctions, however, aggressive tax avoidance has not been classified as illegal. Much as it does not attract penal sanctions, no protection is offered in law for engaging in aggressive tax avoidance.[8]

Regulation of aggressive tax avoidance poses challenges since strategies adopted by multinational companies do not necessarily amount to express infraction of the letter of the statute but rather an infraction of the spirit or intention and purpose of the law.[9] Though problematic, the issue falls in between the realm of ethics and the law.[10]Therefore, it violates the moral obligation of multinational companies to abide by the letter and the spirit of the law[11]. This ethical dimension calls on multinational companies to reflect on their tax planning strategies in economic, legal and ethical terms.[12]

[7] Charles G. Kamau, 'Tax Avoidance and Evasion as a Factor Influencing 'Creative Accounting Practice' Among Companies in Kenya' [2012] Vol. 4(2): Journal of Business Studies Quarterly. 77
[8] Ibid 78.
[9] The US Court of Appeal has had occasion to deal with the right of a taxpayer to avoid tax in *Gregory vs Helvering* (1928) in which it held that every taxpayer has a right to organize his affairs so as to lower the tax liability.
[10] Jennifer Blouin, 'Defining and Measuring Tax Planning Aggressiveness' [2014] National Tax Journal 875.
[11] James Alm and Benno Torgler, 'Do Ethics Matter? Tax Compliance and Morality' (2011) Vol. 101, No. 4, Journal of Business Ethics 640.
[12] Lutz Preuss, *Corporate Tax Avoidance-An Ethical Evaluation. In A. M. Hayne, A. Murray & J. Dillard (Eds.), Corporate Social Responsibility* (New York Routledge 2013) 365.

The escalation of aggressive tax avoidance can be attributed to, among other factors, poorly drafted bilateral treaties, high tax rates, the globalization of the world economy, ease of communication and the differences in national tax levels and laws between different jurisdictions.[13]

Poorly drafted treaties between countries have led to treaty abuse by multinational companies which take advantage of loopholes created in treaties to further aggressive tax avoidance.[14] Kenya has in place a number of bilateral and multilateral treaties which are aimed at increasing foreign direct investments through reduced taxes and other benefits. However, some of the treaties are disadvantageous to Kenya and create loopholes for aggressive tax avoidance, a good example being the Kenya-Mauritius double tax agreement.[15]

The Kenya-Mauritius double tax agreement was challenged in the high court of Kenya due to the provisions which were gratuitously favorable to Mauritius to the extent that its net effect was to reduce tax collection in Kenya[16]. The petitioners also faulted the process of enactment of the agreement for not factoring public participation. Though the agreement was invalidated, the court was emphatic that the negotiation of the terms of the agreement was the sole mandate of the executive and that the terms of the agreement can only be questioned through parliament when the legal notice for operationalization is tabled.[17]

---

[13] Kudakwashe Hove, 'An Investigation into The Causes of Tax Avoidance and Tax Evasion in Zimbabwe: A Survey of Business Operators in Bulawayo' (2016) Vol. IV, Issue 5 International Journal of Economics, Commerce and Management United Kingdom 522.

[14] Marian Omri, 'Unilateral Responses to Tax Treaty Abuse: A Functional Approach' [2016] UF Law Faculty Publications 1159.

[15] Sol Picciotto, 'The interactions of National and International Tax Law and the Kenya - Mauritius Tax Treaty'(2019) Vol. 1, Issue 1, Journal on Financing for Development 16.

[16] *Tax Justice Network- Africa v Cabinet Secretary for National Treasury & 2 others* [2014] eklr.

[17] Picciotto (n 15).

The tax rates in Kenya are relatively high and duplicitous.[18]

High tax rates provoke aggressive avoidance reactions in the country to the extent that tax increases may in some cases result to a reduction in revenue collection rather than an increase in revenues.[19]

This coupled with differences between national tax policies offer a breeding ground for multinational companies to aggressively avoid tax.[20] This is especially significant in cross border trade in which companies structure their transactions through low tax jurisdictions such as tax havens. These jurisdictions offer a cocktail of attractive benefits to multinational companies including secrecy of information, minimal taxes and efficiency which when aggressively exploited by the entities, can result in tax savings.[21]

Globalization of the world economy has facilitated seamless connectivity and cross border transactions. The ease of connectivity has enabled multinational companies to produce raw materials in one jurisdiction and transfer them to a higher tax jurisdiction for further processing and in the process exploit the transfer pricing regime. Multinational companies can distort their pricing by overpricing exported goods from lower tax jurisdictions or underpricing imports into high tax jurisdiction.[22]

---

[18] Michael Ng'ang'a Thiga and Willy Muturi, 'Factors That Influence Compliance with Tax Laws among Small and Medium Sized Enterprises in Kenya (2015) Vol 5, Issue 6, International Journal of Scientific and Research Publications 2.

[19] James Long and James Gwartney, 'Income Tax Avoidance: Evidence from Individual Tax Returns' (1987) Vol 40 Issue No 4 National Tax Journal 517.

[20] Simon Loretz, 'Aggressive Tax Planning Indicators' (2017) European Commission Taxation Papers Taxation and Customs Union Working Paper No 71 – 2017, 35. <https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_papers_71_atp_.pdf> Accessed 21.10.2019.

[21] ibid 36.

[22] Jens Wittendorf, 'Transfer Pricing and the Arm's Length Principle in International Tax Law' [2010] Kluwer Law International 3.

Finally, corruption in government affects the perception of taxpayers on the benefits of paying taxes. The negative perception encourages aggressive avoidance behavior due to the minimal benefit attached to tax compliance.[23]

These factors have led to constant mutation of complex structured transactions due to the aggressive exploitation of the tax laws. The fast-changing structures have left the Kenya revenue authority lagging and playing a catch-up game to multinational companies.[24] Several methods have been used to facilitate aggressive tax avoidance including, transfer pricing, contract manufacturing use of tax havens and thin capitalization.[25] Though these concepts are regulated using various tax legislation, multinational companies continue to engage in more complex structured transactions around the concepts with the aim of making tax savings.[26]

The most commonly abused method is transfer pricing which takes up more than half of the total aggressive tax avoidance by multinational companies.[27] This is enabled by the cross-border operations of multinational companies coupled with the jurisdictional differences in tax rates. Multinational companies minimize the payable taxes by allocating more of the profit to lower tax Countries.[28]

---

[23] Yukun Sun, 'Corporate tax avoidance and government corruption: Evidence from Chinese firms' [2021] Vol 38 Economic Modelling Journal 15.
[24] Eliud Moyi and Eric Ronge, 'Taxation and Tax Modernization in Kenya: A Diagnosis of Performance and Options for Further Reform' [2016] Institute of Economic Affairs 21.
[25] Mark Holtzblatt, Eva Jermakowicz and Barry Epstein, 'Epstein Tax Heavens: Methods and Tactics for Corporate Profit Shifting' [2015] International Tax Journal 36.
[26] Ibid 37.
[27] Joel Barker, Kwadwo Asare and Sharon Brickman 'Transfer Pricing as a Vehicle in Corporate Tax Avoidance' [2017] Volume 33, Number 1 Journal of Applied Business Research 9.

[28] Ibid

Aggressive Tax Avoidance has significant adverse effect on the economy. This practice erodes moral values and leads to inflationary tendencies in the economy. [29] The individuals who avoid taxes have more money within the system leading to the distortion of the economy. This creates inflationary pressures in which case a lot of money chase few goods in the economy.[30]

The resultant revenue leakages lead to significant loss of revenue by the government and effectively affects the government's fiscal policy. The rich in the country and the multinational companies, who essentially are the owners of capital in the economy, avoid taxes thereby shifting the tax burden to the middle class.[31] The government then compensates for the lost taxes by raising tax rates. The higher rates then penalize the middle-class honest taxpayers, who either comply due to their honesty or because they have no opportunities for avoidance.[32]

In response to the increasing exploitation of the tax regime, Kenya has made effort to design a viable tax system which can seal systemic loopholes and sustain the Government budget. Tax reforms in Kenya were majorly pushed by the policy reform conditions for the grant of loan and aid funding imposed by the World Bank otherwise known as the Structural Adjustment Programs. [33] These conditional reforms started from the mid-1980s and were adopted voluntarily by Kenya to gain favour with the donors.[34]

---

[29] Martin Petrin, 'Corporate Tax Avoidance - The Problem of Aggressive Tax Planning' [2018] University College London Journal 22.
[30] Ibid 22.
[31] Fuest Clemens and Spengel, Christoph, 'Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform; [2013] Leibniz Centre for European Economic Research Journal 9.
[32] Martin Petrin, 'Corporate Tax Avoidance the Problem of Aggressive Tax Planning' [2018] University College London 22.

[33] Timothy Okech and Peter Mburu, 'Analysis of Responsiveness of Tax Revenue to Changes in National Income in Kenya between 1986 -2009' (2011) Vol. 2 No. 21 International Journal of Business and Social Science 276.
[34] Ibid 277.

Kenya enacted the Income Tax Act which is supplemented by robust enforcement mechanisms undertaken by the Kenya Revenue Authority to control aggressive tax avoidance. The laws in place do not effectively deal with aggressive tax avoidance thereby leaving loopholes that are easily exploited by multinational companies.[35] Some of the significant policy and legislative interventions proposed in dealing with this problem include restructuring and rationalization of the tax exemptions to curb harmful tax competition, rationalization of tax rates and improving the efficiency of tax administration.[36]

The general anti-avoidance rule in the Income Tax Act[37] is the foremost effective method of dealing with aggressive avoidance in Kenya. Owing to the advancement in business, companies often structure transactions in infinite ways, and it is not possible to set exhaustive rules for curbing aggressive tax avoidance. However, the adoption of the general anti avoidance rules gives a blanket leeway to the commissioner to appropriately adjust transactions should he deem fit.[38]

General anti-avoidance rules are a flexible instrument which provide a balance between the freedom to structure transactions, and the power of the tax authority to curb aggressive tax avoidance. Structuring a transaction to reduce or extinguish the tax liability is a natural economic behaviour. However, the general anti-avoidance rules enable the tax Authority to reign in on transactions put in place with the principal objective of avoiding tax and adjust such transactions accordingly for tax purposes.[39]

---

[35] Moyi and Ronge (n 24).
[36] Anne Van de Vijver, Danny Cassimon and Peter-Jan Engelen, 'A Real Option Approach to Sustainable Corporate Tax Behavior' [2020] MDPI Journal 4.
[37] Income Tax Act Cap 470, s 23.
[38] Christophe J Waerzeggers and Cory Hillier, 'Introducing a General Anti-Avoidance Rule (GAAR)' [2016] Volume 2016: Issue 001, IMF Journal
[39] Christophe Waerzeggers and Cory Hillier, 'Introducing a General Anti-avoidance Rule (GAAR)—Ensuring That a GAAR Achieves Its Purpose' (2016) Tax Law IMF Technical Note 13.

When invoked by the tax authority, general anti avoidance rules can limit unacceptable tax avoidance schemes that look compliant from a textual interpretation of the statute. The rules are designed to prevent otherwise lawful practices that abuse the spirit of the law.[40]

This thesis essentially analyses the Kenya tax laws and questions their effectiveness in addressing aggressive tax avoidance.

1.2 Statement of the problem

There is an increase in aggressive tax avoidance in Kenya resulting in revenue losses of approximately 151 Million US Dollars annually.[41] The escalation of aggressive tax avoidance can be attributed to, among other factors, poorly drafted bilateral treaties, high tax rates, the globalization of the world economy, ease of communication and the differences in national tax levels and laws between different jurisdictions.[42]

This has led to mismatches between economic growth and revenue collection.[43] The economy recorded an average economic growth of 5.7% between the years 2015-2019 making it one of the region's fastest growing economies.[44] However, revenues have not been growing at the same rate. The 2019/2020 budget presented a fiscal deficit of 6.2% of GDP.[45] This research seeks to explore the correlation between the inadequacies in the legal and institutional regime and the increase in aggressive tax avoidance.

---

[40] Ibid 13.
[41] Kirui (n 5).
[42] Kudakwashe Hove, 'An Investigation into The Causes of Tax Avoidance and Tax Evasion in Zimbabwe: A Survey of Business Operators in Bulawayo' (2016) Vol. IV, Issue 5 International Journal of Economics, Commerce and Management United Kingdom 522.
[43] Cyrus Muriithi, 'The Relationship Between Government Revenue and Economic Growth in Kenya' (2013) Vol 1, Issue 1 International Academic Journal of Information Sciences and Project Management 87.
[44] https://www.worldbank.org/en/country/kenya/overview#1
[45] Ibid

1.3 Research

I propose to undertake secondary research to better understand the building blocks of this issue and to attempt to suggest the way out. As such, the research component of this study is structured as follows:

1.3.1 Research Methodology

Qualitative Research Techniques will be used for the research. Qualitative research will be used because it does not limit the scope of the research and therefore creates room for a deeper analysis of the topic.[46] The research in this thesis is intended to generate theory, develop policy, propose reform and justify the proposed reforms. Qualitative research is appropriate because I intend to define and explore aggressive tax avoidance in relation to Kenya tax laws and generate a correlation with revenue collection. Qualitative methods can provide context and a deeper understanding of stakeholders' needs and perspectives.

Information for this research will be collected from books, journals, and scholarly articles. I will refer to these sources to gain insight on previous studies and other works of literature on the subject.

1.3.2 Research Questions

1. What is the definition of aggressive tax avoidance?
2. What strategies are used for aggressive tax avoidance in Kenya?
3. Is the increase in aggressive tax avoidance as a result of a weak legal regime in Kenya?
4. What amendments can be made to the laws to control aggressive tax avoidance?

---

[46] Howard Lune and Bruce Berg, *Qualitative Research Methods for the Social Sciences* (9th edition, Pearson 2017) 11

1.3.3. Objectives

The general objective of the thesis is to define aggressive tax avoidance and examine the strategies used for aggressive tax avoidance in Kenya with a view to propose legal reform. The specific objective is to examine the sufficiency of Kenya's legal regime in curbing aggressive tax avoidance and evaluate how best the legislation can be structured to curb aggressive tax avoidance while at the same time make Kenya a preferred international financial hub and investment destination.

1.3.4. Hypothesis

1. Kenya's institutional and legal framework has loopholes which allow room for aggressive tax avoidance. The weak legal regime has led to the rapid increase in aggressive tax avoidance with a corresponding increase in fiscal deficit.

1.4 Theoretical Framework

The research will be premised on the economic analysis of law theory. In this regard, it will evaluate the economic plausibility of the laws and the regulatory regime to establish whether it leads to the creation of more value. One of the leading proponents of this theory, Richard Posner argues that laws ought to be efficient and thereby maximize the social willingness-to-pay. He further argues that laws should have efficient rules which should enable individuals make an economic response to Legal Rules.[47]

He further points out that the theory improves the law by avoiding instances in which the laws have uneconomical consequences. The theory will help explain how the laws can be amended to

[47] Richard Posner, 'Values and consequences: An introduction to Economic Analysis of Law' (2006) John M. Olin Law & Economics Working Paper 53/1998, 2.<https://pdfs.semanticscholar.org/fcca/671b93a88efd6d5807b12ea01f4094a8833c.pdf> accessed 5 February 2019.

curb aggressive tax avoidance while at the same time market Kenya as a preferred international financial center. The laws in this regard will have to be optimally efficient to achieve both ends.[48]

The research will also be based on the legal positivism theory of law. One of the leading proponents of this, Prof HLA Hart, holds that laws are peremptory directives of human beings and he further finds no necessary linkage between law and morality.[49] He argues that the fact that a policy is just, widely accepted, efficient, or wise does not make it the law, and in the same vein, the mere fact that a law is unjust, inefficient or widely unaccepted does not make it cease being a law. Therefore, the law is what has been enacted and nothing less.[50] This research will analyze the laws in place and question their effectiveness in combating aggressive tax avoidance. Further, the research will suggest possible amendments to the laws to enhance effectiveness and efficiency in dealing with aggressive tax avoidance.

1.5 Literature review

The issue in question here has been the subject of intense enquiry. Relevant sourcing and pointers on the same bring into focus the works of the following authors:

Charles Rettig defines aggressive tax avoidance as the artificial arrangement of transactions with the objective of tax avoidance. He argues that these are paper transactions with no economic substance.[51]

---

[48] ibid.
[49] H.L.A Hart, 'Positivism and the Separation of Law and Morals' [1958] Harvard Law Review 593.
[50] Ibid 594.
[51] Charles Rettig, 'IRS Enforcement Strategic Options for Taxpayers' (2005) Working Paper Tax Controversies Conference Hawaii Society of CPAs <http://nyujilp.org/wp-content/uploads/2013/02/40.2-Pearson.pdf> accessed 5 February 2019.

John Mwangi, David Kiragu and Donatus Mathenge argue that ease of doing business has enhanced an underground cash economy which has aggravated aggressive tax avoidance since this kind of business does not leave a trail and can easily be concealed using artificial transactions aimed at aggressively avoiding tax. They propose technology adoption and staff training at Kenya revenue authority in mitigation of fraud.[52]

Jane Gravelle argues that central to aggressive tax avoidance is the use of tax havens by multinational companies to hide dubious transactions. She notes that in order to address profit shifting and transfer pricing hurdles placed by multinational companies, some of the recommended tax law reforms should include restricting deferral of tax obligations, controlling the use of foreign tax credits and maximizing on disclosure requirements in the home jurisdiction.[53]

David Kerzer and David Chodikoff emphasize on the need for treaties to promote international commerce owing to the relative predictability. They note that the treaties can greatly help in the fight against aggressive tax avoidance and help promote efficiency though provisions such as information exchange, assistance in collection and information exchange agreements.[54]

Joel Slemrod has written on the need to come up with comprehensive legislation to make payment of taxes a compulsory duty of every citizen. He notes that a country's tax system cannot be based on a taxpayer's moral duty and obligation to pay taxes. Only a handful will voluntarily pay while a vast majority will default. Therefore, the legal responsibility to pay taxes ought to be compulsory

---

[52] John Mwangi, David Kiragu and Donatus Mathenge, Effect of Technology Adoption and Staff Training on Tax Fraud among Large Taxpayers in Kenya Revenue Authority (2018) Vol. VI, Issue 5 International Journal of Economics, Commerce and Management United Kingdom 596.

[53] Jane G. Gravelle, 'Tax Havens: International Tax Avoidance and Evasion' [2015] Congressional Research Service 44.

[54] David Kerzner and David Chodikoff, *International Tax Evasion in the Global Information Age* (Springer publishers, 2016).

and not based on a taxpayer's sense of duty. This should be buttressed with penal sanctions for non- compliance.[55]

John Tretola vouches for a more purposive approach to the interpretation of tax statutes as opposed to the strict literal interpretation. He fronts the position that an absurd or irrational construction should not be adopted in tax statutes. He supposes that even the literal meaning of the wording of the statutes may be abandoned if doing so will give effect to the objects of the law. Generally, tax statutes are given the same interpretation as other statutes in which case, none of the parties is favoured but reference should be made to the language used in the context underlying the legislation. This amounts to purposive interpretation of the law which gives the Judge in tax matters greater discretion than the literal approach. In sum, they are of the view that tax statutes should not be interpreted in overly strict and technical terms but should rather be interpreted in light of the purpose underlying the legislation.[56]

John Christensen & Richard Murphy are of the view that aggressive tax avoidance enables companies to benefit from government services without paying taxes, while at the same time causing market distortions leading to the transfer of the tax obligations to the compliant taxpayers in the country. Their research reaches a conclusion that about 60 per cent of transactions by multinational companies are intra-company and are often channeled through low tax jurisdictions.[57]

---

[55] Joel Slemrod, 'Cheating Ourselves: The Economics of Tax Evasion' (2007) Vol 21, No 1 Journal of Economic Perspectives.

[56] John Tretola, 'The interpretation of Taxation Legislation by the Courts: A reflection on the views of Justice Graham Hill' (2006) Vol 16 Revenue Law Journal 73.

[57] John Christensen and Richard Murphy, 'The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the bottom line. [2004] Society for International Development Journal 39.

Most of the transactions are more often on paper and employ the use of creative accounting for the purpose of tax avoidance and evasion. They point to the obscure thin line between tax avoidance and tax evasion. It is their view, that the complexity of the tax legal regime creates loopholes which corporates take advantage of and exploit. They opine that in order to effectively deal with aggressive tax avoidance, the categorization of 'acceptable' and 'unacceptable' tax avoidance should be abolished. This will effectively close the loopholes which give room to corporates to evade paying taxes.[58]

Jasper Mbiuki acknowledges Kenya's legislative dilemma with regard to transfer pricing. He laments that the inadequacies of the transfer pricing legal regime greatly impedes the fight against aggressive tax avoidance. He examines the institutional framework for transfer pricing especially laying emphasis on the Unilever -vs- Commissioner of income tax[59] case and comes to a conclusion that the Institutional framework is inadequate as it still greatly depends on the OECD guidelines.[60]

The determination by the court prompted the enactment of rules[61] which set out the guidelines on transfer pricing. He posits that the rules, which are largely modelled on OECD regime have inherent inadequacies which create loopholes for multinational companies to evade tax payment He recommends the strengthening of the legal and institutional framework for transfer pricing in Kenya.[62]

---

[58] Ibid 39.
[59] *Unilever Kenya Ltd v Commissioner of Income Tax* [2005] eklr.
[60] The OECD -Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations provide guidance on the application of the "arm's length principle" for the valuation of transactions between Multinational enterprises for tax purposes.
[61] The Income Tax (Transfer Pricing) Rules 2006.
[62] Jasper Mbiuki,'The legal and Institutional Framework of Transfer Pricing in Kenya: A Case Study of the Unilever Case and its Aftermath' (LLM Thesis University of Nairobi 2011) 41.

In conclusion, from the sourced literature on this topic, aggressive tax avoidance has been satisfactorily defined. Further, the writings have answered my research questions especially on the taxpayer's moral duty to comply with tax statutes. It is now clear that taxes are statute based and should not be based on moral obligations. The tax obligations ought to be defined, administered and sanctions meted from the statute. The writings also confirm that the Kenya legal regime has loopholes which are often abused by multinational corporations. Finally, the reliance on the OECD Model law by Kenya has contributed greatly to the aggressive tax avoidance problem because Kenya has not crafted laws that work for its unique challenges but rather rely on the model law with all its complexities without taking into account its local circumstances.

1.6 Chapter breakdown

The thesis is organized into four chapters and proposes to tackle the issues at hand as follows:

Chapter 1 begins with an introduction to the study and gives a definition and analysis of the concept of aggressive tax avoidance, its effects to the economy, and the measures taken to curb it. The chapter also explores the objectives of the study, the research questions and the literature review. The thematic score of this chapter is to lay foundation for the discussion in subsequent chapters and conclusions ultimately arrived at.

Chapter 2 functionally defines aggressive tax avoidance and elaborates on the strategies used in Kenya. The chapter presents a multi-jurisdictional comparative analysis on the definition of the concept. It evaluates the statutory enactments and judicial precedent from the UK, USA and Kenya and reaches a definition of aggressive tax avoidance. Further, within the chapter, the various modes of aggressive tax avoidance are discussed in detail including transfer pricing, use of tax havens,

thin capitalization and accounting methods. In analyzing the methods, the chapter will also attempt to draw the boundary between acceptable and unacceptable tax avoidance.

Chapter 3 discusses the Kenyan laws aimed at controlling aggressive tax Avoidance. It includes an in-depth analysis of the various statutes and identifies the strengths and weaknesses in controlling aggressive tax Avoidance. Overall, the chapter presents an overview of the effectiveness or otherwise of the legal instruments including the Income Tax Act, Accounting Act, Tax Procedures Act, and the Transfer Pricing Rules in controlling aggressive tax avoidance.

Chapter 4 presents the conclusion and it gives recommendations on the legal reforms that should be undertaken to seal the loopholes that facilitate aggressive tax avoidance.

CHAPTER TWO: THE MEANING OF AGGRESSIVE TAX AVOIDANCE AND THE PROFILE OF AGGRESSIVE TAX AVOIDANCE STRATEGIES USED IN KENYA.

2.1 Definition of Aggressive Tax Avoidance

The definition of aggressive tax avoidance has remained fluid and unsettled over the years. It is noteworthy that different legislation, judicial decisions and writings use different interchangeable synonyms for the term aggressive tax avoidance. The OECD refers to it as unacceptable/ abusive tax planning.[63]In the USA, the Internal Revenue Service refers to it as abusive tax schemes.[64]

To effectively define aggressive tax avoidance, we must start with the definition of tax avoidance from which it largely derives its definition. The Tax Procedures Act defines tax avoidance as a transaction conceived or aimed at avoiding tax liability under any tax law.[65] The strict reading of the Tax Procedures Act does not mention aggressive/abusive tax avoidance therefore leaving it open for judicial interpretation considering all surrounding facts. Therefore, views on the categorization of transactions differ due to the lack of a definite statutory definition.[66]

Earlier judicial decisions in Kenya adopted the strict interpretation approach in which case the interpretation of tax statutes can only be through the textual clear approach without room for

[63] OECD, 'International Tax Terms for the Participants in the OECD Programme of Cooperation with Non-OECD Economies' < http://www.oecd.org/dataoecd/17/21/33967016.pdf> Accessed 17 February 2019.
[64] <https://www.irs.gov/compliance/criminal-investigation/overview-abusive-tax-schemes> Accessed 17 February 2019.
[65] The Tax Procedures Act 2015 s 3.
[66] Hansrudi Lenz, 'Aggressive Tax Avoidance by Managers of Multinational Companies as a Violation of Their Moral Duty to Obey the Law: A Kantian Rationale' [2018] Journal of Business Ethics 682.

extrapolation. The High Court of Kenya has held that taxation cannot be by inference or analogy as any attempt to do so perpetrates an illegality; is arbitrary and oppressive.[67]

The same approach was used by the courts in the United Kingdom in earlier decisions which similarly insisted on the textual interpretation of tax statutes. Lord Donovan held in favour of literal interpretation of tax statutes and that no extrapolation ought to be made in the meaning to fit the purpose of curbing tax avoidance.[68] Further, Lord Hoffmann found that since words like 'avoidance' and 'mitigation are not expressly provided in a statute, introducing them in practice by tax authorities would be unhelpful. The language of the statute ought to be applied in determining whether a tax avoidance strategy is acceptable or not.[69]

A similar position was taken in the US when Lord Clyde found in favour of the strict textual interpretation of tax statutes and further stated that every individual has a right to arrange his financial affairs so as to reduce the tax payable.[70]

Taking into account the precedent set by the earlier court cases, and in the absence of a clear statutory definition, a literal interpretation of tax statutes makes the distinction between tax avoidance and aggressive tax avoidance conceptually redundant.[71]

Recent decisions now favour a purposive interpretation of tax statutes.[72] Notably, in the USA, the supreme court found that notwithstanding the letter of the law which gaves a blanket authority to

[67] *Keroche Industries Limited v Kenya Revenue Authority & 5 Others* [2007] eKLR

[68] *Mangin v Inland Revenue Commissioner* [1971] AC 739.

[69] *MacNiven-v-Westmoreland Investments* [2001] UKHL 6.

[70] *Ayrshire Pullman Motor Services & Ritchie v Inland Revenue Commissioners* [1929] 14 TC 754.

[71] David G. Duf, 'Tax Avoidance in the 21st Century' [2009] Allard Research Commons, Faculty Publications 14.

[72] Judith Freedman, 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' [2007] Law Quarterly Review 52.

the tax payer to enter into schemes aimed at reducing tax liabilities, the key consideration is whether the tax payer's action in pursuance of the tax avoidance objective, is what the statute intended.[73]

The Court further defined the business purpose doctrine and found that any transaction done including transfer of assets between companies should be made in pursuance of an actual business objective. Such transactions should not be done in pursuance of a plan which is not related to either's business whatsoever and is basically contrived solely to avoid taxes. In this case, the alleged reorganization had no business purpose but rather was a scheme concealed as corporate reorganization meant to achieve a preconceived plan not to reorganize the business but to avoid taxes. The supreme court in this case laid emphasis on the question of motive in respect of the scheme in determining what abusive/unacceptable tax avoidance is.[74]

The USA has codified the economic substance doctrine[75] and defines the conditions to be met by a transaction to achieve economic substance. First, the transaction ought to make an actual impact to the economic position of the taxpayer in a meaningful way other than the attendant tax effects; and secondly, apart from the tax consequences of the transaction, the taxpayer ought to have a substantial business objective.[76]

In the United Kingdom, the court of appeal found that community laws cannot cushion transactions carried out solely with the aim of exploiting the tax laws. Such transactions are not undertaken within the context of ordinary market driven operations but are crafted with the sole aim of tax

---

[73] *Gregory v. Commissioner* [1932] 27 B.T.A. 223.
[74] The decision is congruent with the 'business purpose' and 'economic substance' doctrines established in the case of *Gregory v. Helvering*, [1935] 293 U.S. 465 and in the UK through the *W T Ramsay Ltd v Inland Revenue Commissioners* [1981] HL 12.
[75] IRC §7701(a).
[76] Ibid §7701(a).

avoidance in mind.[77] The court opined that if it is to be found that a transaction is abusive, it is important to first establish whether the transaction leads to tax benefits which beat the purpose of the statute. Second, the transaction's main purpose ought to be achieving tax advantages and not any business purpose.[78]

The court found that to crack the continuum, the court is tasked with the responsibility of determining the real substance of the transactions concerned. In so doing, it may consider whether the transactions are purely artificial and the links between the persons involved in the scheme.[79]

The UK Supreme Court[80] has given deeper guidance of how a scheme ought to be analyzed by the courts. The court held that notwithstanding the commercial benefit of a transaction, it will still be abusive if it is established that its main aim is the accrual of a tax advantage. This therefore means that courts will consider the commercial aim of a scheme comprehensively, and each component of the scheme. The supreme court recognized that tax avoidance was legal, but that it could have significant social costs. In essence, courts will now consider two key factors in determining whether a tax avoidance structure is abusive or not namely, whether the main purpose of the transaction is to obtain a tax advantage and whether the transaction is driven by a commercial benefit.[81]

In Kenya, courts have now adopted the purposive interpretation approach which broadens the scope of a statute beyond the literal words to the intention of parliament. The high court[82] had

[77] *Halifax plc v Commissioner of Customs and Excise* [2006] ECJ 21.
[78] Ibid ECJ 21.
[79] *Halifax plc v Commissioner of Customs and Excise* [2006] ECJ 21.
[80] *HMRC V Pedragon Plc & 5 Others* [2015] UKSC 37.
[81] Ibid UKSC 37.
[82] *Republic vs. Kenya Revenue Authority, ex parte Bata Shoe Company (Kenya) Limited* [2014] eklr.

occasion to grapple with the question of interpretation of tax statutes and Justice Weldon Korir made the finding that:

First, perceived moral concepts are not applicable in interpreting tax statutes. The words ought to be given their ordinary natural meaning and not some other meaning just because the statute's objective is to frustrate tax avoidance; Secondly, there is no room for any extrapolation or intendment in interpreting tax statutes. The language used in the statute ought to be read plainly without reading perceived moral or equity considerations; thirdly, if the plain literal interpretation of a tax statute produces absurdity or injustice, then the statute may be interpreted in a way that will ascertain the will of the legislature so as to cure the absurdity; and finally, so as to avoid any absurdity and to give light to parliament's intention, the court ought to factor in the history of an enactment in establishing the purpose of the statute.[83]

The court of appeal affirmed the position in the case of *Mount Kenya Bottlers Ltd & 3 others v Attorney General & Kenya Revenue Authority* in which it found that wholesome purposive interpretation of tax statutes is necessary to prevent injustice and absurdity.[84]

The Income Tax Act recognizes that there are some transactions whose main purpose is to avoid the payment of taxes and goes ahead to give the commissioner the discretion to make necessary adjustments. The Income Tax Act bestows on the commissioner the authority to carry out an audit and charge tax where appropriate.[85] This provision grants the commissioner the power to make adjustments to transactions to counteract the avoidance of a tax liability. The discretion to define

[83] *Republic* (n 81).
[84] [2019] eKLR
[85] The Income Tax Act Cap 470 S.23

an unacceptable avoidance scheme is entirely left to the commissioner without any supporting legislative definition of aggressive tax avoidance.[86]

In conclusion, from the judicial precedents discussed above, aggressive/ abusive/ unacceptable tax avoidance refers to schemes that fall in the grey area between acceptable tax avoidance and evasion. Though these transactions comply with the terms of the statute, they are contrived with no business or corporate purpose but are rather devices designed with the sole object and motive of tax avoidance.[87]

It is the use of business schemes and strategies with the sole aim of eliminating or lowering tax liability using paper transactions without any business objective.[88]It is therefore an arrangement contrived with the end goal being tax avoidance.[89] Aggressive tax avoidance is mainly carried out through accounting policies and strategies, corporate reorganizations, transfer pricing, use of financial instruments and thin capitalization.[90]

The different strategies are discussed in detail below:

2.2 Transfer pricing

Transfer pricing refers to the pricing of intra firm transactions between related parties.[91] It is the process by which subsidiaries of multinational companies sell goods and services to each other

[86] ibid s.23.
[87] Charles P. Rettig, 'IRS Enforcement Strategic Options for Taxpayers' (2005) Tax Controversies Conference, Hawaii Society of CPAs Working Paper 11.
[88] ibid 11.
[89] John Braithwaite, *Markets in Vice, Markets in Virtue* (The Federation Press 2005) 17.
[90] OECD, 'Corporate Loss Utilisation through Aggressive Tax Planning' (2011) OECD Publishing 49.
[91] Jens Wittendorf, 'Transfer Pricing and the Arm's Length Principle in International Tax Law' [2010] Kluwer Law International 3.

and is key in determining the income of each of the entities.[92]It involves the setting and analysis of transactions between related parties for goods, services, or use of property.[93]

Transfer pricing is recognised in the Kenyan legal regime and its practice is regulated under the Income Tax Act[94] and the Transfer Pricing Rules 2006.[95] Transfer pricing is problematic and is prone to abuse, due to 'mis-pricing' which is majorly done outside the arm's length principle.[96]

In furthering aggressive tax avoidance, multinational companies may in the course of controlled transactions resort to fictitious transfer pricing to manipulate profits. This helps them avoid taxes by recording losses or lower profits in high tax jurisdictions and higher profits in low tax jurisdictions.[97]The transfer prices charged in intra group transactions could in certain cases be arbitrary or fictitious. This could be achieved through manipulation of accounting entries using non- existent transactions which only exist on paper.[98]

Multinational companies are therefore able to take advantage and reap heavy profits at the expense of the exchequer. The ever-increasing cross border capital flows which has been highly encouraged by the removal of restrictions on capital flows, has triggered the increase in manipulative transfer pricing. According to UNCTAD, one third of global trade is between related parties.[99] The increased presence of multinationals in several countries has further propelled intra-firm trade in

---

[92]< http://www.businessdictionary.com/definition/transfer-price.html> Accessed 15 February 2019.

[93] Wolfgang Schön, Kai A. Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Publishing 2012) 44.

[94] Income Act 2018, s18.

[95] The Income Tax Transfer Pricing Rules 2006 Legal Notice No. 67.

[96] Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (University of Toronto Press 1998) 20.

[97] Lorraine Eden, 'Transfer Price Manipulation in Peter Reuter (2012) Draining Development: Controlling Flows of Illicit Funds from Developing Countries' [2012] World Bank Publication 205.

[98] Ibid 206.

[99]UNCTAD, 'World Investment Report on Investment, Trade and International Policy Arrangements' (1996) United Nations Publications 214 < https://unctad.org/en/docs/wir1996_en.pdf> Accessed 11 September 2019.

the recent years. While multinational companies reap supernormal profits by manipulating transfer pricing, countries lose billions of dollars in revenues and are forced to impose higher taxes on citizens to finance their budgets.[100]

In Kenya, the Income Tax Act[101] prescribes the framework for determining transfer prices. Central to controlling transfer pricing is the arm's length principle which comes with patent difficulties thereby creating loopholes for manipulation and abuse.[102] The Income Tax Rules (2006) provide several methods of computing the transfer price. These methods are anchored on adjustments, taking into account various socio-economic factors. These methodologies are flexible, and it is upon the multinational company to justify the use of whichever method.[103]

Transfer Pricing was often abused in Kenya due to the lack of proper regulation prior to the enactment of section 23 of the Income Tax Act which embodies the general anti avoidance rule. Following the publication of the OECD guidelines for transfer pricing, Kenya introduced section 23 of the Income Tax Act and the Transfer Pricing Rules, 2006.[104]

The arm's length principle is key in evaluating the concept of transfer pricing. It recognizes that the transaction between related parties are not influenced by the market forces as is the case between independent parties. The conditions of commercial relations are in many cases determined by the intra-group dynamics and not the market forces.[105] When related party transfer prices are not congruent with prices charged between independent parties, the collectable taxes from such

---

[100] Lutz (n 11).
[101] Cap 470 Laws of Kenya.
[102] Anuschka Bakker, 'Transfer Pricing and Business Restructurings: Streamlining All the Way' [2009] IBFD Publications 63.
[103] The Income Tax Rules 2006 r7.
[104] Hillary Kariuki Wangai, 'Impact of Transfer Pricing on Corporate Income Tax In Kenya'(MBA) Thesis, University of Nairobi, 2012) 10.
[105] OECD, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010'.

transactions could be greatly diminished. To cure the distortion, profits from such transactions can be adjusted accordingly.[106]

This is achieved by establishing reasonable conditions of commercial relations that would ordinarily be in place in transactions between independent entities in similar comparable circumstances. In making appropriate adjustments, there has to be a distinction between controlled transactions which are intragroup transactions between associated enterprises and uncontrolled transactions which are carried out between independent enterprises.[107]

The concept of comparability/similarity is also key in this exercise in order to draw an accurate distinction between the transactions and further, not to unjustly prejudice transacting parties. Transactions between independent parties and those between related parties are deemed to be comparable if there is significant similarity with immaterial minor differences that cannot materially affect the element under review. Alternatively, comparability can be achieved if reasonable adjustments can be made to do away with the significant consequences of such differences.[108]

Comparability of the transactions can be affected by factors including availability, reliability, nature of product or service and intellectual property considerations. It is therefore imperative to conduct a functional analysis to accurately depict the functions performed by each component of a multinational group. This will take into account the economic activities and responsibilities of

---

[106] ibid Para 1.7.
[107] Ibid Para1.8.
[108] OECD, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010' Para 1.9.

the parties in order to ascertain the extent of the allocation functions, risks, and the compensation to expect at an arm's length arrangement.[109]

2.3 Thin Capitalization

Thin capitalization is an aggressive tax avoidance technique which companies take advantage of in order to enjoy finance cost reduction. [110] It is employed by multinational companies to finance activities largely on debt from a related entity instead of equity capital. Companies based in high tax jurisdictions borrow from those in low tax jurisdictions in order to enjoy finance cost deduction.[111]

It is also referred to as earnings stripping which essentially refers to the payment of unrestrained or non-existent allowable interest to a related company. In most cases, the interest paid attracts meagre taxes or is exempt from taxes on the side of the related party. The upshot of this is the shifting of profits from the jurisdiction through debt and interest repayment.[112]

Multinational companies have taken advantage of and substituted external for internal debt in which case, they are still eligible for interest deductions even though the loan might be fictitious.[113] External debt on the other hand is generally not impacted by thin capitalization rules. The deduction on the books is based on the actual interest paid on the loan to the external lender.

---

[109] Amir Pichhadze, 'The Arm's Length Comparable in Transfer Pricing: A Search for an "Actual" or a "Hypothetical" Transaction?' (2015) Volume 7 No. 3 World Tax Journal 17.
[110]Agus Bandiyono, 'Effect of Intra Group Transaction, Thin Capitalization and Executive Characters on Tax Avoidance with Multinationality as a Moderation' (2019) Journal of Accounting, Business and Finance Research,Vol. 7, No. 2, 83
[111] ibid 2.
[112] United States of America Treasury Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (2007) 12.
[113] Karen B. Brown(ed), *Taxation and Development - A Comparative Study*. (Springer Publishers 2017) 357

The impact of the illicit deductions on the revenues collected by the state is colossal.[114] Interest expense is deductible from gross income for the purpose of computation of income tax.[115]This has always been to provide firms with a motivation to employ debt financing instead of equity and also, to afford companies with high gearing ratios a tax reprieve unlike those financed using equity who do not pay interest.[116]

This initiative has often been abused by unscrupulous businessmen who take advantage through profit shifting and record income from non-resident related companies as debt, thereby significantly reducing the due taxes.[117] In this context, profits are transferred to foreign subsidiaries as debts aimed at reducing the tax payable. The debt is just on paper and there is no actual interest paid on the loans.[118] To counter the negative impact to the net revenue collected, Kenya introduced rules aimed at restricting the deductibility of interest charged on debt exceeding three times the capital.

Thin capitalization rules are effective in taming aggressive tax planning using intercompany loans. On the other hand, investment decisions are affected by both local tax rates and the imposition of thin capitalization rules. Thus, countries are facing the tradeoff between wooing investors and limiting aggressive tax avoidance.[119]

---

[114] n15.

[115] Agus Bandiyono, 'Effect of Intra Group Transaction, Thin Capitalization and Executive Characters on Tax Avoidance with Multinationality as a Moderation' (2019) Journal of Accounting, Business and Finance Research,Vol. 7, No. 2, 85

[116] Ibid

[117]Eggert Wolfgang and Gideon Goerdt, 'Substitution across Profit-Shifting Methods and the Impact on Thin Capitalization Rules' (2020) CESifo Working Paper, No. 8046, 1

[118] ibid.

[119]Ruud de Mooij and Li Liu, 'At A Cost: The Real Effects of Thin Capitalization Rules' (2021) IMF Working Paper, WP/21/23, 4.

In conclusion, thin capitalization rules prevent abuse of interest deductions on loans thereby shielding the erosion of a resident company's tax base through excessive, unscrupulous interest deductions on non-existent loans. In addition, resultant foreign exchange losses are deferred until the thin capitalization conditions reverse.[120]

2.4 Accounting Methods

The creative use of accounting methods involves using the right accounting techniques to take advantage of the laws on taxation.[121] It involves several techniques some of which border on fraud such as income smoothing and aggressive accounting.[122]

Some of the popular legal accounting strategies include taking advantage of credits and deductions to reduce your taxable income.[123]Some of the accounting strategies adopted by companies are legitimate and lead to genuine tax savings including saving with pension schemes, investing in life policies to enjoy insurance relief, using debt capital to finance growth instead of equity in order to enjoy interest deductions.[124]

Life interest borrowing is often abused to advance aggressive tax avoidance. In this method, one borrows against the asset, which in this case is the life policy. Banks will give loans based on the surrender value of the policy. Ordinarily, one has to pay tax on the maturity based on the value of

---

[120] ibid 3.
[121]Oriol Amat and Catherine Gowthorpe, 'Creative Accounting: Nature, Incidence and Ethical Issues' [2010] Journal of Economic Literature 11.
[122] Charles Guandaru Kamau, Agnes Ndinda Mutiso, Dorothy Mbithe Ngui, 'Tax Avoidance and Evasion as a Factor Influencing 'Creative Accounting Practice' Among Companies in Kenya' (2012) Vol 4 No 2 Journal of Business Studies 77.

[123] Income Tax Act Cap 470, s15 &16.
[124] Charles, Agnes and Dorothy (n 121).

the policy. To avoid paying the taxes, one then borrows against the policy and the bank will then receive the surrender value to offset the loan.[125]

The life-interest holder will then enjoy the tax advantage together with interest deductions on the loan. Aggressive tax planning will then come in if one takes a policy with the sole objective of using it as security for loans and assigning the surrender value to the lender.[126]

2.5 Controlling the Tax Year of Income

The year in which a transaction falls can be influenced by timing of various transactions. This can be done by either accelerating or delaying when a company receives income or incurs expenses therefore enabling one to control taxable income in any given year.[127]

Income recognition can be deferred to a year of income with minimal tax rates. This can be done if one will fall in a lower tax bracket in a subsequent year of income or if one expects accelerated expenses in a subsequent year of income. One can delay the timing of particular income items to influence the period when the particular item is to be reported in the return. This has the effect of transferring the liability to a different year of income. These methods can be abused using false entries in books by falsely reporting the year of income to benefit from lower taxes.[128]

---

[125] Sally. J. Willbanks, 'Interest-free Loans Are Nolonger Free: Tax Consequences of Business Loans' (1986) Vol 47 Issue 2 Summer Montana Law Review 11.
[126] Sally (n 127).
[127] George Cooper, 'The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance' (1985) Vol. 85, No. 4, Columbia Law Review 657.
[128] ibid 680.

2.6 Leasing Property and Equipment.

Leases are contractual arrangements in which one party obtains an asset from the other at agreed periodic lease rentals.[129]Leasing has several advantages over outright purchase of assets. The ownership of the property and the attendant risks remain with the lessor in this case. Some lease contracts provide for the eventual transfer of ownership of the asset at the end of the lease period. On the other hand, outright purchase of an asset involves change of title and the ownership risks are transferred to the buyer.[130] Leases can be classified either as operating leases or finance lease. For Operating Leases, the asset is not identified as such in the financial statements neither is the lease obligation recognized as a liability in the financial statements. The lease payment is recognized as an expense in the financial statements.[131]

Leasing of assets has relatively favourable tax treatment compared to outright purchase.[132] In a lease, the lease rentals are deductible as allowable expenses in the computation of income tax. On the other hand, for owned assets, only depreciation expense is deductible. This is a significantly lower deduction compared to the lease rentals. Leasing will therefore result in greater tax savings.[133]

Unscrupulous business people can therefore account for all their property as leases despite the fact that the assets might be owned. In this case, the lease rentals deducted are significantly higher to enable them benefit from the accompanying tax savings. The most commonly abused transaction

---

[129] Annet Oguttu, 'Curbing Income Tax Avoidance that results from Cross-Border Leasing: A Comparative Overview with Specific Reference to South Africa' [2014] SA Mercantile Law Journal Vol. 26, No. 2, 4

[130] ibid.

[131] International Accounting Standards No. 17.

[132] Frank M. Werner, James A.F. Stoner, *Modern Financial Managing Continuity and change* (Freeload Press 3rd ed, 2007) 346.

[133] ibid 347.

is the sale and leaseback transaction which constitutes the sale of an asset to a third party and thereafter lease back the same asset.[134] Essentially, the seller of the asset becomes the lessee and the purchaser becomes the lessor in this arrangement. The asset is briefly recognized in the books before the sale and subsequently recognized as a lease.[135]

A company can purchase an asset, transfer the ownership to a related company then lease it back. The asset is still owned by the same company and the classification and recognition in the books is just on paper. This amounts to aggressive tax avoidance since the company will benefit from deductible lease expense which is in most cases exaggerated instead of a modest depreciation deduction.[136]

2.7 Use of Tax Havens

Tax Havens are jurisdictions that offer several incentives to taxpayers including favorable tax and other commercial conditions which cumulatively lead to payment of low taxes, secrecy of financial information and a safe passage for illicit cash.[137] The term popularly refers to a jurisdiction which operates an opaque financial system based on the financial secrecy, which facilitates concealing of income to avoid taxes in the home jurisdiction. The OECD has identified certain peculiar activities which make a jurisdiction a tax haven.[138]

---

[134] William L. Cary, 'Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations' (1948) Vol. 62, No. 1 Harvard Law Review 32.
[135] International Financial Reporting Standards No.16.
[136] William (n 133).
[137] Gizela Lénártová, 'The Economic and Social Consequences of Tax Havens in the World' (2020) SHS Web of Conferences 83, 01041, 5.
[138] ibid.

Tax havens have been in existence for many decades. Historians trace the origins to the 1920s and some of the oldest include Panama, Liechtenstein and Switzerland.[139]The OECD has come up with attributes for identifying a tax haven:[140]

Nominal taxes form the most important attribute of tax havens. All tax havens offer nominal taxes or generous tax incentives. This attracts foreigners to incorporate companies, invest or stash their money in that jurisdiction. This limb alone does not suffice in defining a tax haven as there are several jurisdictions which offer generous tax rebates to investors but are not classified as tax havens.[141]

These jurisdictions do not share personal financial information with other Jurisdictions. This prevents scrutiny of the taxpayer information, making it attractive for hiding illicit money. [142] Most tax havens have laws preventing scrutiny. The lack of transparency and information exchange can be used for unlawful purposes, including aggressive tax avoidance. This is achieved by keeping the beneficial owners of a company secret, the trail of the proceeds of crime is therefore hidden from the eyes of foreign enforcement authorities. They also have laws or administrative mechanisms preventing exchange of information with other jurisdictions.[143]

Other than the three main factors, there are also other socio-economic factors which contribute to a jurisdiction's attractiveness as a tax haven. Some of the factors include lack of exchange controls.

---

[139] Ronen Palan, Richard Murphy and Christian Chavagneux, '*Tax havens*' [2013] Cornell University Press 123
[140] Gizela Lénártová, 'The Economic and Social Consequences of Tax Havens in the World' (2020) SHS Web of Conferences 83, 01041, 5
[141] ibid 6.
[142] ibid
[143] ibid

This means that the value of the assets in the country will not be subject to exchange rates. The jurisdictions have no exchange controls leading to better certainty and minimum losses.[144]

The jurisdictions also enjoy political and economic stability.[145] These jurisdictions exhibit a constant output coupled with low inflation. A stable economy can absorb shocks using self-corrective mechanisms, thereby preventing a disruption of the economy. They have well developed infrastructure, facilities and systems. Structures such as roads, transport, water supply, electricity, telecommunications, and so forth, are well developed to make the jurisdictions attractive investment destinations.[146] They also have developed banking systems to facilitate fast and reliable transactions.[147]

The offshore companies located in the Jurisdictions are incorporated as vehicles for owning assets without much economic activities. The companies are merely meant to hold assets with no substantive business activities.[148]

There are underlying problems with this International financial system which portend serious consequences to the global financial sanity. The use of tax havens for tax evasion or for money laundering is hinged upon the secrecy of financial information. The lack of proper information

---

[144] Rolf Eicke, 'Tax Planning with Holding Companies - Repatriation of US Profits from Europe Concepts, Strategies, Structures' [2009] Kluwer Law international Journal, 90.
[145]Marc Herkenrath, *A comment on Léonce Ndikumana's "Capital Flight and Tax Havens: Impact on Investment and Growth in Africa* (University of Zurich,2013) 2.
[146] Gizela Lénártová, 'The Economic and Social Consequences of Tax Havens in the World' (2020) SHS Web of Conferences 83, 01041, 5
[147] ibid.
[148] ibid.

exchange between jurisdictions is facilitated using secrecy laws that bar tax authorities from accessing information on the complex financial transactions and structures located in tax havens.[149]

Owing to the secrecy in these jurisdictions, the beneficial ownership of the companies are kept anonymous noting that these jurisdictions do not cooperate with other tax authorities. [150] This enables the actual owner of the companies to abuse instruments such as thin capitalization, in which case, a company can claim interest deduction on intercompany Loans from a company based in a tax haven. This can be abused if the lender is not related to the resident company. Since the ownership details in the offshore country are secret, the other jurisdiction will be unable to draw the link between the two companies leading to huge tax savings by the companies.[151]

[149] Dhammika Dharmapala, 'What problems and opportunities are created by tax havens?' (2008) Vol 4, No. 4 Oxford Review Journal 661.
[150] Mark P Hampton, 'The offshore Interface: Tax Havens in The Global Economy' [1996] Mark Hamptons Publications 20.
[151] ibid.

CHAPTER 3: KENYA LEGAL AND INSTITUTIONAL REGIME ADDRESSING AGGRESSIVE TAX AVOIDANCE.

3.1 LEGAL FRAMEWORK

3.1.1. Transfer pricing Legal Regime in Kenya

In Kenya, transfer pricing is governed by the Income Tax Act. Section 18(3) gives the commissioner of domestic taxes the authority to adjust the declared profits in transactions between related entities if he have reason to believe that the transaction could have yielded more profits if it was between independent entities.[152]This provision is effected by the Commissioner by conducting regular tax audits to ascertain the prices of goods and services in intra group transactions.

The Transfer Pricing Rules 2006 were enacted to provide guidelines for the determination of the arm's length prices of goods and services in dealings between related parties and to provide administrative regulations for transfer pricing arrangements. The rules provide the conditions for the application of arm's length pricing. One must come up with a policy, ascertain the arm's length price and furnish the commissioner with documentation upon request[153].

These rules give a number of methods for determining the arm's length price. These methods include the comparable uncontrolled price method which is used to determine the independent price by comparing the price charged in a related party transaction to that charged in a comparable independent party transaction in similar circumstances.[154] For this method to achieve accuracy, the differences between the transactions should be immaterial and such differences should not affect

[152] Income Tax Act Cap 470 s18 (3).
[153] Transfer Pricing Rules 2006 r10.
[154] Transfer Pricing Rules 2006 r7(a).

the open market price. Should such differences exist, reasonable adjustments should be made to obviate any effect on the price.[155]This method is advantageous because it gives a reasonable, direct juxtaposition and can accurately arrive at an independent price for a wide range of transactions. On the other hand, it is not appropriate where no open market price exists or where there is no strict product comparability.[156]

The resale price method is useful in determining the market value of goods acquired in a controlled transaction from a related party and is sold in an uncontrolled transaction to an independent party. The sale price to an unrelated party is adjusted by the gross margin, comprising the selling and other expenses. In making the adjustment, consideration should be made to the risks taken, function performed and expected profits.[157] The remainder is further adjusted with the costs associated with the purchase of the property leaving the arm's length price between the associated enterprises.[158]

The method is best suited for distributing companies that resell products without adding significant or any value at all, parts or altering them physically. This method cannot yield accurate results if the reseller adds significant value to product, owns Intellectual Property or takes and manages significant risk. [159]

The cost-plus method is used to ascertain the market value of goods that are transferred to related companies usually in semi-finished state. The comparable under this method is the mark-up. The supply costs or services rendered to a related party are added to an arm's length mark-up in

---

[155] Ceteris, 'Guide to International Transfer Pricing: Law, Tax Planning and Compliance strategies' (2010) 8th Edition Kluwer Law International 22.
[156] ibid.
[157] Transfer Pricing Rules 2006 r7(b).
[158] ibid r7(b).
[159] United Nations Practical Manual on Transfer Pricing for Developing Countries, 2017, 208.

accordance with the functions performed.[160]This method is used for goods and services sold to related parties, using the production cost of the controlled company as base, and adding an appropriate mark-up, which should be equal to the sales price that would have prevailed in an arm's length operation.[161]

The information required in respect of the intended mark-up can be obtained from the mark-up charged by the company to third parties or the margin obtained by other third parties in comparable uncontrolled operations. This method is applicable where goods are sold in a semi-finished state between related parties or where services are to be provided in the transaction.[162]The aim is to ascertain whether the enterprise making the product or service is adequately rewarded for the undertaken tasks, deployed assets and risks assumed. That rewards in such transactions ought to be equivalent to those it would have obtained had it been dealing with an independent third party, at arm's length.[163]

Profit split method is applicable where transactions are highly integrated and cannot be separated, or where there is significant intangible asset contribution by each party making it impossible to make a separate evaluation.[164]The method seeks to determine the realistic profit division that would have been expected should the transaction have been between independent entities. This is achieved by eliminating the effects that special conditions imposed in a controlled transaction have on the profits.[165]

---

[160] Transfer Pricing Rules 2006, r7(c).
[161] OECD, 'Centre For Tax Policy And Administration, Transfer Pricing Methods 2010' 4.
[162] Robert Feinschreiber, *Transfer Pricing Methods: An Applications Guide(*John Wiley & Sons Inc 2004) 32.
[163] ibid 32.
[164] Elizabeth King, *Transfer Pricing and Corporate Taxation: Problems, Practical Implications*. (Springer 2009) 29.
[165] Transfer Pricing Rules 2006, r7(d).

The transactional net margin method measures and compares the net profit realized in a related party transaction with that realized in a transaction between unrelated parties in a comparable transaction to arrive at arm's length net profit margin.[166]

Finally, the rules allow the Commissioner to prescribe a method where the arm's length price cannot be determined from the methods detailed in the guidelines.[167]

3.1.2. Thin capitalization

In Kenya, section 2 and 16(2)(j) of the Income Tax Act were enacted to control thin capitalization. The definition of a thinly capitalized company in Kenya is based on the condition that first, the company is controlled by a non-resident alone or jointly with no more than four persons; the company is not a financial institution; and the company holds a loan portfolio of more than three times its revenues and share capital.[168]

To control thin capitalization, a company is limited to claiming interest deduction for loans not exceeding three times the sum of revenue reserved and issued and paid up share capital. i.e. debt: equity ratio ought to be 3:1 but for firms in the extractive industry the ratio is 2:1.[169] Section 16(2)(j) of the Income Tax Act provides for interest restriction on account of thin capitalization. The section limits the deductions on account of interest on loans to a maximum loan portfolio of three times the share capital of the company.[170]

[166] Transfer Pricing Rules 2006, r7(e).
[167] Transfer Pricing Rules 2006, r7(f).
[168] Income Tax Act s16(2).
[169] Income Tax Act, s 16(2)(j).
[170] ibid s16(2)(j).

Further, the provision applies when the company is solely controlled by a non-resident person or jointly with not more than four other people and where the company is not a bank, or a financial institution licensed under the Banking Act.[171]

3.1.3. General Anti-Avoidance Rule

Section 23(1) of the Income Tax Act is the general anti avoidance provision. Where a transaction is intended to avoid or reduce the liability to tax, the commissioner has discretionary powers to direct adjustments in respect of the tax liability in order to prevent abusive transactions entered into with the sole aim of tax avoidance.[172]

The general anti avoidance provision counteracts "abusive tax arrangements" which deny countries of much needed revenue.[173] The commissioner has a wide discretion to make adjustments which includes taxing transactions that were erstwhile non-taxable or increasing the tax liability of a particular transaction and charging of a greater amount of tax than would be charged but for the adjustments.[174]

However, the application of this rule is subject to the Constitution which provides that tax can only be imposed in accordance with legislation.[175] This therefore implies that the rule cannot be applied arbitrarily without legal justification. This position was also taken by the high court in the case of *Primarosa Flowers Limited v Commissioner of Income Tax*[176] *in* which justice Olga Sewe stated that the imposition or assessment of tax by the Kenya Revenue Authority pursuant to Section 23

[171] Shanthi Divakaran, Patrick McGinnis and Sam Schneider, 'Survey of the Kenyan Private Equity and Venture Capital Landscape' [2018] World Bank Policy Research Working Paper 8598, 47.
[172]Income Tax Act, s 23.
[173] Income Tax Act, s23(2) (a).
[174] Income Tax Act, s23(2) (b).
[175] Constitution of Kenya, a 210(1)
[176] [2017] eKLR.

of the ITA can only be in strict compliance with the law. The legal foundation of taxation lies not on the commissioner's whims but on the relevant statutes.[177]

3.1.4. Restriction on Deduction of Interest, Royalties, Management & Professional Fees and Forex Losses.

The Income Tax Act prohibits the deduction of interest expense, forex losses, royalties and management fees, paid by a resident permanent establishment to its non-resident associate.[178]The deduction of interest expense and royalties have been particularly problematic since they have often been misused for aggressive tax avoidance.[179]

Prior to the year 2014, a permanent establishment was defined in the Income Tax Act as a fixed place of business in which a person carries on business and which has existed for six months or more. The Finance Act 2014 amended section 2 of the Income Tax Act and further expanded this definition to include a person's dependent agent as a permanent establishment. A dependent agent has been defined in the Act as a person who acts on the principal's behalf and who exercises authority to conclude contracts in the principal's name.[180]

The OECD has incorporated in its definition among others, a place of management; a branch; an office; a factory; a workshop.[181] multinational companies normally pay interest on land, royalties,

---

[177] [2017] eKLR.
[178] Income Tax Act, s18(5).
[179] Steven Clark, 'Assessing the FDI Response to Tax Reform and Tax-Planning' [2008] OECD Global Forum on International Investment Session 1.4, 3.
[180] Income Tax Act Cap 470, s.2.
[181] OECD Model Tax Convention, a. 5.

management and professional fees to their parent companies. These payments when uncontrolled can be used to avoid taxes as the entire profit can be paid as royalty, interest or management fees.[182]

3.1.5. Offences and Penalties under the Tax Procedures Act

The Tax Procedures Act was enacted in the year 2015. It has collated administrative provisions including offences and penalties from the Income Tax Act, Value Added Tax Act, 2013, the Kenya Revenue Authority Act, 1995 and Excise Duty Act.[183]

Section 81 to 103 of the Tax Procedures Act creates offences and penalties relating to registration and licensing,[184] failure to keep documents,[185] late submission of returns,[186] penalty for tax shortfall,[187] failing to comply with the electronic tax system,[188] penalty for tax avoidance,[189] penalty for failure to appear before the commissioner,[190] and penalty in relation to fraudulent claim for refund.[191]

Tax penalties play a fundamental role in defining tax compliance. [192] Noting that the Kenya tax regime is largely based on the self-assessment model in which a taxpayer is expected to disclose their tax obligations and make good the due taxes without compulsion. The taxpayer is expected to be honest in disclosing their own tax liabilities. Tax penalties therefore set the boundaries and

[182] OECD (n181)
[183] Tax Procedures Act No. 29 of 2015.
[184] Tax Procedures Act, Section 81.
[185] ibid, s 82.
[186] ibid, s 83.
[187] ibid, s 84.
[188] ibid, s 85.
[189] ibid, s 86.
[190] ibid, s 87.
[191] ibid, s 88.
[192] Michael Doran, *Tax Penalties and Tax Compliance* (Georgetown University Law Center, 2009) 114.

deter non-compliance. It is expected that the deterrence element coupled with a taxpayer's moral duty to pay taxes work in synergy to improve compliance.[193]

3.1.6. Offences by Accountants

As is the case with other businesses, accountancy firms have in the recent times supplemented their core mandate of providing accountancy and financial audit services and diversified into other creative services. [194]Chief among them is selling tax avoidance and evasion schemes to corporations.[195] The provision of such services as has been discussed in Chapter 1 arguably leads to revenue leakages and a reduction of tax collections.[196]

Due to the increased competition in the market for accountancy services, these firms prioritize making profits with the major goal being to please the customer by coming up with strategies that increase profits. To sell aggressive tax avoidance schemes, firms emphasize commercial acumen of the accountants as opposed to ethical conduct. Many accountants therefore bend the rules to accumulate more profits for the client.[197]

Kenya has legislation and rules in place to enforce ethics among accountants. The Accountant's Act makes it a professional misconduct for a member of ICPAK to engage in fraudulent

---

[193] Michael (n 191)

[194] Prem Sikka, Mark P. Hampton, 'The role of Accountancy Firms in Tax Avoidance: Some Evidence and Issues' [2005] Research Gate Publication 6.

[195] Charles Guandaru Kamau Agnes Ndinda Mutiso Dorothy Mbithe Ngui, 'Tax Avoidance and Evasion as a Factor Influencing Creative Accounting Practice Among Companies in Kenya' (2012) Vol. 4, No. 2 Journal of Business Studies Quarterly 78

[196] Charles Kamau, Gregory Namusonge and Walter Bichanga, 'Creative Accounting Related Practices Among Corporations Listed in Nairobi Securities Exchange in Kenya' (2016) International Journal of Sciences: Basic and Applied Research 14.

[197] Prem (n 194).

activities.[198] This is a great deterrent to accountants from engaging in aggressive tax avoidance schemes done through manipulation of accounting records or information.

ICPAK's code of ethics provides that an accountant should not be associated with materially misleading reports, returns and communications.[199] The code also prohibits accountants from issuing reports prepared recklessly[200] or omits material information whose omission would make the statements misleading.[201]

False accounting involves an accountant altering the accounts statements to reflect an untrue position of the financial activities. Misleading reports can either increase the tax liability or reduce the tax liability of a company. As a form of aggressive tax avoidance, accountants understate the incomes and exaggerate losses in the books of accounts to either extinguish or significantly reduce the tax liability. This is an offence committed by an accountant and is an additional ground for disciplinary action by the disciplinary committee of ICPAK.[202]

The code espouses the principle of objectivity which obligates accountants to exercise unbiased professional judgment free from undue influence.[203] The duty of defining a situation or relationship that might impair an accountant's objectivity rests with the accountant who is supposed to exercise a *reasonable man's test* in determining whether the situation will unduly influence his professional judgment.[204]

---

[198] Accountants Act s 30(1)(r).
[199] Code of Ethics for Professional Accountants, s110.2 (a).
[200] Code of Ethics for Professional Accountants, s110.2 (b).
[201] Code of Ethics for Professional Accountants, s110.2 (c).
[202] Code of Ethics for Professional Accountants, s110.2 (c)
[203] Code of Ethics for Professional Accountants, s120.1
[204] ibid 120.2.

The code also establishes disciplinary committee which deals with noncompliance with the ethical requirements. The committee has powers to mete sanctions including suspension of errant members from practice.[205]

In conclusion, though the Code of Ethics for Professional Accountants has specific rules on dealing with ethical requirements for accountants, it is an internal regulation for members of ICPAK and does not bind all and sundry. Further, the sanctions available are also limited and do not bear as much consequences as would be in a legislation. The Accountant's Act on the other hand has not given much emphasis on the conduct of accountants thereby leaving a loophole which can be exploited by accountants in aiding aggressive tax avoidance. The prescriptions within the Code of Ethics for Professional Accountants ought to be codified into legislation to ensure the Accountants Act is more robust and effective in regulating accountants.

3.1.7. Chapter 6 of the Constitution of Kenya on Leadership and Integrity.

The Constitution has leadership and integrity provisions which govern all state officers. The state officers including officers from the Kenya revenue authority are entrusted with the management of public revenues and any rot in public offices portends great consequences to the moral fabric of the society. The behavior of state officers should therefore be beyond reproach. [206]

The Constitution therefore lays down the conduct expected of a public officer and it should bring honour to the office, build public confidence and exhibit the highest level of integrity. The expected conduct includes objectivity and impartiality, selfless service, honesty and accountability.[207] Aggressive tax avoidance in some instances is facilitated by corrupt state officers

[205] Accountants Act, s 31.
[206] Constitution of Kenya 2010 a.73(2).
[207] Constitution of Kenya 2010 a.73(2).

who take bribes to conceal unacceptable practices. Such conduct goes against chapter six of the Constitution.

3.1.8. Income Tax (Transfer Pricing) Rules 2006.[208]

These rules supplement the provisions of the Income Tax Act[209] which gives the Commissioner of domestic taxes the power to alter the profits from cross border, related party transactions to reflect realistic expected profits should the transaction have been undertaken by independent parties.[210] These rules prescribe the methods of transfer pricing at paragraph 7.[211] The methods are critical in ascertaining the price of goods and services in intra-group transactions for the purposes of deriving an independent market price.[212]

The rules empower the Commissioner of Income Tax to demand for accounting records and other information for the purpose of determining the independent transfer price.[213] This requirement essentially means that every taxpayer must keep records evidencing all relevant transactions.

The rules obligate all persons subject to the transfer pricing rules to first prepare a transfer pricing policy. A taxpayer ought to select a method from those outlined at paragraph 9 of the rules in the determination of the arm's length price. Before choosing any of the methods, one should formulate a transfer pricing policy and avail all the supporting documentation to the commissioner when required to. The policy is important in achieving consistency and transparency of terms and

---

[208] Legal Notice no 67 of 2006.
[209] Income Tax Act Cap 470, s 8 (3).
[210] TPA Global, (Transfer Pricing Country Summary Kenya 28 July 2015).
[211] The methods include the comparable uncontrolled Price (CUP) method, resale price method, cost plus method, profit split method, transactional net margin method, such other method as may be prescribed by the commissioner from time to time.
[212] The methods can be applied by the Commissioner of income tax in adjusting the transfer price in transactions between related parties to arrive at an arm's length price.
[213] Income Tax Transfer Pricing Rules 2006, r 9.

conditions for the conduct of controlled transactions and thereby reduce the possibility of aggressive tax avoidance using fictitious accounting entries.[214]

Secondly, the taxpayer is required to avail documentation to the commissioner upon request. The Commissioner is empowered to undertake audit of the method chosen by a Taxpayer. Availing the documentation to the commissioner, facilitates the audit of the methods to confirm compliance with the arm's length principle.[215]

3.1.9. Double Tax Agreements (DTA's)

Kenya has 10 double tax agreements in force and several others under negotiation. Double tax agreements are an instrumental means by which different jurisdictions can cooperate and provide certainty by specifying tax treatment for various types of income.[216]Multinational companies engage in aggressive tax avoidance with different objectives in mind including to avoid double taxation in cross jurisdiction transactions. This has been cured by the double tax agreements that create certainty on the treatment of transactions.[217]

However, in certain instances, double tax agreements have proven to be a tool for aggressive tax avoidance especially if the terms are lopsided and poorly drafted. A case in point is the Kenya-Mauritius double tax treaty which was lopsided in favor of Mauritius entities. This treaty had provisions that allow tax sparing thereby allowing Mauritius based entitles tax credits for Kenyan tax. It also significantly reduced royalties on source withholding tax in favour of income from

[214] Income Tax Transfer Pricing Rules 2006, r 10 (a).
[215] Income Tax Transfer Pricing Rules, 2006, r10(c).
[216]< https://www.icpak.com/wp-content/uploads/2016/06/Kenya-DTA-Status.pdf> Accessed 26.10.2019.
[217] Julia Braun and Martin Zagler, 'An Economic Perspective on Double Tax Treaties with(in) Developing Countries' [2014] World Tax Journal 49.

Mauritius. Though the treaty was declared unconstitutional for lack of public participation, the adverse provisions were not found to be unconstitutional.[218]

Overall, well negotiated Double Tax Agreements are an important tool in establishing consistency between the tax systems in different jurisdictions. This relieves Multinational companies the burden of multiple tax obligations in different jurisdictions and clarifies the tax treatment of transactions in cross border trade. Due to the clarity of tax obligations, double tax agreements are an important tool in reducing aggressive tax avoidance.

3.9.10. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters

Kenya signed this convention on 8th February 2016 but has not tabled it in parliament for ratification. The convention is therefore yet to become part of Kenya Laws.[219]

The object of this convention is to facilitate international co-operation between signatory jurisdictions for better implementation of national tax laws. It provides for administrative co-operation between states on matters such as access to information, assessment and recovery of taxes and service of documents while at the same time respecting the fundamental rights of taxpayers.[220]

The administrative assistance is instrumental in dealing with cross border transactions. The key areas covered by the convention include information exchange for the administration of domestic tax laws on request[221], spontaneous exchange of information where a party has reason to believe

---

[218] *Tax Justice Network- Africa v Cabinet Secretary for National Treasury & 2 others* [2019] eKLR.
[219] <https://www.oecd.org/ctp/exchange-of-tax-information/kenya-becomes-the94th-jurisdiction-to-sign-the-mac.htm> Accessed 9 November 2019.
[220] The Multilateral Convention on Mutual Administrative Assistance in Tax Matters a 1.2.
[221] Ibid a 5.

that there may be loss of tax revenue or where a party believes that a transaction is organized such as to lead to artificial transfer of profits.[222]

The convention also provides for automatic exchange in accordance with mutually agreed circumstances and procedures[223], tax examinations abroad[224], simultaneous tax examinations in which case, multiple jurisdictions may simultaneously carry out examination of a taxpayer in their respective jurisdictions with a view of exchanging the information[225] and assistance in tax collection. The convention guarantees the protection of the taxpayer's rights by ensuring that the information exchanged is kept confidential and is only divulged to authorities concerned with the collection, assessment and recovery of taxes.[226]

Once ratified, the convention will give a significant boost to the fight against aggressive tax avoidance by improving transparency and international cooperation.[227]

The convention is different from Double Tax Agreements which are agreements between two contracting states. This Convention is a multilateral agreement and binds several contracting states. Each party owes the same obligations to all other parties to the Convention. Considering the unique circumstances of each contracting state, the blanket provisions in the Convention might not necessarily be effective for each state. Unlike Double Tax Agreements which are tailor made to fit the circumstances of the two contracting states, the Multilateral Convention assumes uniformity in circumstances of contracting states with cross cutting obligations between multiple states.

---

[222] Ibid a 7.
[223] Ibid a 6.
[224] Ibid a 9.
[225] Ibid a 8.
[226] Ibid a 22.
[227] <https://www.oecd.org/ctp/exchange-of-tax-information/kenya-becomes-the94th-jurisdiction-to-sign-the-mac.htm> Accessed 9 November 2019.

3.2. INSTITUTIONAL FRAMEWORK.

3.2.1. Rewards for whistle blowers by the Kenya Revenue Authority.

Kenya Revenue Authority introduced iwhistle, an online platform for reporting incidences of tax crime.[228] This is in line with the provisions of Section 5A of the Kenya Revenue Authority Act which provides for Rewards to whistleblowers. For information leading to identification of unassessed taxes, this provision rewards whistleblowers one percent of the unassessed taxes or Ksh. 100,000 whichever is lesser. For information leading to recovery of taxes, the provision rewards whistleblowers with 5% of the taxes or Kshs. 2,000,000/= whichever is lesser.[229]

3.2.2. Use of technology by The Kenya Revenue Authority

The Kenya Revenue Authority has also invested in Information Technology in order to curb aggressive tax avoidance. Systems such as ITAX, Integrated Customs Management System and Electronic Cargo Tracking System for transit cargo.

The Electronic Cargo Tracking System facilitates real time tracking of transit cargo from the port of Mombasa to through to the exit border point using a digital platform. This platform helps in reducing incidences of diversion of cargo destined for neighbouring countries.[230]

The itax system enables a taxpayer to register online, file returns, access ledger accounts and lodge queries real time on the digital platform. The system also has auto generated reminders which have helped reduce default. By streamlining the collection and filing of returns and collection of taxes,

---

[228] Cynthiah Kerubo, Kenya Revenue Authority Blog [23/12/2020] https://www.kra.go.ke/en/media-center/blog/1039-anonymous-reporting-of-tax-offences-iwhistle. Accessed on 04.10.2021.

[229] Ibid

[230] Jato Syong'oh, Kenya Revenue Authority Blog [21.11.2018] https://kra.go.ke/en/media-center/blog/429-leveraging-on-the-regional-electronic-cargo-tracking-system-for-fair-trade-facilitation. Accessed on 04.10.2021.

the system makes it easy for the Authority to identify tax chats by comparing input and output tax ledgers using Pin numbers.[231]

The Integrated Customs Management System introduced by Kenya Revenue Authority has consolidated and interfaced all customs processed in one digital platform. This system has increased transparency, accuracy and efficiency. By making the process seamless and transparent, the system has reduced corruption and the possibility of manipulation of documents to achieve aggressive tax avoidance.[232]

3.2.3. Taxpayer Education and training by the Kenya Revenue Authority.

Kenya Revenue Authority has enhanced taxpayer education. The main objective of taxpayer education is encourage voluntary compliance and to impart knowledge on the various taxes and procedures for compliance. The Authority has in place taxpayer weeks dedicated for tax training with townhall session and online webinars on topical issues. Seminars are also scheduled from time to time to train taxpayers.[233]

3.2.4. Taxpayer surveillance and investigations by the Kenya Revenue Authority.

The Authority established the Investigations and Enforcement department which actively investigates tax crimes and prosecutes culprits. The Department obtains the facts and evidence by executing search warrants, surveillance on business operations, conducting interviews and obtaining information from third parties. A key success of the department has been the 'Missing

---

[231] Kasii David Mutisya and Lucy Kavindah, 'Adoption of Technology and Performance of Kenya' (2016) Revenue Authority International Journal of Science and Research 1.
[232] David Yego, Implementation of Integrated Customs Management System (iCMS) for Cargo Clearance [13/06/2019] Kenya Revenue Authority, Customs and Border Control Public Notice.
[233] Giulia Mascagni and Fabrizio Santoro, 'What is the Role of Taxpayer Education in Africa?' [2018] ICTD African Tax Administration Paper 1, 10.

Trader Scheme' in which the Authority busted a Value Added Tax racket which operated through the generation of fictitious tax invoices from ghost traders in order to claim input tax. The fictitious companies are incorporated with the sole objective of issuing fraudulent tax invoices with without engaging in any trade.[234]

CHAPTER 4: CONCLUSION AND RECOMMENDATIONS

Kenya has several methods in place to address aggressive tax avoidance, including legislative anti-avoidance rules embodied in the Income Tax Act, judicial anti-avoidance doctrines, double tax agreements and robust enforcement efforts through the Kenya Revenue Authority. However, as has been observed above, these methods are inadequate in dealing effectively with aggressive tax avoidance hence the need for reform to tighten the loose ends and effectively deal with the problem. Further, the loopholes have led to an increase in aggressive tax avoidance. Therefore, the hypotheses in this thesis have been established and this informs my recommendations on reforms. The proposed reforms are as follows:

4.1. Proposed Reforms on the Legal Framework.

4.1.1 Review Harmful Double Taxation Agreements (DTAs).

A major factor insighting aggressive tax avoidance by multinational corporations is poorly drafted and lopsided double tax agreements with certain tax jurisdictions. These DTAs have gaps and

[234] Wycliff Kiame, Influence of Enforcement Measures on Tax Debt Revenue Realization (2019) Paper presented at the 7th annual ICTD Meeting African Tax Administration Research Day at Rwanda, Kigali 7.

provide a safe leeway for aggressive tax avoidance. This inevitably leads to the exploitation of mismatches between different tax systems.[235]

Kenya should codify and adopt the reforms aimed at hindering the abuse of treaty provisions. Some of the provisions that can prevent treaty abuse include, recognition that treaties are not an enabler for aggressive tax avoidance,[236] limiting treaty benefits to persons with substantive economic activities in a way that does not result in treaty abuse[237] and the incorporation of a general anti-avoidance rule. Most importantly, treaty abuse is best addressed by adding domestic anti-abuse rules which would effectively terminate abusive clauses.[238]

Kenya should clarify at the preamble of all its DTAs that their purpose is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. By doing so, the interpretation of the treaties will be premised on the objective statement at the preamble.[239]

Including anti-abuse rules in treaties also prevents treaty benefits from being granted in unintended circumstances. This would ensure that obtaining that benefit would be in line with the object and purpose of the relevant provision, given the applicable facts and circumstances.

A major milestone was achieved in a high court decision in Kenya[240] in which the Judge found that a statutory instrument in the nature of a double tax agreement ought to be tabled before

---

[235] Omri Marian, 'Unilateral Responses to Tax Treaty Abuse: A Functional Approach' [2016] UF Law Scholarship Repository 1161.
[236] OECD, 'Action Plan on Base Erosion and Profit Shifting' (2013)<www.oecd.org/ctp/BEPSActionPlan.pdf> Accessed 5 August 2019.
[237] 'Final report on BEPS Action Plan 6' para 20.
[238] ibid. para 21
[239] Adolfo Martin Jimenez, 'Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective' 2014 Bulletin for International Taxation - Journal - IBFD, p 6
[240] Tax Justice Network (n 218).

Parliament before operationalization. This is particularly important because such agreements need to be scrutinized before operationalization. In the case of the Kenya- Mauritius Double Tax Agreement, the provisions therein were challenged by the Tax Justice Network for being unconstitutional.

Kenya has in place a law[241] which requires the tabling of the legal notices before Parliament[242]. The tabling of statutory instruments such as legal notices operationalizing double tax agreements is instrumental in ensuring checks and balances to avoid abuse. This allows Parliament to discharge its functions by representing the people and providing checks in line with the principle of separation of powers.[243] However, the technical expertise of the members of parliament has come to question since most of them barely understand the tax issues which are highly technical. Members of Parliament have therefore become mere rubber stamps and rarely question the substance of DTAs. Scrutiny of DTAs should therefore be delegated to specialists with vast knowledge on the subject to ensure that proper scrutiny takes place.

The court decision on the Kenya-Mauritius double tax agreement presents a mixed outcome since it declares that double tax agreements are not subject to the treaty ratification rules. [244] This gives the executive the leeway to conclude double tax agreements with limited or no scrutiny and only table the legal notice before parliament at the tail end of the process. It is noteworthy that at this point, the Double Tax Agreement has already been negotiated and signed between the countries and parliament rarely intervenes at such late stages. Further, the nullification of the legal notice brings to question the legality of all other existing double tax agreements which were negotiated

[241] Statutory Instruments Act 2013.
[242] Statutory Instruments Act 2013, s10 and s11.
[243] Jeremy Waldron, 'Separation of Powers in Thought and Practice' (2013) Vol 54 Issue 2 Boston College Law Review 456.
[244] Sol Picciotto, 'The Interactions of National and International Tax Law and the Kenya - Mauritius Tax Treaty' (2019) Financing for Development Journal 12

and operationalized after the Statutory Instruments Act of 2013, since they were not tabled in Parliament.[245]

The level of scrutiny in the negotiation of double tax agreements ought to be optimized and it ought to include public participation which is a vital element of the social contract theory. The Constitution of Kenya[246] provides for public participation as one the principles of good governance. This enables the citizens to directly contribute to important discourse over and above the indirect representation through Parliament.[247]

Public Participation is necessary to the citizenry and leads to the following important outcomes; empowerment, legitimacy and education. Participation empowers people by gaining consensus through input from citizens and therefore democratizes the legislative process. Adopting this participatory process increases the legitimacy of the policy choices and ensures inbuilt checks and balances through throughout the double tax agreement making process.[248]

4.1.2 Establish Public Beneficial Ownership Registries

Beneficial ownership of companies is a major tool used to hide income and keep the identity of the real owners of a company hidden.[249] To effectively deal with hiding of income and wealth, Kenya should make disclosure of beneficial ownership information mandatory. This can be achieved through the creation of a beneficial ownership registry which enables the government to

[245] Sol Picciotto, 'The Interactions of National and International Tax Law and the Kenya - Mauritius Tax Treaty' (2019) Financing for Development Journal 12.
[246] Constitution of Kenya, Article 10.
[247] Luigi Bobbio, 'Designing effective Public Participation' (2019) Vol 1 Policy and Society Journal 42.
[248] Bobbio (n 239).
[249] <https://www.oecd.org/ctp/treaties/BENOWNMLL_vanBladel.pdf> Accessed 1 September 2019.

have access to the beneficial ownership information with a view of avoiding misuse of corporate structures. This will also facilitate international exchange of beneficial ownership information.[250]

This is particularly important in dealing with abusive arrangements done merely on paper using related companies guised as independent entities for tax purposes. Such transactions as abusive intercompany loans and transfer pricing can easily be pinpointed using the beneficial ownership information.[251]Improving transparency on the beneficial ownership of companies is important in preventing the misuse of corporate structures for corruption and criminal activity. Further, Kenya should amend the Tax Procedure Act to give KRA tracing powers for beneficial ownership of companies when conducting tax investigations.[252]

The Kenya Companies Act, 2015 was amended by the Companies (Amendment) Act, 2017, in a bid to improve government access to information on beneficial ownership of companies in Kenya.[253]The Act requires companies to lodge information on its members and beneficial owners with the registrar of companies within 30 days after its preparation, and within 14 days in case of amendments.[254]The Act also proscribes a fine for failure to keep a register on members and beneficial ownership[255]. However, the rules on disclosure of the beneficial owners are yet to be operationalized and therefore the provisions are yet to fully take effect.

---

[250] <https://www.oecd.org/ctp/treaties/BENOWNMLL_vanBladel.pdf> Accessed 1 September 2019.

[251] Wilson Prichard, 'Linking Beneficial Ownership Transparency to Improved Tax Revenue Collection in Developing Countries' [2018] ICTD Summary Brief No. 15, 2.

[252] Ibid 3.

[253] The Act defines a 'beneficial owner' as "*the natural person who ultimately owns or controls a legal person or arrangements or the natural person on whose behalf a transaction is conducted, and includes those persons who exercise ultimate effective control over a legal person or arrangement*".

[254] Companies Act 2015 s 93.

[255] Ibid s 93.

4.1.3 Enhance Disclosure of Tax Planning Measures.

Efforts to combat aggressive tax avoidance have been complicated by the information gap between tax authorities and taxpayers. This information asymmetry has made tax authorities play a catchup role in which case they lag in controlling abusive transactions.[256] This is because new methods and structures evolve every other day. By their nature, abusive transactions are complex, and difficult to detect since they manipulate laws and are hidden.[257]

The solution to bridging the information gap is in establishing a reporting mechanism by taxpayers on potentially abusive transactions. The early identification of abusive transactions can cause taxpayers not to engage in them at all.[258]Kenya should make disclosure of aggressive tax avoidance arrangements mandatory. The taxpayer should be required to make disclosure where tax arrangements bear avoidance hallmarks. These arrangements can be notified by the intermediaries who advise on designing or managing the tax implications of the arrangements.[259] The obligation to file information on tax planning rests with the taxpayer and thereafter, the information is exchanged with other tax jurisdictions.[260]

The same position as been taken by the OECD which has spearheaded the base erosion and profit shifting action plan No. 12 on disclosure of aggressive tax planning arrangements. The proposition seeks to have member states enact legislation to impose mandatory reporting by taxpayers to the

---

[256] Celia Whitaker, 'Bridging the Book-Tax Accounting Gap' (2005) Vol. 15 Issue 3 Yale Law Journal 703.
[257] Cecilia (n 263).
[258] Reportable transactions under IRC §165.in the U.S are confidential transactions, loss transactions, listed transactions, contractual protection and transaction of interest.
[259] The United States of America has codified disclosure of potentially abusive transactions under § 6112 of the Internal Revenue Code.
[260] In the U.S, the Internal Revenue Services can demand documents exchanged between a taxpayer and his adviser including opinions and memoranda.

tax authorities. The proposition is aimed at dissuading intermediaries and taxpayers from engaging in potentially aggressive schemes, ensure that tax authorities have information on such schemes and to enhance cooperation between tax authorities to tackle cross-border abuse.[261]

4.2. Proposed Reforms on the Institutional Framework.

4.2.1 Curb Tax Competition by Ending Issuance of Harmful Tax Incentives by the National Treasury.

Harmful legislative, regulatory and administrative tax measures can have significant impact on the tax collection in the country. Potentially harmful measures can be identified using the following criteria:- Significantly lower than average taxes, tax incentives and benefits for non-resident taxpayers, tax incentives for transactions that have no real economic activity and lack of transparency.[262]

Extensive use of tax incentives and exemptions often opens space for tax resistance through aggressive tax avoidance and outright evasion. Tax exempt entities engage in competitive business with firms that do not enjoy the exemptions. Exemptions give such firms undue competitive advantage and can easily lead to the collapse of otherwise competitive entities.[263] Harmful tax competition is majorly comprised of tax incentives and advantages offered to businesses with the aim of attracting investments in the absence of transparency and the effective exchange of information with other countries.[264]

---

[261] OECD, 'Mandatory Disclosure Rules, Action 12 – 2015' Final Report. <https://dx.doi.org/10.1787/9789264241442-en> Accessed 15 February 2019.
[262] Joann M. Weiner and Hugh J. Ault, 'The OECD'S Report on Harmful Tax Competition' (1998) Vol. 51, No. 3 National Tax Journal 604.
[263] Harold M. Somers, 'Competition from Tax-Exempt Business' (1951) Vol. 6 No. 2 The Journal of Finance 178.
[264] Somers (n 250) 179

The Organization for Economic Development spearheaded the BEPS[265]Action Plan No. 5 on countering harmful tax practices more effectively, taking into account transparency and substance. There are two significant aspects to the action plan: reviewing tax incentives to ensure they are not harmful, and a transparency framework applicable to tax rulings.[266]

The OECD found that Kenya has special economic zones and export processing zones which enjoy tax advantages. The exemptions and incentives ought to be rationalized to ensure that no undue advantage is given to the extent that it triggers aggressive tax avoidance practices by competing local firms.[267]

4.2.2. Strengthen Tax Administration by the Kenya Revenue Authority.

Kenya has improved its tax administration and enforcement mechanism over the years with the Kenya Revenue Authority taking charge. Significant improvement in tax collection has been attributed to the use of technology in tax collection and improved surveillance. Chiefly, KRA introduced Itax and the Integrated Customs Management System to offer integrated online services to taxpayers. Further, there is now enhanced ease of processing payments through the use of mobile money platforms.[268]

On the administration front, the biggest pitfall has been corrupt practices by KRA officials who act in concert with taxpayers to avoid taxes in exchange for bribes. In recent times, the directorate

---

[265] 'Base Erosion and Profit Shifting Action Plan'.
[266] OECD, 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 Final Report (2015) OECD Publishing http://dx.doi.org/10.1787/9789264241190-en Accessed 4 June 2019.
[267] <https://www.oecd-ilibrary.org/docserver/9789264311480-en.pdf?expires=1574254896&id=id&accname=guest&checksum=29E897D73D4A5CC105E94151CB00798B> Accessed 11 November 2019.
[268] KRA, '7th Corporate Plan (2018-2021) Revenue Mobilization Through Transformation' [2018] 8. <https://www.kra.go.ke/images/documents/7th-Corporate-Plan-FA-Online-version-min.pdf >Accessed 26 October 2019.

of criminal investigations has tightened the noose around the corrupt officials with several people being arraigned before courts of law.[269]Considering that the people trusted with collection of taxes have infiltrated the system and are now collaborating with taxpayers to aggressively avoid taxes, such officers should be made liable to pay the taxes that could have otherwise been collectable. The penalties and fines should be double the amount forgone to discourage such actions since it amounts to sabotage.[270]

Secondly, the tax administration approach is critical in promoting compliance among taxpayers.[271] In this regard, the use of 'taxpayer as client" approach to tax compliance by the tax administrators has achieved more success where education and information are emphasized over threats.[272] KRA is seen as a bogeyman with a whip keen to punish for non-compliance. The obligation to pay taxes is therefore to avoid the repercussions rather than a personal moral choice.

In such a situation, cases of aggressive tax avoidance rise because taxpayers often engage in schemes designed with the sole aim of stretching the limits of the statute. In the recent weeks, we have seen the high-profile arrests of Keroche breweries directors.[273] The arrests were done based on alleged tax evasion investigations by KRA which disclosed activities aimed at evading taxes. On the other hand, the taxpayers insist that the transactions in question were tax avoidance schemes aimed at reducing tax liability.

---

[269] <https://citizentv.co.ke/news/75-kra-tax-officials-arrested-on-suspicion-of-corruption-244954/> Accessed 26 October 2019.

[270] Alex Raskolnikov, 'Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty' (2006) Vol. 106 No. 3 Columbia Law Review 578.

[271] Kirchler E, *The Economic Psychology of Tax Behaviour* [2007] Cambridge University Press 45.

[272] Hallsworth M, List J. A, Metcalfe R. D and Vlaev I, 'The Behavioralist as Tax Collector: Using Natural Field Experiments to Enhance Tax Compliance' (2014) National Bureau of Economic Research 441.

[273] <https://www.standardmedia.co.ke/business/article/2001339105/keroche-breweries-owners-arrested > Accessed 29August 2019.

Keroche breweries diluted one of its vodka brands with water in manufacturing a ready to drink vodka and remitted taxes only for the alcohol used in preparing the vodka and not for the entire volume which consists of water and alcohol. Although the brewer sells the ready to drink vodka at the same price as that of undiluted vodka, it claimed that the tax consequences of the transaction should be limited to the alcohol used in preparing the drink. Although the directors were charged with tax evasion, they insisted that the transaction was a legal tax avoidance measure.[274]

KRA opted to prefer charges against the directors of Keroche Breweries despite the pendency of an appeal on the tax assessment before the Tax Appeals Tribunal. The bravado displayed by KRA in the cases tells of an institution keen to exercise power play and shock therapy to force compliance. The cited example could have been better handled through the laid down civil dispute resolution mechanisms. In any event, the magistrates before whom the accused persons have been arraigned are not tax experts. In a recent decision in *Kenya Revenue Authority v WOW Beverages Limited & another; Humphrey Kariuki Ndegwa*, Justice Luka Kimaru declared that the DCI has no jurisdiction to investigate tax matters.[275]

Such forceful actions are counterproductive and do not necessarily lead to better compliance, instead they lead to increased aggressive tax avoidance.[276] This therefore provides impetus to use behavioral science to encourage compliance. Evidence has shown that behaviorally informed interventions improve tax compliance.[277]The role of the tax administrator should therefore not just

[274] <https://www.the-star.co.ke/business/2019-08-29-home-grown-keroche-cries-foul-in-tax-battle-with-kra/> Accessed 30 August 2019
[275] [2019] eKLR.
[276] John Hasseldine, 'Using Persuasive Communications to Increase Tax Compliance: What Experimental Research Has (and Has Not) Told Us' (2000) vol. 15, no 3 Australian Tax Forum: A Journal of Taxation Policy, Law and Reform 227.
[277] ibid.

be about power calculations but rather ensuring a close collaboration with the taxpayer to achieve compliance[278].

KRA should adopt a tax compliance model that incorporates behavioral characteristics in order to influence positive tax compliance within the moral fabric. Further, alternative dispute resolution channels envisaged under the VAT Act and the Income Tax Act ought to be exhausted before resort to criminal proceedings in case of tax disputes. This

4.2.3. Undertake frequent KRA Taxpayer engagement fora and seminars.

Lack of knowledge about tax laws is a significant factor leading to non-compliance. Much as ignorance of the law is no defence, it is noteworthy that tax rules are complex and require constant education to ensure full compliance. A taxpayer would be required to use his knowledge in computing his tax obligations, declaring the obligations and remitting the due taxes.[279]

Without adequate knowledge and information about these obligations and how they are computed, a taxpayer will most likely fail to declare taxes or under declare. Tax education increases the knowledge level of taxpayers with regards to technical skills needed to determine the tax liability and awareness of tax regulation.[280]

KRA should organize frequent outreach programs and distribute adequate material to the taxpayers at fora and seminars to educate the taxpayers on the needs.

---

[278] Lumumba Omweri Marti, Migwi S. Wanjohi, Obara Magutu, 'Taxpayers Attitudes and Tax Compliance Behaviour in Kenya' [2010] AIBUMA Publishing 120.
[279] Kelvin Gitaru, 'The Effect of Taxpayer Education on Tax Compliance in Kenya (a case study of SME's in Nairobi Central Business District)', (2017) MPRA Paper 80344, University Library of Munich, Germany 4.
[280] ibid 37

4.2.4. Enhance taxpayer compliance awards and recognition.

Kenya Revenue Authority should recognize and reward various categories of taxpayers for loyalty and compliance. Presently, the reward scheme administered by KRA is for top taxpayers for remitting huge amounts of money in taxes. This ought to be expanded to apply to not only the top taxpayers but also the small taxpayers recognizing loyalty and compliance.

Cognitive evaluation theory predicts that when feelings of competence are affirmed it can enhance the intrinsic motivation for an action.[281] Japan rewards its compliant taxpayers by allowing them take pictures with the Emperor. In the Philippines, the Revenue Authority enters compliant taxpayers into a lottery in which they stand a chance of winning money and other gifts. South Korea rewards its compliant taxpayers by allowing compliant taxpayers to airport VIP rooms, certificates or awards, and gives free parking in towns.[282] KRA should expand the scope of the rewards to recognize all categories of taxpayers.

[281] Marina Bornman,'Rewarding tax compliance: taxpayers' attitudes and beliefs'[2015] Journal of Economic and Financial Sciences 8(3) 795

[282] Ronald Cummings, Jorge Martinez-VazqWuez, Michael McKee and Benno Torgler, 'Tax morale affects tax compliance: Evidence from surveys and an artefactual field experiment' [2009] Journal of Economic Behavior and Organization 70, 447

5.0 SOURCED REFERENCES

5.1 Books

Brealey A, Myer S and Allen F, *Principles of corporate finance* (McGraw Hill 2008)

Gordon R, *Taxation in Developing Countries: Six Case Studies and Policy Implications* (Columbia University Press 2010).

Kerzner, D Chodikoff D, *International Tax Evasion in the Global Information Age* (Springer publishers, 2016).

Prosser J and Murray R, *Tax Avoidance* (Sweet and Maxwell 1st Edition 2012).

Rugraff E and Hansen M, *Multinational Corporations and Local Firms in Emerging Economies* (Amsterdam University Press 2011)

5.2 Journals and Articles

Kirui B, 'Tax Practitioners: Advocates of Compliance or Avoidance?' [2016] African Tax Research Network Working Paper No. 04.

Alm J 'Designing Responsible Regulatory Policies to Encourage Tax Compliance' [2013] Modern Economy Journal. <http://murphy.tulane.edu/files/events/AlmDesigningResponsibleRegulatoryPolicies-Murp hy Institute-021113.pdf> Accessed 15 August 2019.

Ameyaw B and Dzaka D, 'Determinants of Tax Evasion: Empirical Evidence from Ghana: Modern Economy' [2016] Scientific Research Publishing. <http://dx.doi.org/10.4236/me.2016.714145> Accessed 24.10.2019.

Adebisi J, Gbegi D, 'Effect of Tax Avoidance and Tax Evasion on Personal Income Tax Administration in Nigeria' (2013) Vo11 No 3 American Journal of Humanities and Social Sciences.

Fuest C, Spengel C, Finke K, Heckemeyer J, and Nusser H, 'Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform' (2013) Center for European Economic Research. Discussion Paper No.13-078.

Gravelle J G, 'Tax Havens: International Tax Avoidance and Evasion' [2015] Congressional Research Service Journal.

Hart H.L.A, 'Positivism and the Separation of Law and Morals' [1958] Harvard Law Review Journal.

Hove K, 'An investigation into the causes of tax avoidance and tax evasion in Zimbabwe: A survey of business operators in Bulawayo' (2016) Vol IV Issue 5 International Journal of Economics, Commerce and Management United Kingdom.

Holtzblatt M, Jermakowicz E and Barry J, 'Epstein Tax Heavens: Methods and Tactics for Corporate Profit Shifting' [2015] International Tax Journal.

Lenz H, 'Aggressive Tax Avoidance by Managers of Multinational Companies as a Violation of their moral duty to obey the Law: A Kantian Rationale' [2018] Journal of Business Ethics.

Masinde M, 'Unlocking the revenue potential of Kenya' (2010) Parliamentary Budget Office Working Paper series 2/2010 < https://www.grin.com/document/199589 > Accessed on 10 September 2019.

Mclaren J, 'The distinction between Tax Avoidance and Tax Evasion has become blurred in Australia: Why has it happened?' (2008) Vol 3 No 2 Journal of the Australasian Tax Teachers Association.

Mwangi J, Kiragu D and Mathenge D, 'Effect of technology adoption and staff training on tax fraud among large taxpayers in Kenya Revenue Authority' (2018) Vol VI Issue 5 International Journal of Economics, Commerce and Management United Kingdom.

Kamau J, 'The effect of tax evasion on tax revenues in Kenya' (MBA Thesis, school of business University of Nairobi 2014).

Kebwaro B, 'The effect of transfer pricing on tax planning for Multinational Companies in Kenya' (MBA Thesis, Nairobi University 2014).

Levin J, Widell L, Tax 'Evasion in Kenya and Tanzania: Evidence from Missing Imports' (2007) Orebro University Working Paper No. 8/2007 < https://core.ac.uk/download/pdf/6534588.pdf> accessed 15 August 2019.

Posner R, 'Values and consequences: As an introduction to Economic Analysis of Law' (1968) John M.Olin Law & Economics working paper no. 53 2nd series< https://pdfs.semanticscholar.org/fcca/671b93a88efd6d5807b12ea01f4094a8833c.pdf> accessed 5 February 2019.

Murphy J, 'The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the bottom line'[2004] Society for International Development Journal.

Orago N, 'Limitation of socio-economic rights in the 2010 Kenyan Constitution: A proposal for the adoption of a proportionality approach in the judicial adjudication of socio-economic rights disputes' (2013) volume 16 Potchefstroom Electronic Law Journal.

Okech T and Mburu P, 'Analysis of responsiveness of tax revenue to changes in National Income in Kenya between 1986 -2009' [2011] Vol 2 No 21 International Journal of Business and Social Science.

Slemrod J, 'Cheating Ourselves: The Economics of Tax Evasion' (2007) Vol 21 Journal of Economic Perspectives.

Slemrod J and Yitzhaki S, 'Tax avoidance, evasion, and administration' (2002) Vol 3 Handbook of Public Economics.

Slemrod J, 'Cheating Ourselves: The Economics of Tax Evasion' (2007) Vol 21, No1 Journal of Economic Perspectives.

Sherry X, 'Social Identities, Ethnic Diversity and Tax Morale' (2010) Vol 38, Issue 2 Sage Journals < http://www.utdallas.edu/~xxl068000/TaxMorale.pdf Accessed on 23.10.2019> Accessed 25 August 2019.

Tretola J, 'The Interpretation of Taxation Legislation by the Courts - A Reflection on the Views of Justice Graham Hil' (2006) Vol 16 Revenue Law Journal.
<http://epublications.bond.edu.au/rlj/vol16/iss1/5> Accessed 23.10.2019.

Waris A, Kohonen M, Ranguma J and Masioma A, 'Taxation and state in Kenya: Enhancing Revenue Capacity to Advance Human Welfare' [2008] Kenya Tax Justice Network Africa (TIN-A) Country Report Series.

Bornman M, 'Rewarding tax compliance: taxpayers' attitudes and beliefs'[2015] Journal of Economic and Financial Sciences 8(3).

Cummings J, Martinez J, McKee M and Torgler B, 'Tax morale affects tax compliance: Evidence from surveys and an artefactual field experiment' [2009] Journal of Economic Behavior and Organization 70.