

**A CASE FOR INTRODUCTION OF ADVANCE PRICING AGREEMENTS
PROVISIONS IN KENYA: CREATING CERTAINTY IN TRANSFER PRICING LAW**

**A Thesis Submitted in Partial Fulfilment of the Requirements for the Award of the Degree
of Master of Laws (LL.M) of the University of Nairobi**

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G62/68431/2013

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NOVEMBER, 2015

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LIST OF ABBREVIATIONS AND ACRONYMS

ALP	Arm's Length Price
APA	Advance Pricing Agreement
ATAF	African Tax Administration Forum
BEPS	Base Erosion and Profit Shifting
FDI	Foreign Direct Investment
IMF	International Monetary Fund
MNE	Multinational Enterprise
OECD	Organisation for Economic Cooperation and Development
TP	Transfer Pricing
UN	United Nations

Kenya

KRA	Kenya Revenue Authority
LTO	Large Taxpayers Office

United Kingdom

GAAR	General Anti-Abuse Rule
HMRC	Her Majesty's Revenue and Customs
PAC	Parliamentary Accounts Committee
TIOPA	Taxation (International and Other Provisions) Act of 2010
UK	United Kingdom

United States

APMA Advance Pricing and Mutual Agreement

IRC Internal Revenue Code

IRS Internal Revenue Service

India

DOR Department of Revenue

CBDT Central Board of Direct Taxes

CBEC Central Board of Excise and Customs

LIST OF INTERNATIONAL LAW AND STATUTES

International Law

United Nations Model Double Taxation Convention between Developed and Developing Countries (2009)

OECD Model Convention with Respect to Taxes on Income and on Capital

Kenya

Income Tax Act Chapter 470 of Laws of Kenya

Income Tax (TP) Rules of 2006

United Kingdom

Taxation (International and Other Provisions) Act (TIOPA) of 2010

Finance Act of 2011

Commissioners for Revenue and Customs Act of 2005.

United States

IRS Restructuring and Reform Act of 1998

The Internal Revenue Code (IRC), Title 26 of the United States Code US Code, s 482, 6038A, 6038C, 6662, 7701(o).

India

Income Tax Act of 1961

Income Tax Rules of 1962

Finance Act 23 of 2012

LIST OF CASES

Kenya

Unilever Kenya Limited V Commissioner of Income Tax High Court at Nairobi, Income Tax Appeal 753 of 2003 (2005) eKLR.

United Kingdom

Fisher's Executors v CIR [1926] AC395

Beneficiary v IRC [1999] STC (SCD) 134 in Fisher & Ors v Revenue & Customs [2014] UKFTT 804 (TC) (14 August 2014)

IRC v Duke of Westminster [1936] AC1 (HL).

Watson v Hornby (1942) 2 All ER 506.

Sharkey v Wernher (1955) 36 TC 275.

Petrotim Securities Ltd v Ayres (1963) 41TC389.

Ayrshire Pullman v CIR (1929) 14TC754.

DSG Retail and others v HMRC (TC 00001) (2009).

United States

Glaxo SmithKline Holdings (Americas) Inc. v Commissioner of Internal Revenue, Docket No 3-01-D., filed on July 5, Internal Revenue Service.

DHL Corporation and its Subsidiaries v Commissioner of Internal Revenue, Docket Nos. 19570-95, 26103-95.

Eaton Corporation and Subsidiaries v Commissioner of Internal Revenue, 140 T.C. No. 18 (2013).

India

Sony Ericsson Mobile Communications India Pvt Ltd v Commissioner for Income Tax (ITA No. 16/2014).

ABSTRACT

Transfer pricing has grown into a global issue because of the increase in international transactions which generate revenue for MNEs, and the realization by these businesses that through manipulation of the tax rules in different jurisdictions, they can report higher profits than their competitors.

This study puts forward a case for the introduction of Advance Pricing Agreements (APAs) in Kenya to create certainty in the process of determining transfer prices in transactions between resident persons and multinational enterprises (MNEs). This proposition is based on the argument that the absence of APAs creates uncertainty in establishing the arm's length price (ALP) for international transactions carried out by the MNE. Where an MNE experiences challenges in establishing the ALP for its transactions, this is likely to make it difficult for the MNEs to develop its TP policy for Kenya. As a result, the MNE would be likely to consider that Kenya is an unfavourable tax environment for its global transactions.

This study argues that taxpayers and the tax revenue authorities face challenges in securing compliance with the current Transfer Pricing (TP) Rules. Through the use of APAs, Kenya's tax revenue authority will find it easier to ensure compliance with the TP Rules as the ALP will be pre-agreed. This will ultimately create certainty for investors due to the predictability of the transfer prices. To achieve this, this study proposes incorporation of provisions on APAs in the existing TP Rules. In addition, it recommends the establishment of a pilot APA program to jumpstart efforts in efficient TP regulation.

The study is influenced by the guidelines provided by the United Nations which offer guidance on the policy and administrative aspects of applying transfer pricing. Through administrative activity,

tax revenue authorities, particularly KRA, can reduce TP disputes. Due to their administrative nature, this study proposes APAs as a possible solution in line with the United Nations guidelines.

ACKNOWLEDGMENT

First I would like to thank the Almighty God for the opportunity He gave me to pursue this Masters' Course, and for seeing me through to the very end. For He did not leave me nor forsake me, and without Him I would not have come this far.

I would like to acknowledge my Supervisor, Professor Arthur Eshiwani, a very busy respected man who took his time to impart knowledge and give guidance to a learning soul. With his expertise and record of accomplishment in Tax Law, he has been my guiding light in the search for academic excellence.

My family has been my support through this long journey, offering me the shoulder to lean on when times got hard. You pushed me to continue chasing my dream and were there for me. Even though I did not give you much time because I was buried in my books, you were understanding and gave me a good backing to keep on. Now I am done with my studies and I have been unleashed back to you!

I have finished the race (this one at least). May God bless you for all you have done for me.

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CHAPTER ONE

BACKGROUND TO THE STUDY

1.0 INTRODUCTION

Globalisation influences nations' systems for corporate taxation.¹ The League of Nations (now the UN), from as far back as the 1920s, began to discuss the possibility that businesses' interactions with different tax revenue authorities could lead to taxation by both jurisdictions, otherwise known as double taxation.² Member countries of the UN are clear that due to its negative effects on international commerce, double taxation should be eliminated.³ Due to its effects on countries across the world and on the global economy as a whole, efforts to reduce or eliminate double taxation must and have been undertaken through joint participation of countries' revenue authorities.

MNEs generally operate on a global basis and are able to decide where to locate activities and how best to structure and finance them to take advantage of different market opportunities.⁴ Since the introduction of TP regulations in various parts of the world, TP has emerged as one of the largest

¹ OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 4 May 2015.

² Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008); OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 4 May 2015.

³*ibid.*

⁴ OECD, *Dealing Effectively with the Challenges of TP* (OECD 2012) 15 <<http://dx.doi.org/10.1787/9789264169463-en>> accessed on 15 May 2015.

sources of tax controversy for MNEs. Tax in developing countries and TP in particular, is becoming a hot topic for international development.⁵

TP is ‘the art of pricing cross border transactions entered into between two or more companies of the same MNE group (related parties /associated enterprises)’.⁶ These subject matter of these transactions includes both goods and services.⁷ TP has grown into a global issue because of the increase in international transactions.⁸ Through these transactions MNEs generate revenue in various countries. It is presumed that through manipulation of the tax rules in these different jurisdictions, the MNEs can report higher profits than their local competitors. While some countries developed TP rules to regulate the practices of allocating prices for the cross border transactions, some jurisdictions have lagged behind. The disconnect between the rules in the well regulated and under-regulated states has become an international discussion point because of the need for the global economies to cooperate to achieve the common goal of their right to tax.

TP rules exist to address the potential mismatch between profit allocation and the distribution of risks, assets and functions across the group. TP rules require MNEs to price, for tax purposes, their internal or intra-group transactions and calculate profits as if the transactions had taken place between independent businesses: the arm’s length principle (ALP). This is the international standard set out in Article 9 of the Organisation for Economic Cooperation and Development

⁵ Martin Hearson & Richard Brooks, ‘Calling Time: Why Sabmillier Should Stop Dodging Taxes in Africa’ (Action Aid 2012) <https://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf> accessed on 8 May 2015.

⁶ PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ *Whitepaper on APA in India* (PWC 2011) <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 8 May 2015.

⁷ Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008).

⁸ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012);

(OECD) Guidelines and Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries and used by tax revenue authorities around the world.⁹

In Kenya, the Income Tax Act Chapter 470 of Laws of Kenya (Income Tax Act) contains the Income Tax (TP) Rules, 2006 (Kenya TP Rules). Kenya TP Rules define ALP as the price payable in a transaction between independent enterprises. ALP always seems to be an elusive concept due to the complex transactions for MNEs.

ALP may result in an administrative burden for both the taxpayer and tax revenue authorities in evaluating significant numbers and types of cross border transaction¹⁰. While it is relatively easy to describe the ALP, establishing guidelines on the practical application of the principle is a complex task. Tax revenue authorities in Africa are very familiar with the practical problems and difficulties which arise in efforts to arrive at the ALP.¹¹

In Kenya, the Kenyan TP rules, modelled as per the OECD guidelines, form the basis for MNEs to develop their TP documentation. The Kenya TP Rules place the burden of proving that prices

⁹ OECD, *Model Convention with Respect to Taxes on Income and on Capital*, Art 9; UN Department of Economic & Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2001) <<http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf>> accessed on 8 May 2015; Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008).

¹⁰ Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008); OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) 35 <http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015.

¹¹ Gerdi van Der Westhuysen, 'South African Transfer Pricing System' (South African Revenue Service' <http://www.taxjustice.net/cms/upload/pdf/Gerdi_van_der_Westhuysen_1206_Helsinki_ppt.pdf> accessed on 8 May 2015; quoted in John Christensen, 'Africa's Lost Tax Revenue, Lost Development Opportunities' *Association of Concerned African Scholars Bulletin* 87 (ACAS 2012) <<http://concernedafricascholars.org/wp-content/uploads/2012/11/caploss08-christ-14th.pdf>> accessed on 8 May 2015.

are at arm's length on the taxpayer. A taxpayer who cannot support the averment of compliance with the ALP is at risk of TP adjustment by the Kenya Revenue Authority (KRA). As such, inadequate documentation would make it difficult for the taxpayer to rebut the TP adjustment.¹²

Due to the complex nature of ALP and the considerable time that it takes to resolve TP disputes, there is need to find a middle ground to resolve TP controversy to create certainty. Advance pricing agreements (APAs) among other efforts, offer the middle ground sought after by MNEs and the tax revenue authorities. An APA is an agreement between the taxpayer and the tax authority covering future transactions, with a view to solve potential taxation disputes in a cooperative manner.¹³ Kenya TP Rules do not provide for APAs. This creates uncertainty for the MNE doing business in Kenya.

In July 2014, while addressing an International Tax Seminar at Strathmore University, KRA Commissioner-General John Njiraini stated that companies use the TP mechanism to declare losses that effectively disqualify them from paying income tax.¹⁴ As such, KRA has forced more than 10 MNEs to rewrite their financial statements, turning Ksh 8 billion losses into profits that

¹² Daniel Ngumy 'Tethering the Group: Transfer Price Regulations in Kenya' *ALN Insight* (Anjarwalla & Khanna 2010) <<http://www.africalegalnetwork.com/wp-content/uploads/2012/10/Transfer-price-regulations-in-Kenya-Daniel-Ngumy-Anjarwalla-Khanna-ALN-Insight-November-2010.pdf>> accessed on 8 May 2015.

¹³ Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008); PWC, 'Certainty in the Uncertain World of Transfer Pricing' *Whitepaper on APA in India* (PWC 2011) <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 8 May 2015.

¹⁴ Gerald Andae, 'Tax Evasion Sting Recovers Sh25bn from Multinationals' (Business Daily, Monday 14 July 2014) <<http://www.businessdailyafrica.com/Tax-evasion-sting-recovers-Sh25bn-from-multinationals/-/539546/2382632/-/lib8wwz/-/index.html>> accessed on 8 May 2015; Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012).

have yielded KSh4 billion in tax revenues. KRA audit of 40 MNEs indicated a widespread abuse of TP to declare losses and evade taxation.¹⁵

TP is a development financing issue, because without adequate tax revenues, a country's ability to mobilise domestic resources for development may be hampered.¹⁶ In terms of tax policy generally, and more specifically, TP policy, one of the main considerations for nations is how to protect their domestic tax base without reducing incentives to international trade and foreign direct investment (FDI).¹⁷

Developing nations lose KSh93.5 billion per day in illicit financial flows that end up in tax havens around the world.¹⁸ Tax is so important for development, thus we need to look at how developing countries can raise more revenue and do so equitably, through better tax systems and indeed through tax justice.¹⁹

After *Unilever Kenya Limited V Commissioner of Income Tax*²⁰ TP rules were introduced in Kenya to regulate cross border related party transactions and to ensure that the profits made in Kenya are

¹⁵ Geoffrey Irungu, 'KRA Busts Sh8bn Tax Evasion Scam Involving Multinationals' (Business Daily, Thursday 12 September 2013) <<http://www.businessdailyafrica.com/KRA-nets-billions-after-audit-of-firms/-/539546/1990540/-/ciulcq/-/index.html>> accessed on 8 May 2015.

¹⁶ Jomo Kwame Sundaram, 'Transfer Pricing Is a Financing for Development Issue' (Friedrich Ebert Stiftung 2012) <http://www.un.org/esa/ffd/wp-content/uploads/2012/03/20120314_08938.pdf>

¹⁷ PwC, 'Spotlight on Africa's Transfer Pricing Landscape' (PwC nd) <https://www.pwc.com/en_GX/gx/tax/transfer-pricing/management-strategy/assets/pwc-transfer-pricing-africa-pdf.pdf> accessed on 8 May 2015.

¹⁸ George Omondi, 'Poor Nations Lose Sh94bn Daily to Tax Cheats, Says Oxfam' (Business Daily, Monday 17 June 2013) <<http://www.businessdailyafrica.com/Poor-nations-lose-Sh94bn-daily-to-tax-cheats-says-Oxfam---/539546/1886194/-/3d4cjb/-/index.html>> accessed on 8 May 2015.

¹⁹ ActionAid, 'Tax Justice: The Domestic Perspective – A Synthesis Of Studies of the Tax Systems in Five Developing Countries' (ActionAid UK 2013) <http://www.actionaid.se/sites/files/actionaid/tax_justice_-_the_domestic_perspective.pdf> accessed on 8 May 2015.

²⁰ High Court at Nairobi, Income Tax Appeal 753 of 2003 (2005) eKLR.

taxed in Kenya and not moved to another jurisdiction by the related entities. With the inception of the rules, KRA did not have capacity to challenge or question the TP documentation prepared by the taxpayer in line with the TP Rules.

KRA has now focused efforts on TP capacity building through establishing a specialized TP unit and joining the African Tax Administration Forum (ATAF), an association created to promote and facilitate mutual cooperation among African tax revenue authorities with the goal of improving the efficiency of their tax legislation and revenue authority²¹. KRA has conducted several TP audits which take a considerable time to conclude due to the standoff between the taxpayer and KRA as each party believes that their TP methodology is correct.

From 2009 to 2011, KRA had requested over 300 taxpayers to submit documentation for audit purposes, but while these general/comprehensive audits have contributed to ascertaining taxpayers' compliance, as at 2011 no special audits had been carried out specifically with regard to TP.²² When the taxpayer submits its tax documentation for a tax audit, there may be uncertainty in whether KRA will accept the TP policy and potential costly and time-consuming proceedings if the taxpayer challenges KRA's determination, with no guarantee of agreement.²³

In countries where TP law is more developed than in Kenya, MNEs have increasingly had a significantly high cost burden relating to TP audits and tax adjustments, and due to the uncertainty

²¹ African Tax Revenue authority Forum, 'ATAF Overview' (ATAF 2012) <<http://www.ataftax.net/en/about.html>> accessed on 8 May 2015.

²² PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC 2011) 18 <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 14 June 2015.

²³ Michelle M Markham, 'Advantages and Disadvantages of Using an Advance Pricing Agreement: Lessons for the UK from the US and Australian Experience' 33 *Intertax* 216 (Kluwer Law International 2005) 215 – 216.

of the tax administration process, these MNEs seek comfort in APAs and advance rulings from the tax revenue administrations.²⁴ If KRA continues with the TP audit path, based on the experiences of these countries similar problems will arise.

KRA and taxpayers stand to benefit from the introduction of APAs. Taxpayers will profit from increased domestic legal certainty, avoidance of international double taxation, and a constructive relationship with KRA; while KRA seeks to gain from lower cost of tax administration as compared with the TP tax audit system, efficient revenue collection, elimination of the risk of losing its tax base to countries with more favourable tax administration systems, and confidence of MNEs in KRA leading to a better investment environment in the country.²⁵

This study addresses the challenges KRA and MNEs experience in implementation of the TP Rules, and dares to suggest that APAs are a possible solution to the challenges. In addition, it presents the benefits and disadvantages KRA and the MNEs would experience with the introduction of APAs in Kenya.

²⁴ Jean-Pierre, 'Advance Pricing Agreements' 8 *EC Tax Rev.* 9 (1999) 8 – 18.

²⁵ *ibid.*

1.1 STATEMENT OF THE PROBLEM

The TP Rules do not make provisions for APAs. With no APAs legal provisions, KRA is disadvantaged because they have no legal basis to enter into any negotiations to create an APA with a tax payer. This creates potential uncertainty in determination of ALP, leading to ambiguity in the application of TP rules and the resultant unfavourable environment for MNE investment in Kenya. Further, with uncertainty comes the potential for TP litigation accompanied by its related angst and heavy costs.²⁶ One of the most effective ways for KRA to ensure attainment of certainty and clarity for taxpayers is through introduction of APAs because they minimise the risk of TP adjustment, are applicable to companies with complex TP transactions and contribute to minimised tax litigation costs.²⁷

In July 2014, while addressing an International Tax Seminar at Strathmore University, KRA Commissioner-General John Njiraini stated that companies use the TP mechanism to declare losses that effectively disqualify them from paying income tax.²⁸ As such, KRA has forced more than 10 MNEs to rewrite their financial statements, turning Ksh 8 billion losses into profits that

²⁶ Tony AO Ferrers, 'Transfer Pricing - The Australian Commissioner Speaks Out' 23 *Intertax* 518 (1995) 505 – 521.

²⁷ Jasmeet Singh and Kartikey Mahajan, 'Advance Pricing Agreements: The Way Forward for India' 38 *Intertax* 380 (2010) 378 – 383.

²⁸ Gerald Andae, 'Tax Evasion Sting Recovers Sh25bn from Multinationals' (Business Daily, Monday 14 July 2014) <<http://www.businessdailyafrica.com/Tax-evasion-sting-recovers-Sh25bn-from-multinationals/-/539546/2382632/-/1ib8wwz/-/index.html>> accessed on 8 May 2015; Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012).

have yielded KSh4 billion in tax revenues. KRA audit of 40 MNEs indicated a widespread abuse of TP to declare losses and evade taxation.²⁹

Kenya TP Rules provide for penalties and interest in the event of non-compliance. However, there are still possibilities for MNE tax evasion which KRA does not have the capacity to curb. An MNE may prepare its TP policy in line with the TP Rules, but there has been uncertainty with the ALP determination because in the past, KRA has displayed a tendency of upward review of the tax liability of taxpayers.

Kenya is lagging behind developed countries and developing countries which are already reaping the advantages of APAs. The US, UK, Australia and various countries in the EU have seen the benefit of APAs and introduced them into their TP laws. Developing countries such as India and South Africa have closely followed in the introduction of APAs, in the search for more efficient tax administration and increased revenue collection.

There is need for introduction of APAs in Kenya to provide a middle ground on matters TP, create certainty for taxpayers and KRA, and secure the revenue that Kenya deserves. This study examines the TP structures, provisions on APAs and efforts of reducing BEPS, of the United Kingdom, United States and India and draws lessons Kenya may learn from in implementing an APA programme.

²⁹ Geoffrey Irungu, 'KRA Busts Sh8bn Tax Evasion Scam Involving Multinationals' (Business Daily, Thursday 12 September 2013) <<http://www.businessdailyafrica.com/KRA-nets-billions-after-audit-of-firms/-/539546/1990540/-/ciulcq/-/index.html>> accessed on 8 May 2015.

1.2 RESEARCH FOR THE STUDY

The research methodology, objectives, questions and hypotheses of this study are discussed below.

1.2.1 Research Methodology

This study employs qualitative methods of research, through desktop-based review of secondary data. The study will draw from scholarly articles and papers in journals, books, constitutions and various pieces of legislation.

1.2.2 Objectives of the Study

The objectives of conducting this study are as follows:

- a. To determine if the introduction of APA in Kenya will assist in addressing the TP database challenges in Kenya.
- b. To determine the benefits created by the introduction of APAs.
- c. To determine the best practice with regards to APAs with UK, US and India as a case studies
- d. To put a case for the amendment for the Kenya TP Rules by the introduction of APAs.

1.2.3 Research Questions

This study seeks to address the following questions:

1. How is Kenya addressing the current challenges in TP?
2. Will the introduction of APAs guidelines in Kenya resolve the TP challenges in Kenya and create certainty in TP matters for both the taxpayer and tax revenue authorities?

1.2.4 Hypotheses

The study is based on the following hypothesis:

- a. That the challenges of complying with TP Rules will be reduced and there will be greater compliance with the introduction of APA.
- b. That Kenya will greatly strengthen the tax structures around TP with the introduction of APA and create certainty for investors.

1.3 JUSTIFICATION FOR THE STUDY

This study is important because it sheds light on the issue of TP in Kenya, suggests APAs as a mechanism of improving the TP environment in the country and contributes to KRA's efforts to keep its activities in line with international best practices. The study argues that an APA program is important in Kenya and should be implemented to facilitate KRA's TP management system. It is important to undertake this study because it suggests APAs which this study posits will benefit KRA and taxpayers in management of TP. It will therefore support KRA's efforts and contribute to the tax revenue authority's objectives.

In the 1960s and 1970s, Kenya was an ideal choice for foreign investors seeking to tap into the East African Market.³⁰ However, over the years, the likes of Uganda and Tanzania have overtaken Kenya, with some foreign investors choosing neighbours as their entry-point into the region. In 2008, The United Nations Conference on Trade and Development's (UNCTAD) described Kenya as 'East Africa region's least effective suitor in attracting FDI'.³¹

The year 2007 was a bumper year for Kenya where the economy received US\$729 million in FDI (2.7% of GDP).³² However, in 2008 this reduced to only US\$96 million (0.3%) arguably as a result of political instability following contested elections in the 2007/2008 period and the Global Financial Crisis. It gained slightly to US\$141 million (0.4%) in 2009, and ended the decade at US\$186 million (0.6%) in 2010 according to the World Bank's World Development Indicators.³³

³⁰ KPMG, 'Kenya – Country Profile' *KPMG in Africa* (KPMG Services Proprietary Limited 2012) 10 <<http://www.kpmg.com/Africa/en/KPMG-in-Africa/Documents/Kenya.pdf>> accessed on 12 May 2015.

³¹ *ibid.*

³² *ibid.*

³³ *ibid.*

Currently, domestic investment tops FDI in terms of volumes of investment, and on the backdrop of this realisation, if Kenya seeks to increase FDI it needs to take serious measures to assure foreign investors a favourable return.

Taxation affects the investment climate, and is a major consideration in an MNE's decision to either lend money or acquire business in a particular jurisdiction.³⁴ One of the factors contributing to reduced levels of FDI in Kenya is an inefficiency of the corporate tax system.³⁵ In 2008, the World Bank, International Finance Corporation (IFC) and Price Waterhouse Coopers observed that Kenya has the most unfavourable tax system in the region.³⁶ Specifically, businesses find that inefficiencies of the KRA tax administration system may hinder investment, with one of the costly activities being a 'perceived reluctance to issue rulings' on tax matters.³⁷ From this observation, protracted administrative processes may cost taxpayers uncertain amounts of time to resolve, and the negative perception drawn against KRA may lead to a shift of business operations to neighbouring countries, thereby reducing FDI into the economy.

While the above observations are recognised, KRA has made significant steps in development since its inception in 1995. Among its achievements, KRA has implemented a Reform and Modernisation Programme to harmonise its operations with recommended best practices; improved service delivery and customer service including successful implementation of the

³⁴ Daudu Yini Olowu, 'Impact of Investment Climate Reforms on Business Operations in Nigeria' 3 International Journal of Humanities and Social Science 21 (Center for Promoting Ideas 2013) <[http://www.ijhssnet.com/journals/Vol_3_No_21_\[Special_Issue_December_2013\]/19.pdf](http://www.ijhssnet.com/journals/Vol_3_No_21_[Special_Issue_December_2013]/19.pdf)> accessed on 12 May 2015.

³⁵ KPMG, 'Kenya – Country Profile' *KPMG in Africa* (KPMG Services Proprietary Limited 2012) 11 <<http://www.kpmg.com/Africa/en/KPMG-in-Africa/Documents/Kenya.pdf>> accessed on 12 May 2015.

³⁶ *ibid.*

³⁷ Kenya Private Sector Alliance (KEPSA), 'Private Sector Development in Kenya' (KEPSA nd) <<http://siteresources.worldbank.org/INTKENYA/Resources/psd.pdf>> accessed on 11 May 2015.

Integrated Tax Management System of online tax presence; and enhanced human resource focus; all the while faced with challenges of limited funding.³⁸

In the 2013/2014 financial year, KRA revenue collection expectation was placed at Kshs 963.7 billion, representing a growth of 20.4% over the 800.5 billion revenue collection in the 2012/2013 financial year.³⁹ KRA surpassed its 2013/2014 estimates by Kshs 100 billion⁴⁰ but fell short of its targets in the first quarter of the 2014/2015 financial year by 6% (Kshs 17 billion), collecting Kshs 241.2 billion. The revenue authority targets collections of Kshs 1,121.5 billion in total for the 2014/2015 financial year.⁴¹

For KRA to maximise on the benefits of the tax collection system, it should seek to reduce the cost of collection and deal with compliance problems attributed to ‘lack of awareness among taxpayers of the need to comply with tax law, high compliance costs, arbitrariness of assessment and corruption, making taxpayers unwilling to comply voluntarily, and poor enforcement, making it unlikely that non-compliant tax payers will be caught and punished’.⁴²

³⁸ KRA, *Fifth Corporate Plan 2012/2013 – 2014/2015* (KRA 2012)
<<http://www.revenue.go.ke/notices/pdf2012/KRAFifthCorporatePlan.pdf>> accessed on 14 June 2015.

³⁹ KRA, *Fourth Quarter and July – June Revenue Report 2013/2014* (KRA 2014)
<<http://www.revenue.go.ke/notices/pdf2014/Revenue%20Performance%20Report%202013%20-%202014%20FY.pdf>> accessed on 14 June 2015.

⁴⁰ Elayne Wangalwa, ‘Kenya Falls Short on First Quarter Revenue’ *CNBC* (ABN Digital Pty 12 February 2015)
<<http://www.cnbcfric.com/news/east-africa/2014/11/14/kra-q1-results/>> accessed on 14 June 2015.

⁴¹ KRA, *Fourth Quarter and July – June Revenue Report 2013/2014* (KRA 2014)
<<http://www.revenue.go.ke/notices/pdf2014/Revenue%20Performance%20Report%202013%20-%202014%20FY.pdf>> accessed on 14 June 2015.

⁴² Michael G Waweru, ‘Organizational Issues for Tax Agencies, Compliance and Taxpayer Relations Strategies’ (KRA 2010) <<http://www.s4tp.org/wp-content/uploads/2010/10/9-waweru.pdf>> accessed on 14 June 2015.

To fulfil its strategic objectives of TP administration, KRA seeks to ‘review the governance structure relating to management of TP’.⁴³ TP is a complex issue, and in arriving at the ALP, the tax revenue authority must scrutinize the individual business and its workings.⁴⁴ Court decisions on TP and ALP vary because the businesses subject to the litigation process are distinct in their organisational structure and operations. For this reason, each TP interaction between an MNE and tax revenue authority is unique, and since there is no meaningful comparison between transactions of any two MNEs and judicial precedent is difficult to form, there is uncertainty in the business environment.⁴⁵

⁴³ KRA, *Fifth Corporate Plan 2012/2013 – 2014/2015* (KRA 2012)

<<http://www.revenue.go.ke/notices/pdf2012/KRAFifthCorporatePlan.pdf>> accessed on 14 June 2015.

⁴⁴ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012);

⁴⁵ PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ Whitepaper on APA in India (PWC 2011)

<http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 8 May 2015.

1.4 THEORETICAL FRAMEWORK

The jurisprudential basis for this study is in positivist legal theory. Legal positivists propose the view that the law is man-made, and the contents of the rule books as sanctioned by the state and preserved through codification are what make up the law. From a legal positivist perspective, laws derive their legitimacy from reduction into writing. The law develops through subsequent changes to the written law.

The bounds of the law are delineated in what is considered by the state and passed as such. Thomas Hobbes' position as one of the earliest legal positivists, and which gains traction in this study, is that the law abolishes chaos and brings order to the state of confusion and anarchy that existed prior to the law.⁴⁶ According to legal positivism, the law can be used to create order, and to bring in a situation of harmony in the TP regime. Absence of APAs results in uncertainty on how the ALP is determined, which in this study is equated to a state of anarchy in the tax system.

The certainty brought about by APAs ensures there is predictability, which rings true with the 19th Century Jonathan Bentham perspective of the “expectation” of the citizens and the application of the law in a bid to have that expectation met.⁴⁷ The doctrine of precedent, another aspect of the law which brings about certainty and predictability may be used to explain how positivist legal theory is important to this study. In the doctrine of precedent, with a consistent application of the law in a certain area and the hierarchy of the court system, litigants go to the courts with an expectation that the courts will follow previous decisions in that area of law, with a case that had similar facts. This encourages litigants to present themselves at the seat of justice because they are

⁴⁶ Friedrich Kessler, ‘Theoretic Bases of Law’ *Faculty Scholarship Series. Paper 2733* (1941) 98 – 112.

⁴⁷ *ibid.*

assured that they will achieve their expectation of consistency. Similarly, with the APAs, the MNEs will be in a position to know how TP transactions will be treated by the revenue authority. The APA takes the position of a revenue authority decision and crystallises the pre-determined outcome.

Legal positivism therefore shapes this study which argues that the introduction of APAs to the tax regime streamlines the anarchy that exists in a TP regulation system without certainty on the determination of the ALP; and further that APAs created as a result of interaction with the revenue authority being a body of the state, results in an APA with the force of law, bringing to the field of TPs the consistency that meets the expectation of the MNEs on the treatment of TP.

Economics forms a large part of the basis of discussions on TP. In economics, the balance of supply and demand of the market determines the price of goods and services. However, transactions between associated enterprises do not realistically have a difference in price, and in accounting one cannot sell to himself. Therefore, these transactions which occur at no cost to the associated enterprises, must be given a set price in order for the MNE group to establish whether it is conducting profitable business. Determining the ALP therefore is artificial price determination.

The classical economic theory approach, also called Hirschleifer's Model⁴⁸, addressed the TP issue as one of marginal analysis. Hirschleifer's Model states that 'market price (is) the correct transfer price only where the transferred commodity (is) traded in a perfectly competitive market' and 'if the market (is) imperfectly competitive or no market exist(s) for the intermediate goods, the correct

⁴⁸ Jack Hirschleifer, 'On the Economics of Transfer Pricing' 29 *The Journal of Business* (1956) 172.

procedure (is) to transfer at marginal cost.⁴⁹ In support of Hirschleifer's Model, Gould⁵⁰ contends that in order to achieve a balance between the marginal cost and marginal utility of transfer pricing, the firm models the process to provide the transfer price which will motivate buying and selling divisional managers to maximise total company profits.

Economic theory suggests that MNEs will maximise global after-tax profits by shifting revenues to low-tax and deductions to high-tax jurisdictions⁵¹. Horst explored the profit maximisation strategy for a monopolistic firm selling in two markets simultaneously in the presence of TP and how the firm reacts to a given set of tariff and tax rates.⁵² Horst's analysis concludes that manipulation of transfer prices is the primary route for such income shifting, where income shifting refers to the practice of separating the gains of a business activity from the location of the actual activity, and recording it in an associated entity in a different jurisdiction.

Tax authorities are aware that MNEs may have strong financial incentives to manipulate their declared transfer prices to shift income from highly to more lightly taxed countries. On this basis, governments provide guidance on the setting of transfer prices for international transactions.

Three common approaches employed to set transfer prices are; negotiated prices, cost basis and market price⁵³. The market provides an objective valuation of the intermediate product, and that

⁴⁹ Messaoud Mehafdi, 'Behavioural Aspects of Transfer Pricing in UK Decentralised Companies' (D.Phil. in Accounting Thesis, Thames Polytechnic London, 1990) 20
<http://gala.gre.ac.uk/8713/1/Messaoud_Mehafdi_1990.pdf> accessed on 14 May 2015.

⁵⁰ JR Gould, 'Internal Pricing in Firms Where There Are Cases of Using Outside Markets' *37 Journal of Business* (1964) 61-67.

⁵¹ T Horst, 'Theory of the Multinational Firm: Optimal Behavior under Different Tariff and Tax Rates' *Journal of Political Economy* (1971) 79.

⁵² *ibid.*

⁵³ Mohammad Talha, Syed Shah Alam and Abdullah Sallehuddin, 'Transfer Pricing And Taxation Implications, Disclosure In Segmental Reporting: Malaysian Evidence' *4 International Business & Economics Research Journal*

price acts as basis for price transfers and guide within the firm. However, conflict may occur in market price, when the price for the intermediate product or service is quoted on a long-term contract and a spot market basis and the market is not perfectly competitive. This complicates the transfer price.

Neoclassical theory of the firm states that the firm has a single goal, that of profit maximisation, which is attained by the application of the marginalist principle in a world of certainty and within a certain time horizon.⁵⁴ These assumptions are made in economic theory but in practice may not be of much value. The assumptions in this theory are that there is certainty in the world, while in reality it is not possible to account for all eventualities. Even in entering into APAs with an MNE, the tax revenue authority must consider that while the terms are evaluated and negotiated, the status quo may shift due to future upshots.

The set times, assumed in this theory, are another factor that does not apply effectively in real life. The theory suggests that during a certain period of time, say 5 years, the firm will concentrate on efforts it considers would lead to profit maximisation. If upon the completion of this period the avenues sought after are not fruitful, the MNE will shift its focus and endeavour to pursue other routes of profit maximisation. This is not a practical situation, because there is fluidity in time and the decision-making of MNEs. It would be illogical to peg the decision-making period to such definite times, and some actions which may lead to profit maximisation may not be planned with the time basis in contemplation.

(July 2005) <<http://www.cluteinstitute.com/ojs/index.php/IBER/article/viewFile/3604/3650>> accessed on 8 May 2015.

⁵⁴ Alan O'Keane, 'Profit Maximisation: An Outdated Hypothesis?' (1987) <<https://www.tcd.ie/Economics/assets/pdf/SER/1987/Profit%20Maximisation-%20An%20Outdated%20Hypothesis..pdf>> accessed on 8 May 2015.

The theory fails in its consideration that the firm has the sole objective of profit maximisation. On asking businessmen about the goals of their organisations, it is rarely found that profit maximisation is among them.⁵⁵ These MNEs seek to make a ‘fair level of profit’ while aiming to beat the competition, maintain good political relations, grow into global influencers, and impact societies and communities. This goes to support the view that this theory is not entirely accurate, and that some MNEs have other considerations in their operations, leaving profit and one of the lesser objectives.

The neoclassical theory of profit maximisation serves as the basis for the conclusion by tax revenue authorities that an MNE may reduce its taxable income and set TPs to a level that maximises profit. MNE theory states that a firm would select the most favourable calculations to determine the ALP and skirt the restrictions of host tax revenue authorities so that it can maximize global tax savings and minimize operating risks.⁵⁶ The MNE may engage in such practices legally, but to the tax revenue authority this would be considered fraudulent activity.

While this may be true to some extent, it may be argued that the shortfalls of the neoclassical theory of profit maximisation oppose the MNE theory. Thus, an MNE may not set the TP based solely on the aim of tax reduction, but may consider other factors such as supporting overseas branches and motivation to well performing functions of the business by attributing greater profits to these competitive MNE members.

⁵⁵ *ibid.*

⁵⁶ Oluwaseun Olanrewaju Avoseh, ‘An Empirical Evaluation of the Advance Pricing Agreement Process in the UK’ (PhD Thesis, University of Glasgow 2014) 7 <<http://theses.gla.ac.uk/5182/1/2014Avosehphd.pdf>> accessed on 8 May 2015.

The ownership theory of the firm separates the shareholders of an enterprise from the management, and supports the idea that the management, in line with agency theory, operates the organisation to bring maximum growth of the owners' wealth.⁵⁷ The managers of the MNE are the day-to-day operators of the business functions. They handle issues concerning steering the enterprise in business affairs, and are the contact persons with the tax revenue authority. According to this theory, then, the managers, who are well versed with the operations of the MNE, are the best placed to offer the tax revenue authority the information required when setting the ALP and entering into APAs.

However, the goal of wealth maximisation may be at crossroads with the goal of the tax revenue authority of revenue maximisation. Payment of high rates of tax reduces the amount of revenue the firm can plough back into retained reserves, thereby lessening the wealth of the shareholders. As agents of the shareholders, the managers may therefore be at the forefront in bending the TP rules, and aggressively negotiate for the best possible terms in APAs, to achieve their aim of protection of the shareholders' wealth.

Macroeconomic administrative theories support discretion, flexibility and experimentation in decisions and operations.⁵⁸ On the other hand, Leitch and Barrett put forward the MNE theory, and argue that 'MNEs arise and engage in foreign direct investment (FDI) in order to exploit

⁵⁷ Harold Demsetz, 'The Structure of Ownership and the Theory of the Firm' 26 *Journal of Law and Economics* 2 in *Corporations and Private Property: A Conference Sponsored by the Hoover Institution* (University of Chicago Press 1983) 375 – 390

<<http://www.rwi.uzh.ch/lehreforschung/alphabetisch/weberr/archiv/FS08/unterlagen/unterlagenLE/aufsaeetze/TheStructureofOwnershipandtheTheoryoftheFirm.pdf>> accessed on 8 May 2015; Armen Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organization' 52 *American Economic Review* 5 (1972) 777-795 <<https://www.aeaweb.org/aer/top20/62.5.777-795.pdf>> accessed on 8 May 2015.

⁵⁸ Oluwaseun Olanrewaju Avoseh, 'An Empirical Evaluation of the Advance Pricing Agreement Process in the UK' (PhD Thesis, University of Glasgow 2014) 20 <<http://theses.gla.ac.uk/5182/1/2014Avosehphd.pdf>> accessed on 8 May 2015.

imperfections in global markets'.⁵⁹ This 'exploitation argument' is premised on the profit-making motive of businesses and is in harmony with the profit maximization theory of economics.

APAs seek to set the ALP beforehand, so that in future transactions the tax revenue authority can use the APA as a yardstick to determine whether the MNE is complying with TP. The TP rules prescribe a number of methods that can be used to determine the ALP.⁶⁰ In negotiating the APA, the tax revenue authority and the MNE identify appropriate methods to use depending on a number of factors, such as the type of transaction and the industry the MNE operates in. The freedom given to the MNE to choose the ALP method is in line with the contingency theory of international TP.

The contingency theory, propounded by Borkowski⁶¹, Eccles⁶² and Spicer⁶³ states that in TP, each MNE uses a method in arriving at the ALP that best applies to its specified needs, and therefore there cannot be a one-shoe-fits-all approach in TP determination. APAs allow for this individualisation, where the particular MNE can put forward its case of the methods of determining the ALP. Upon consideration of the particular MNE, the tax revenue authority can arrive at methods that suit the MNE and its stakeholders.

It is against the backdrop of the modelling approach that TP Rules are needed to provide guidance to the taxpayers and the tax revenue authorities. With the contingency theory in play, the MNE

⁵⁹ R Leitch and K Barrett, 'Multinational Transfer Pricing: Objectives and Constraints' *11 Journal of Accounting Literature* 1 (1992) 47 – 92.

⁶⁰ Angharad Miller and Lynne Oats, *Principles of International Taxation* (A&C Black 2012).

⁶¹ S C Borkowski, 'Environmental and Organizational Factors Affecting Transfer Pricing: A Survey' *Journal of Management Accounting Research* (1990) 78-99.

⁶² R G Eccles, *The Transfer Pricing Problem: A Theory for Practice* (Lexington Books, 1985).

⁶³ B H Spicer, 'Towards an Organizational Theory of the Transfer Pricing Process.' *13 Accounting Organizations and Society* 3 (1988) 303-324.

may select the relevant ALP determination method which may be concretised in the APA with the tax revenue authority.

1.5 LITERATURE REVIEW

This section contains a review of available literature on TP and specifically on the impact of APAs in tax administration. Most of this literature covers the developed world: US, Canada, Europe and Australia.⁶⁴ Hong Kong, The People's Republic of China and India have also joined in the attention with regard to literature focus on TP and APA management issues.⁶⁵ The developing world, including Kenya, has been left behind in these international tax rule negotiations.

Matthijs Alink and Victor van Kommer analyse the role of tax revenue authorities and conclude that one of the primary interests of every tax revenue authority is to ensure that tax laws it is mandated to apply are simple, clear, comprehensible, and have sanction possibilities.⁶⁶ Similarly, it is in the interests of tax revenue authorities from all across the world to ensure TP, ALP and APA rules are clear and easily applicable.

On an international level, literature on TP, ALP and APAs covers developments of several international organisations working actively on the provision of guidance in the area of TP, some of which have particularly addressed the needs of developing countries. According to Jens Wittendorff, while these organisations have made efforts in harmonising guides to determination of ALP, due to legally oriented problems such as different tax regimes across the globe, there is

⁶⁴ Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); Wagdy Moustafa Abdallah, *Critical Concerns in Transfer Pricing and Practice* (Greenwood Publishing Group 2004); Michelle Markham, *The Transfer Pricing of Intangibles* (Kluwer International 2005);

⁶⁵ Alan Paisey and Jian Li, *Transfer Pricing: A Diagrammatic and Case Study Introduction, with Special Reference to China* (BrownWalker Press 2012); Crowe Horwath International, *International Master Tax Guide* (6 edn, CCH Australia 2009).

⁶⁶ Matthijs Alink and Victor van Kommer, *Handbook on Tax Administration* (IBFD 2011).

no international consensus on the ALP concept, and no definitive set of methods used in calculating ALP.⁶⁷

The United Nations (UN) published the United Nations TP Practical Manual for Developing Countries (TP Manual) in 2013, a guide concerned with the practical implementation of TP rules in accordance with the arm's length principle. Under Chapter 3 Paragraph 2.2 of the TP manual the UN states that there are countries that have introduced specific domestic tax rules to prevent possible tax base erosion through incorrect pricing of transactions between related parties.

Wagdy Moustafa Abdallah states that the conflicts between the determination of TPs between MNEs and the tax revenue authorities which seek to collect their share of profits has driven countries such as Canada, France, Germany, Japan, Mexico, Netherlands, the UK and the US to adopt the ALP.⁶⁸ Under the arm's length principle, discussed by authors such as Judy S Kuan and Robert Feinschreiber, it is in principle necessary to conduct a comparability analysis of third party transactions.⁶⁹ Anuschka Bakker and Radhakishan Rawal state that when the taxpayer fails to provide the tax authorities with the required data to compute ALP in some circumstances, some countries such as Japan and India have adopted a presumptive taxation method.⁷⁰ This is subject

⁶⁷ Jens Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010).

⁶⁸ Wagdy Moustafa Abdallah, *Critical Concerns in Transfer Pricing and Practice* (Greenwood Publishing Group 2004).

⁶⁹ Judy S Kuan, *Global Transfer Pricing Solutions: 2005* (World Trade Executive 2005); USA International Business Publications, *Korea South Tax Guide* (USAIBP 2008); Robert Feinschreiber, *Transfer Pricing Methods: An Applications Guide* (John Wiley & Sons Inc 2004).

⁷⁰ Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); Radhakishan Rawal, *The Taxation of Permanent Establishments: An International Perspective* (Spiramus 2006).

to rebuttal by a taxpayer, who may present counter-evidence to show the results as being at arm's length.

There is vast literature covering the 34 OECD member countries. Raymond Vernon notes that this literature, especially with regard to APAs in ALP determination, gained prominence in the 1990s.⁷¹ Over the years, OECD has made considerable efforts to establish common ground in TP matters for OECD member states based on the OECD TP Guidelines.⁷² OECD Guidelines state that there may be genuine difficulties in accurately determining a market price in the absence of market forces, offer guidance on the steps related parties may take to formulate the ALP, and proposes 5 main methods of determining ALP.⁷³ OECD recommends that tax revenue authorities may use administrative approaches to avoiding and resolving TP disputes, and suggest that APAs are a possible avenue of both resolving TP disputes and avoiding double taxation.⁷⁴

Lyndon Maither analyses the OECD guidelines and their application in TP law in Canada; recognising that APAs are a recommended approach for dispute resolution under the OECD guidelines.⁷⁵ Richard L. Doernberg covers the issues of tax avoidance, anti-tax haven measures and harmful tax competition with relation to TP based on the OECD guidelines; while analysing the application of TP in electronic commerce, a field dominated by multijurisdictional taxation

⁷¹ Raymond Vernon, *In the Hurricane's Eye: The Troubled Prospects of Multinational Enterprises* (Harvard University Press 2000).

⁷² OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) <http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuiid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015.

⁷³ Ekkehart Reimer, Nathalie Urban and Stefan Schmid, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty, and OECD Perspective* (Kluwers Law International 2010).

⁷⁴ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 1999).

⁷⁵ Lyndon Maither, *The Canadian Federal Income Taxation of Corporate Foreign Affiliates* (Lyndon Maither nd).

issues.⁷⁶ In distinguishing tax planning TP instruments such as APAs from tax avoidance and tax fraud and asserting that the advantages of APAs, and while quoting from the OECD guidelines, Claudio Maria Radaelli notes that APAs are beneficial in avoiding long tax disputes.⁷⁷

OECD guidelines are limited in their scope.⁷⁸ Koen Feyter argues that first, the guidelines are not a treaty and are therefore non-binding – observance is therefore voluntary; second, they do not adequately provide for MNE activities in developing countries – despite the urge in the 2000 revised guidelines for MNEs to apply them to their activities in developing countries.⁷⁹ Some countries lack the basis in their domestic laws to enter into APAs.⁸⁰ As a result of these limitations, while literature on the OECD guidelines is relevant to this study, texts analysing the application of the ALP and APAs in developing countries such as Kenya may be more persuasive in supporting the case for APA provision in Kenya.

In the 2013 Action plan for Base Erosion and Profit Shifting (BEPS), OECD provides that existing domestic law and treaty rules governing the taxation of cross-border profits could produce the correct results and may not give rise to BEPS.⁸¹ The Action plan for BEPS indicate that the TP Rules which focus on governing a transaction both in its home country and considers the

⁷⁶ Richard L. Doernberg, *Electronic Commerce and Multijurisdictional Taxation* (Kluwer Law International 2001).

⁷⁷ Claudio Maria Radaelli, *The Politics of Corporate Taxation in the European Union: Knowledge and International Policy Agendas* (Psychology Press 1997).

⁷⁸ Angharad Miller and Lynne Oats, *Principles of International Taxation* (A&C Black 2012).

⁷⁹ Koen Feyter, *World Development Law: Sharing Responsibility for Development* (intersentia NV 2001).

⁸⁰ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 1999).

⁸¹ Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015); OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 8 May 2015.

international aspect would lead to TP compliance clarity and predictability are fundamental building blocks of economic growth. It is important to retain such clarity and predictability by building on this experience. At the same time, instances where the current rules give rise to results that generate concerns from a policy perspective should be tackled.

Peter Reuter posits that while BEPS is a global issue, most empirical studies on BEPS focus on OECD countries, leaving developing countries like Kenya ignored but for the little literature generated by NGOs.⁸² True to this, Action Aid, an NGO, states that developing countries' concerns are not addressed in the international tax rule negotiations, especially concerning BEPS.⁸³ OECD recognises that there is an increasing need to involve developing countries in the BEPS conversation, and invites the UN to offer its insight on how to adapt BEPS guidelines to the developing world to explore solutions applicable to all stakeholders.⁸⁴

With specific reference to APAs, Vögele and Brem posit that APAs provide certainty to MNEs especially with regard to the legal implications of the process of ALP determination because they 'determine the appropriate TPM (Transfer Pricing Methodology) for the specific circumstances of the taxpayer; resolve adversarial transfer pricing disputes with the tax authorities; and avoid potential double taxation'.⁸⁵ Damon recognises that over the years, there has been an increase in the number of tax revenue authorities encouraging MNEs to enter into APAs, and more MNEs are

⁸² Peter Reuter (ed), *Draining Development? Controlling Flows of Illicit Funds from Developing Countries* (World Bank 2012).

⁸³ UK House of Commons International Development Committee, *The Future of UK Development Cooperation: Phase 2: Beyond Aid* (Tenth Report of Session 2014 – 2015).

⁸⁴ OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013); OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing 2013); OECD, *Foreign Direct Investment, Development and Corporate Responsibility* (OECD 2000).

⁸⁵ Alexander Vögele and Markus Brem, 'Do APAs Prevent Disputes?' *14 International Tax Review 1* (2003)

making such applications, because APAs provide a ‘significant opportunity for improved compliance with the arm’s length principle and increased collection of tax revenue’⁸⁶.

Michelle Markham discusses APAs in developed countries, specifically making reference to the US and UK in promotion of the successful implementation of APAs programmes.⁸⁷ Henry J Aaron and Joel Slemrod laud APAs and the US APA program which seek to reduce the IRS audit and litigation in a process that is hardly effortless and requires fewer resources than those used in TP audits and litigation.⁸⁸ Karl Wündisch adds to this point in his reference to APAs as an alternative dispute resolution for TP issues.⁸⁹

In the US, the US General Accounting Office reports on the impact of APAs in ‘curtailing complex, lengthy, multimillion-dollar TP disputes with business taxpayers’.⁹⁰ The General Accounting Office presents APAs a mechanism of dealing with ALP problems.⁹¹ Alan Paisey and Jian Li introduce the concepts and practices in TP; evaluate the different methods of ALP determination available to taxpayers and tax revenue authorities; discuss the impact of the

⁸⁶ Dylan Democrat Damon, ‘To What Extent do APAs Confer Greater Certainty with Respect to Transfer Pricing Issues?’ *15 Revenue Law Journal* 1 (2005) 111

<<http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1160&context=rlj>> accessed on 8 May 2015.

⁸⁷ Michelle Markham, *The Transfer Pricing of Intangibles* (Kluwer International 2005).

⁸⁸ Henry J Aaron and Joel Slemrod, *The Crisis in Tax Administration* (Brookings Institution Press 2004).

⁸⁹ Karl Wündisch, *International Transfer Pricing in the Ethical Pharmaceutical Industry* (IBFD 2003).

⁹⁰ US General Accounting Office, *Tax Administration: IRS' Advance Pricing Agreement Program: Report to the Honorable Byron L. Dorgan, U.S. Senate* (GAO 2000).

⁹¹ US General Accounting Office, *International Taxation: Problems Persist in Determining Tax of Intercompany Prices: Report to the Ranking Minority Member, Committee on Foreign Relations, US Senate* (GAO, June 1992); Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012).

introduction of APAs in China, weighing the advantages over their disadvantages in achieving the tax revenue authority's goals of collection maximisation.⁹²

Damon however notes that while there are advantages to introduction of APAs into the TP process, they are not without qualification: there are various challenges associated with introduction of APAs, and these water down the benefits to a certain extent.⁹³ Ring postulates that APAs limit the MNE's transactions openness to scrutiny, have a high information cost for regulations, and pose serious risks to all the parties involved⁹⁴ due to uncertainties of the market and the reality that agreements based on the future conditions of the market are highly indeterminate. To this end, Lorraine Eden suggests that while APAs provide advantages to governments and MNEs, they should not take the place of clear and transparent rules.⁹⁵

The situation in Europe with reference to TP, ALP and APAs has been significantly addressed in literary works. Carlo Romano discusses advance price rulings in the EU as compared with the US; outlines the features of APAs under the OECD guidelines and concludes that while advance price rulings are statements and opinions on the standpoint of the tax revenue authority, APAs are agreements with a binding effect on both the taxpayer and revenue authority.⁹⁶

⁹² Alan Paisey and Jian Li, *Transfer Pricing: A Diagrammatic and Case Study Introduction, with Special Reference to China* (BrownWalker Press 2012).

⁹³ Dylan Democrat Damon, 'To What Extent do APAs Confer Greater Certainty with Respect to Transfer Pricing Issues?' *15 Revenue Law Journal 1* (2005) 111
<<http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1160&context=rlj>> accessed on 8 May 2015.

⁹⁴ Diane Ring, 'On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross-Border Taxation' *21 Michigan Journal of International Law 2* (2000) 143 – 234.

⁹⁵ Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (University of Toronto Press 1998).

⁹⁶ Carlo Romano, *Advance Tax Rulings and Principles of Law: Towards a European Tax Rulings System?* (International Bureau of Fiscal Documentation 2002).

While there is literature on TP, the ALP and APAs in developed and some developing countries, Africa has glaringly been left out of the discussion. Crowe Horwath International, for example, only make reference the US, UK, Asia, Australia and South America.⁹⁷ According to Hadija Murangwa Ndongiza developing countries encounter particular problems when dealing with TP, where local tax revenue authorities are often inexperienced with regard to TP and lack basic information and technical expertise.⁹⁸ Further problems exist in gathering taxpayer information due to the absence of documentation requirements or the inability to enforce existing requirements. Equally, tax revenue authorities sometimes lack the capacity to process and evaluate such information, partly because of the lack of technical expertise or because they do not have the necessary resources at their disposal to process the data.

Mutua Ngundi analyses the development of TP, examines why it is a key concern to both MNEs and revenue tax authorities, and evaluates the management strategies put in place by MNEs to cope with TP challenges in emerging markets with particular reference to Kenya.⁹⁹ However, Mutua Ngundi's study does not approach the TP subject from a legal perspective and further does not touch on the impact of APAs in TP administration in Kenya.

From the above literature review, it is evident that there is little focus on the contribution of APAs to TP administration in Kenya. This study is therefore relevant because it spearheads the discussion

⁹⁷ Crowe Horwath International, *International Master Tax Guide* (6 edn, CCH Australia 2009).

⁹⁸ Hadija Murangwa Ndongiza, *ATAF Regional Studies on Reform Priorities of African Tax Administrations (ATAF 2012)*.

⁹⁹ Mutua Ngundi, *Transfer Pricing Management Strategies by Multinational Enterprises within the Main Investment Segment of the Nairobi Securities Exchange* (Master's Thesis, University of Nairobi School of Business, 2012).

on the implementation of APAs in Kenya and champions the supportive role they offer in achieving certainty in determination of the ALP.

This study adds to the TP discussion by focusing on the Kenya scenario on the challenges it is facing and whether the solution lies in APAs and create a case for the amendment of the Kenya TP Rules. This area has not been analysed from the Kenyan perspective. This study seeks to fill this gap in knowledge and in so doing will improve the level of awareness of both KRA and taxpayers of the instrumental role APAs play in TP administration.

1.6 CHAPTER BREAKDOWN

The remaining part of this study is covered in the following four chapters:

Chapter Two introduces the concepts of ‘TP’, ‘BEPS’ and ‘advance pricing agreements’. It contains the background of what TP is and looks into the main principles of TP. It covers the role of TP in BEPS, introduces APAs, and discusses the nature, design and application of APAs in a tax structure.

Chapter Three draws lessons on the structure of APAs and their application from international experience. It discusses APA regimes as applied in the UK, US and India and details the successes or challenges of APAs in these countries.

Chapter Four gives an overview of the TP environment in Kenya. The chapter determines the current challenges facing taxpayers and tax revenue authorities in complying with the TP regulations in Kenya. It analyses if the introduction of APAs in Kenya will assist in encouraging compliance with TP regulations.

Finally, **Chapter Five** presents the recommendations, and outlines the conclusions arrived at as a result of this study.

CHAPTER TWO
TRANSFER PRICING, BASE EROSION & PROFIT SHIFTING (BEPS) AND
ADVANCE PRICING AGREEMENTS (APAs)

2.0 INTRODUCTION TO TP, BEPS AND APAs

This chapter introduces the concepts of ‘TP’, ‘BEPS’ and ‘advance pricing agreements’. It contains the background of what TP is and looks into the main principles of TP. It covers the role of TP in BEPS, introduces APAs, and discusses the nature, design and application of APAs in a tax structure.

2.1 TRANSFER PRICING

To begin the discussion on TP, a definition must be sought. The UN defines TP as ‘the general term for the pricing of cross-border, intra-firm transactions between related parties; and ‘the setting of prices for transactions between associated enterprises involving the transfer of property or services’.¹⁰⁰ The key terms that arise from the UN definition beg the questions of what an associated party is; how the prices are set; and why the setting of prices becomes a subject of discussion and warrants regulation. These are discussed further below.

¹⁰⁰ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 1 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 6 May 2015.

The OECD does not provide a definition of TP. However, article 9 of the OECD Model Tax Convention¹⁰¹ provides for the regulation of transfer prices in cross border transactions of associated companies. It defines an ‘associated enterprise’ as an enterprise of a Contracting State which participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State.¹⁰² Where the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, the two enterprises are also ‘associated enterprises’.¹⁰³

The transfer price is therefore the price set between the transactions of these associated enterprises in two different states.¹⁰⁴ The absence of a definition of TP by the OECD may be attributed to the advancement in the law in the jurisdictions involved in OECD, most of which have had the concept of TP on the discussion table for many years and therefore leading to a situation where the definition would be unnecessary. All the same, it would be beneficial to have a definition under the precepts of the OECD for clarity purposes.

TP is a term that has been discussed in texts by economists and economic theorists. The term has been defined as the practice of setting the prices at which associated enterprises in an MNE group trade in goods and services.¹⁰⁵ The price referred to as TP is defined by economists as ‘the amount

¹⁰¹ OECD, *Model Convention With Respect to Taxes on Income and on Capital*, Art 9.

¹⁰² *ibid.* Art 9(1); Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012).

¹⁰³ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); OECD, *ibid.*, Art 9(1).

¹⁰⁴ Jens Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010) ch 1.

¹⁰⁵ Anisoara Hondru, ‘TP: models which can be used to determine transfer prices for cost center companies’ (Academia de Studii Economice – Bucuresti, 2011) 1 <<http://www.dafi.ase.ro/revista/6/Hondru%20Anisoara.pdf>> accessed on 27 April 2015.

that is charged by a part or segment of an organisation for a product or service that it supplies to another part or segment of the same organisation'.¹⁰⁶ This definition makes it clear that TPs are set for internal company operations, for example where the MNE head office sends inventory to a branch office, or where a contractor from a branch in one country offers services to a branch in another country.¹⁰⁷ As the term suggests, transfer prices are the prices at which the goods and services are 'transferred' from one company to the other in the same MNE group, in cross border transactions.¹⁰⁸

With offices and activities in different countries, MNEs engage in internal cross-border transfer. Constituent companies in an MNE group transfer goods and services on a regular basis in line with business demands.¹⁰⁹ While they are members of the same group, these companies are still distinct legal persons with separate accounts. A large part of global transactions is made up of this flow of goods and services across the world. Intragroup transfers account for more than 30% of total international transactions.¹¹⁰ On this basis it is evident that the stakes are high for MNEs and the

¹⁰⁶ UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, 'An Introduction to Transfer Pricing' *Background Paper, Working Draft* (UN 2011) 4 <http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter1_Introduction.pdf> accessed on 6 May 2015.

¹⁰⁷ Belverd Needles, Marian Powers and Susan Crosson, *Financial and Managerial Accounting* (Cengage Learning 2010) 1205.

¹⁰⁸ Susan Crosson and Belverd Needles, *Managerial Accounting* (Cengage Learning 2013) 408.

¹⁰⁹ Keith Head, *Elements of Multinational Strategy* (Springer Science & Business Media 2007) 197 – 199.

¹¹⁰ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015; Sony Ericsson Mobile Communications India Pvt Ltd v Commissioner for Income Tax (ITA No. 16/2014); UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, 'An Introduction to Transfer Pricing' *Background Paper, Working Draft* (UN 2011) 2 <http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter1_Introduction.pdf> accessed on 6 May 2015.

risks prevalent for MNEs to consider engaging in mispricing of transfer prices to gain an unfair advantage.¹¹¹

TP arises as an issue in international taxation where the constituent companies in a group are in different countries.¹¹² Countries have different methods of calculating tax due to the authorities. TP is closely related to double taxation because through its use, a company can generate revenues in one country, while both the countries in which the companies exist lay claim to the tax on the revenue.¹¹³ The relevance of this concept to interaction of companies on an international level is evident in that the OECD TP Guidelines do not consider TP on a domestic level, but instead concentrate on the ‘international aspects’ of TP.¹¹⁴

TP rules are important to tax revenue authorities because they create a guideline for the allocation of profits to individual companies in the MNE group which sets the basis for the tax revenue authorities in the individual companies’ countries of domicile to determine revenues due to the state.¹¹⁵ Under the OECD guidelines the taxable profit of a company is determined based on the

¹¹¹ FC Mberi, ‘Addressing Challenges Facing SARS relating to the Application of Transfer Pricing in Business Restructurings’ (Mini-Dissertation, North-West University, South Africa 2012) 12.

¹¹² Angharad Miller and Lynne Oats, *Principles of International Taxation* (A&C Black 2012).

¹¹³ Anisoara Hondru, ‘TP: models which can be used to determine transfer prices for cost center companies’ (Academia de Studii Economice – Bucuresti, 2011) 2 <<http://www.dafi.ase.ro/revista/6/Hondru%20Anisoara.pdf>> accessed on 27 April 2015.

¹¹⁴ OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) 17 <http://www.ilsole24ore.com/pdf/2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015.

¹¹⁵ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015.

functions it performs (e.g. trade, transportation, manufacturing), the assets it holds (both tangible and intangible), and the business risks associated with the industry in which it operates.¹¹⁶

2.2 ARM'S LENGTH PRINCIPLE

2.2.1 Arm's Length Principle Defined

The arm's length principle is the principle applied in Article 9 of the OECD Model Tax Convention to determine the transfer prices to be set between associated enterprise, as Article 9 provides as follows: where 'conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprises and taxed accordingly'.¹¹⁷ Where the ALP is charged by MNE it harmonises the positions of the MNEs with the revenue authorities.¹¹⁸

Kenya's Income Tax (TP) Rules define the 'arm's length price' as the price payable in a transaction between independent enterprises,¹¹⁹ and a 'controlled transaction' as a transaction which is

¹¹⁶ HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013)

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015.

¹¹⁷ OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) 23
<http://www.ilsole24ore.com/pdf/2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuiid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015.

¹¹⁸ Wagdy Moustafa Abdallah, *Critical Concerns in Transfer Pricing and Practice* (Greenwood Publishing Group 2004).

¹¹⁹ Income Tax (TP) Rules (2006), rule 2.

monitored to ensure payment of ALP for goods or services.¹²⁰ ALP is the price at which independent enterprises would negotiate if they were bargaining in competitive market.¹²¹ ALP is determined by analysing a number of factors, including expected benefits of the MNE in adopting a high cost structure.¹²² The arm's length range is 'a range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same TP method to multiple comparable data or from applying different TP methods.'¹²³ The importance of these definitions under Kenyan law cannot be overstated. These provisions show that at the national level, the tax revenue authority has gained cognisance of the phenomenon that may allow MNEs to hide revenue due and owing to the tax revenue authority.

In economics, market forces influence a firm's conditions of operations.¹²⁴ Microeconomics posits that the price of goods or services is determined by the supply and demand of the market, and as a result the firm adjusts its price to match that of the market to ensure that it sells.¹²⁵ If the price set by the firm is too high, customers will turn to other providers who are ready to operate on the basis of the set price. If on the other hand the firm sets its price too low below the market-determined price, it forfeits the amount of profit it would have made had it sought out the optimal price.

¹²⁰ *ibid.*

¹²¹ Lorraine Eden, 'Taxes, Transfer Pricing and MNEs' in Alan M Rugman (ed), *The Oxford Handbook of International Business* (2 edn, Oxford University Press 2003).

¹²² Andreas Bullen, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing* (IBFD, 2010).

¹²³ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) 23
<http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015.

¹²⁴ Richard G Lipsey and Colin Harbury, *First Principles of Economics* (Weidenfeld and Nicolson 1992).

¹²⁵ J Bruce Lindeman, *Microeconomics* (Barron's Educational Series 2002).

Therefore, in the standard operations of a firm, it is affected by externalities which determine the prices and the firm itself has no control over this.

In intercompany transactions, where one company in a group transacts with another associated company, there is little or no effect of external market forces.¹²⁶ Since the transaction is within itself, the group can determine the price it will charge for goods and services, and likewise the receiving party may determine the price at which it will purchase the goods and services.

2.2.2 Challenges with implementing the arm's length principle

In any TP scenario, there are a number of parties involved: the associated enterprises and their respective countries of operation. With the different types of parties in the process of implementing the ALP, a number of challenges may emerge.

First, determining the ALP may turn out to be a lengthy process therefore creating an administrative burden.¹²⁷ In tax jurisdictions that provide for ascertainment of TP by considering the ALP, the MNE submits the tax returns first. What follows is an assessment of TP as determined by the MNE and an audit as to whether it conforms to the ALP. If the tax revenue authority considers that there is a class of transactions incorrectly priced, or which the MNE does not classify

¹²⁶ Angharad Miller and Lynne Oats, *Principles of International Taxation* (A&C Black 2012).

¹²⁷ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); US General Accounting Office Washington Dc General Government Div, *International Taxation: Problems Persist In Determining Tax Effects Of Intercompany Transfer Prices* (Diane Publishing 1992) 61.

as a controlled transaction, the revenue authority reviews the prices. The MNE may challenge the decision of the tax revenue authority, leading to litigation.

Secondly, the involvement of government organs from different countries may pose a challenge. When the tax revenue authorities seek to tax their respective tax bases from the income of the country, there may be a difference in the local laws on the applicability of the ALP. Only the countries which have adopted the OECD Guidelines under their local laws or make reference to the Guidelines would arrive on the TP determination using these methods. However, where one tax revenue authority does not have the legal basis for determination of TP, and does not provide for the ALP, then there may be delays and uncertainty on how to classify and tax the MNE members in these different jurisdictions.

Third, the ALP must be set through evaluating comparable transactions with third parties, which may not always be possible especially with unique types of businesses.¹²⁸ Some controlled transactions may be difficult to regulate because there is little or no information available to the tax revenue authority on transactions of a similar nature.¹²⁹ The tax revenue authority sets the ALP using an approximation, which may not be accurate in determining the TP. This opens the determination to contest. The MNE may not be in agreement with the introduction of data that may lead to the adoption of a higher ALP than anticipated.

Fourth, setting the ALP requires information of the MNE, its operations in the different jurisdictions in which it operates, and therefore data needs to be provided for the determination of

¹²⁸ Diane M Ring, 'On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation' *Michigan Journal of International Law* 21, no.2 (2000) 153 <<http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1451&context=lsfp>> accessed on 7 May 2015

¹²⁹ Wolfgang Kersten (ed) *Global Logistics Management: Sustainability, Quality, Risks* (Erich Schmidt Verlag GmbH & Co KG 2008) 6.

the TP.¹³⁰ There are asymmetries between the knowledge and power of developing countries and the tax revenue authorities in developed countries, which would present difficulties in collaboration to establish the ALP.¹³¹ The probable outcome would be that the developed countries, with more established procedures and highly trained tax specialists, would have a higher hand in the negotiations and presentation of data used in determining the ALP for different cross border transactions.

2.3 ADVANCE PRICING AGREEMENTS (APAs)

2.3.1 APAs Defined

An APA is ‘an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparable and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the TP for those transactions over a fixed period of time’.¹³² It is ‘an agreement between a tax authority and an MNE about the determination of the appropriate TP method to be used for pricing intercompany transactions’.¹³³

¹³⁰ Angharad Miller and Lynne Oats, *Principles of International Taxation* (A&C Black 2012).

¹³¹ BEPS Monitoring Group, ‘Transfer Pricing Comparability Data and Developing Countries’ (OECD 2014) 1 <<http://www.oecd.org/ctp/transfer-pricing/bmg-comparability-data-and-developing-countries.pdf>> accessed on 7 May 2015.

¹³² OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) 23 <http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015.

¹³³ Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011) 457 – 469; Ernst & Young, *Transfer Pricing Global Reference Guide* (EY 2013) 6 <[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

Japan and the United States championed the TP scene in the 1990s through establishing APA programs, which different countries all around the world have adopted to create certainty for MNEs and the tax revenue authorities, for TP determination in accordance with the arm's length principle.¹³⁴ APAs are considered an alternative to litigation.¹³⁵ This is because when the parties have decided in advance what the conditions and requirements are for the TP determination and the terms agreed to, if both parties uphold the APA then there would be no reason for a dispute to arise.¹³⁶

If the TP process is left unbridled, the MNE may attempt to use the uncertainty of the TP rules to their favour. In response, the tax revenue authority may disregard the MNE's set prices and present a higher value of the transactions, leading to a dispute. With the APA, therefore, it is perceived that the level of litigation would be lower than in a situation where there is no fixed rates and categorisation of covered transactions. If there were any disagreement raised during a TP audit carried out by the tax revenue authority, the closest point of reference would be the APA to establish the previous agreement.

APAs in some countries are binding contracts between the taxpayer and the tax revenue authority, while in others they are simply mutual understandings of administrative nature.¹³⁷ APAs are

¹³⁴ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 346 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

¹³⁵ Henry J Aaron and Joel Slemrod, *The Crisis in Tax Administration* (Brookings Institution Press 2004); UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 346 – 347 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

¹³⁶ Michelle M Markham, 'Advantages and Disadvantages of Using an Advance Pricing Agreement: Lessons for the UK from the US and Australian Experience' 33 *Intertax* 216 (Kluwer Law International 2005) 215 – 216.

¹³⁷ Yair Holtzman and Paul Nagel, 'An introduction to transfer pricing', 33 *Journal of Management Development* 1 (2014) 57 – 61.

important because they confirm the result of ALPs so that as an MNE proceeds with its business activities it is certain of the tax obligations it will bear from its international transactions.¹³⁸

Consistency is important in forecasting¹³⁹ and it assists MNEs to set their global pricing policies for intergroup transactions and this assists them to set targets and project profits fairly accurately considering the impact of taxation on their global revenues.¹⁴⁰ Secondly, since APAs are emerging as an international practice to create certainty in TP,¹⁴¹ when an MNE has an existing APA with a certain country with regard to a particular transaction, it can use the existing APA as a basis for agreeing on the transfer prices in another jurisdiction for with the tax revenue authority in the other tax jurisdiction, for comparable transactions.¹⁴² Further, if the MNE seeks to set the transfer prices in its own jurisdiction with a domestic subsidiary, this international APA can also serve as a template for determination of the prices to be applied.

However, not all tax revenue authorities use APAs. Some countries prefer to wait to see how the TP mechanism pans out so that the APA programs and models can incorporate local lessons.¹⁴³ These countries consider that putting effort in APAs would be costly in ensuring their compliance.

¹³⁸ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 77 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

¹³⁹ JS Armstrong, *Principles of Forecasting: A Handbook for Researchers and Practitioners* (Springer Science & Business Media 2001).

¹⁴⁰ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 78 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

¹⁴¹ Alan Paisey and Jian Li, *Transfer Pricing: A Diagrammatic and Case Study Introduction, with Special Reference to China* (BrownWalker Press 2012).

¹⁴² Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 78 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

¹⁴³ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 78 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

The presumption made is that since MNEs placing these applications would already generally conform to the arm's length principle, the tax revenue authority would incur unnecessary expenses instead of concentrating on implementation of the young TP regulation.

Some countries may resort to having joint TP audits involving two or more tax revenue authorities to reduce the cost of the process.¹⁴⁴ These tax revenue authorities working together can produce an APA relating to the audited MNE to resolve the outstanding issues in a way similar to the exercise undertaken in 2011 by HMRC in the UK and IRS of the US.¹⁴⁵

2.3.2 Types of APAs

APAs may be 'unilateral', involving the MNE and one tax revenue authority, 'bilateral' (between two governments), or 'multilateral', between three or more tax revenue authorities.¹⁴⁶ The following are the advantages and disadvantages of the three types of APAs:¹⁴⁷

¹⁴⁴ Diana Criclivaia, "'Magic Formula" of the Joint Audits in Raising Revenue through Weeding Out Corrupt Practices (Based on Romania and Moldova Cases)" *15 Scientific Papers Series: Management, Economic Engineering in Agriculture and Rural Development 1* (Moldova State University 2015) 135 – 146.

¹⁴⁵ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 340 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015

¹⁴⁶ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); OECD, *OECD TP Guidelines for Multinational Enterprises and Tax Revenue authorities* (OECD 2010) 23
<http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Norme%20e%20Tributi/2011/02/istruzioni-uso-societa-perdite-fiscali/ocse-linee-guida-2010-prezzi-trasferimento.pdf?uuid=3d4ba2c4-3c0b-11e0-9341-61eb1896ac2b> accessed on 27 April 2015; Ernst & Young, *Transfer Pricing Global Reference Guide* (EY 2013) 6
<[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

¹⁴⁷ Xinkui Fan, 'Difficulties in Pressing Forward Advance Pricing Agreement (APA) in China' 4 *Asian Social Science* 11 (CCSE 2008) 53 – 58; PWC, 'Certainty in the Uncertain World of Transfer Pricing' *Whitepaper on APA*

First, it is easier to administer a unilateral APA against the MNE, than to involve other tax revenue authorities. The tax revenue authority in the unilateral APA would only require to interact with the MNE. However, to enter either bilateral or multilateral APAs, it would need to involve tax revenue authorities in other countries. This would require an understanding of the interrelation of the tax laws of the different jurisdictions.

Secondly, bilateral and multilateral APAs take a considerably longer time to conclude, than unilateral APAs. With a bilateral or multilateral APA the tax revenue authorities would need to work in harmony, which could take a long time due to the bureaucracy involved in dealings between state organs.

Thirdly, to intensify efforts to combat double taxation, tax revenue authorities should consider bilateral or multilateral APAs as opposed to unilateral APAs. This is because some foreign jurisdictions where the MNE also transacts business may not recognise the unilateral APA and this may cancel out the gains of the APA process since the tax revenue authorities may subject the MNE to double taxation on the same transaction.

in India (PWC 2011) 9 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 13 May 2015.

2.3.3 Salient Issues in an APA

APAs may cover a variety of transactions,¹⁴⁸ but it is advisable to enter an APA for only the complex transactions owing to the high cost of negotiation and concluding the agreements.¹⁴⁹ However, since this is at the discretion of the taxpayer who submits the application for the APA, the resultant APA covers different areas from one MNE to another. The transactions involved in APAs include dealings in goods and services, financing arrangements, and transfer and use of tangible/intangible assets.¹⁵⁰ Due to the cross border nature of TP, the APAs normally cover intercompany transactions across borders. However, in more developed jurisdictions, the APAs include certain domestic transactions between associated companies.

When the taxpayer makes the application and lists the transactions to form part of the APA, the tax revenue authority may amend this list to either include more transactions or limit the scope. The application would normally have a description of all the intercompany transactions the MNE has in its operations. Out of all of them, the MNE notes the transactions it proposes to be covered in the APA. It also notes the transactions it proposes to be excluded from the APA. The reasons for exclusion include the simplicity of the transactions. Where the tax revenue authority views that

¹⁴⁸ Johannes Becker, Ronald B Davies and Gitte Jakobs, *The Economics of Advance pricing Agreements* (Oxford University Centre for Business Taxation, WP 14/26, 2014).

¹⁴⁹ Maria Alm and Helena Ehrstedt, *Advance Pricing Agreements – The Concept and its Implementation in Swedish Tax Law* (Degree Project, Jönköping International Business School 2011) ch 6; PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ *Whitepaper on APA in India* (PWC 2011) 9 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 14 May 2015.

¹⁵⁰ Michelle Markham, ‘Tax in a Changing World: The Transfer Pricing of Intangible Assets’, *Tax Notes International* 40 (2005) 895-906; PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ *Whitepaper on APA in India* (PWC 2011) 9 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 14 May 2015.

any of the transactions the MNE proposes to be excluded are actually important and should be covered in the APA, it could review the list through discussion with the MNE.

The general period for APAs in a number of countries is 3 – 5 years.¹⁵¹ The period takes into consideration both the tax revenue authority and the taxpayer. It takes a considerable length of time for the application process to be concluded. It involves all stakeholders putting in effort to secure favourable terms for all parties. Therefore, after the hard work put in, it would be illogical to subject the parties to a similar exercise again within less than 3 years. This minimum period also guarantees the MNE certainty in the operations because they can plan for the minimum 3 years into the future, on how to conduct operations.

On the other hand, the agreements should not last too long. After 5 years the situations under which the MNE operates could have changed considerably. Changes in the business environment and development of the law on TP may warrant a re-evaluation of the terms agreed. With a maximum of 5 years the balance can be met, in securing the MNE an agreeable period and the certainty that attaches, while at the same time giving the tax revenue authority the opportunity to tweak the parties' standing after a maximum of 5 years.

Strictly speaking, and going by the name attributed to them, APAs are agreements where the tax revenue authority and the MNE agree on the ALP in advance.¹⁵² However, the parties may use the

¹⁵¹ Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); KPMG, *Advance Pricing Agreement Considerations for India* (KPMG 2011); PWC, 'Certainty in the Uncertain World of Transfer Pricing' *Whitepaper on APA in India* (PWC 2011) 9 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 13 May 2015.

¹⁵² Maria Alm and Helena Ehrstedt, *Advance Pricing Agreements – The Concept and its Implementation in Swedish Tax Law* (Degree Project, Jönköping International Business School 2011) ch 6.

APA to determine the ALP for transactions in the past, through a ‘rollback’. The APA may be rolled back to cover transactions which were conducted in previous years.

A rollback offers certainty in the tax liability for historical activities, and are an effective way of resolving outstanding TP issues.¹⁵³ Take for example a dispute arising in 2012 due to ALP determination. The matter may be undergoing administrative attention and may still be unresolved. In 2015, the subject MNE and the tax revenue authority may still not have reached a conclusion to the matter, but may have entered into an APA. Instead of leaving the loose ends untied, the tax revenue authority upon request from the MNE, may roll back the agreement to resolve the 2012 dispute. This is similar to entering a judgment by agreement in the legal sense. While a rollback could be undertaken upon suggestion by the MNE, the tax revenue authority may also recommend a rollback on its own initiative.

Towards the end of the APA term, the MNE may apply for renewal of the APA, which may be a simple process if there is no momentous alteration in the terms, or if the TP legal regime has not undergone substantive changes.¹⁵⁴ Where it is a straightforward application for renewal, the tax revenue authority may or may not require the MNE to submit an extensive application. It may

¹⁵³ Marc M Levey, Steven C Wrappe, Kerwin Chung, *Transfer Pricing Rules and Compliance Handbook* (CCH, 2006); Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); Amanda Johnson, *US Transfer Pricing Sourcebook* (WorldTrade Executive Inc 2005); PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ *Whitepaper on APA in India* (PWC 2011) 10 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 13 May 2015.

¹⁵⁴ Amanda Johnson, *US Transfer Pricing Sourcebook* (WorldTrade Executive Inc 2005); PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ *Whitepaper on APA in India* (PWC 2011) 10 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 13 May 2015.

simply require the MNE to submit a request for renewal where it would keep the status quo. There would only be need for a renegotiation if there were a significant variation from the initial APA.

Tax revenue authorities require the APA to provide for reporting procedures.¹⁵⁵ The MNE would need to submit an annual report (APA Annual Report) concerning its compliance with the APA, and specifically on the following issues:¹⁵⁶

First, compliance with the APA's terms and conditions: the report would cover the activities the MNE has carried out throughout the year to comply with the APA. It would note the areas which proved difficult to comply and describe the level of adherence to the TP rules.

Secondly, validity and accuracy of the annual report's material representations: the report would contain averments on the financial reports, which would normally be the result of audits of the MNE. Compliance with the APA and specifically on the determination of the ALP would only be measured against valid and accurate financial information. Otherwise, if the financial information contains inaccuracies, this would prejudice the tests of compliance, which would amount to fraudulent misrepresentation and create suspicion of tax evasion.

Thirdly, correctness of the supporting data and computations used to apply the TPM: The APA has a set method for arriving at the ALP. It contains the procedure and the supporting data the MNE requires to prove the ALP. In the report, therefore, the MNE should submit the constituent

¹⁵⁵ Maria Alm and Helena Ehrstedt, *Advance Pricing Agreements – The Concept and its Implementation in Swedish Tax Law* (Degree Project, Jönköping International Business School 2011) ch 6.

¹⁵⁶ Angharad Miller and Lynne Oats, *Principles of International Taxation* (A&C Black 2012); Amanda Johnson, *US Transfer Pricing Sourcebook* (WorldTrade Executive Inc 2005); PWC, 'Certainty in the Uncertain World of Transfer Pricing' *Whitepaper on APA in India* (PWC 2011) 11 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 13 May 2015.

building blocks of the ALP determination to further confirm whether it has complied with the APA requirements.

Fourthly, satisfaction of the critical assumptions: The critical assumptions are operational, legal, tax-based, financial-based, accounting-based or economic. These build the basis for the determination of the ALP, and in essence are the factors in the internal business environment that should be present when the MNE establishes the ALP.

Fifthly, correct application of the agreed TPM: The APA sets the agreed TP mechanism. The mechanisms are set formulae that assist to arrive at the ALP. The MNE would show in the report how it followed the TP formula to form a basis for proving that it accurately determined the ALP.

The following figure shows is the common process flow for APA programmes. The MNE first considers the marginal utility in deciding whether or not to enter the APA process; it meets with representatives from the tax revenue authority to disclose information, ask questions and ascertain the requirements; it makes the application; it enters into negotiations on terms it seeks to settle with the tax administration; the tax administration finalises the process by concretising the terms into the final APA which is executed by both parties; the tax revenue authority administers the APA over the APA period, facilitated by periodic reports submitted by the APA; and finally at the end of the agreed period, the APA expired. At this point, the parties may evaluate whether the APA will be extended or whether the MNE should make a new application:

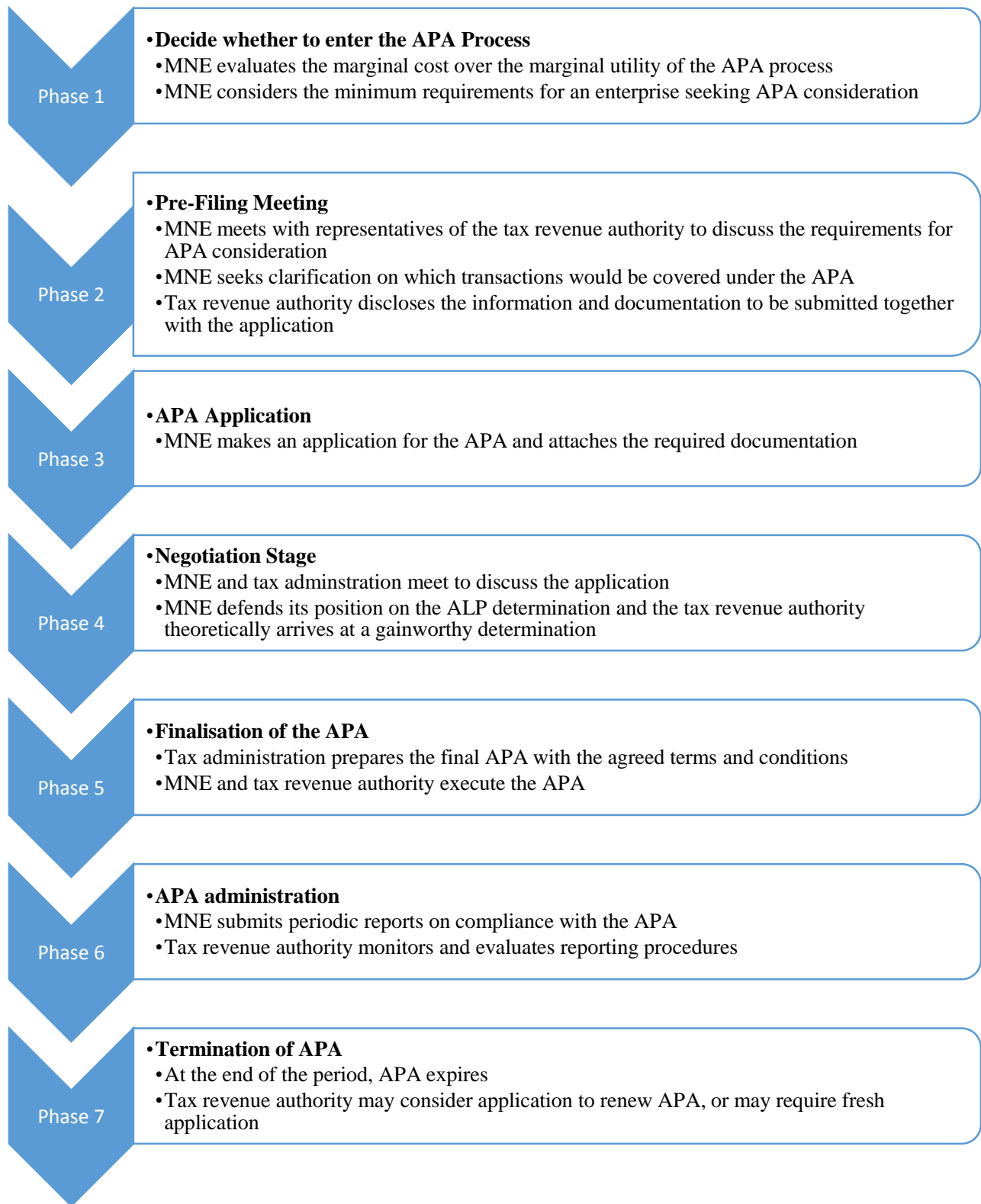


Figure 1 – APA process flow, Source: Author

2.3.4 APAs and Certainty

MNEs require certainty, predictability, consistency and timeliness in dealings with tax revenue authorities in the various jurisdictions in which they carry on business.¹⁵⁷ With specific reference to TP revenue authority and determination of the ALP, MNEs require ‘legal certainty’.¹⁵⁸ This ‘would imply dynamic and efficient substantive laws clearly stating the rights, obligations, and liabilities of all business parties, rule-based business transactions, procedural law providing prompt and inexpensive means to the courts, an institutional framework that supports business development and sustainability, strict adherence to the principles of ‘rule of law’ and ‘supremacy of the law’, and an efficient and independent judiciary.’¹⁵⁹

For an MNE to commence business in a certain environment, it must evaluate whether there are clear laws governing taxation. While the laws may be clear, the process of enforcing the taxpayer’s rights may be time consuming and expensive, making it difficult to approximate the risk involved in filing and processing tax returns. Further, if there is a dispute arising from the taxation process, the MNE must be certain on the length of time and cost of the dispute resolution process for it to make an informed decision of the level of risk in tax contests.

From a TP perspective, MNEs require certainty that the tax revenue authority and judiciary will apply the ALP. The MNE requires certainty that the tax revenue authority will apply the TP regulations according to best practice. If the MNE is uncertain about the legal processes involved

¹⁵⁷ OECD, ‘Tax Effects on Foreign Direct Investment’ *Policy Brief, February 2008* (OECD 2008) 4 <<http://www.oecd.org/investment/investment-policy/40152903.pdf>> accessed on 13 May 2015.

¹⁵⁸ Maria Alm and Helena Ehrstedt, *Advance Pricing Agreements – The Concept and its Implementation in Swedish Tax Law* (Degree Project, Jönköping International Business School 2011) ch 6.

¹⁵⁹ Martin Zagler, ‘Foreign Direct Investment and Corporate Income Taxation under Legal Uncertainty’ (ETPF nd) 4 <<http://www.etpf.org/papers/52FDI.pdf>> accessed on 13 May 2015.

in determination of the ALP, it may consider this a large risk associated with business operation in the particular jurisdiction. As a result, the MNE may consider establishing its enterprise in another jurisdiction where there is lower risk, hence greater profitability.

Legal certainty may be divided into two: subjective legal certainty, and objective legal certainty. ‘Subjective legal certainty’ refers to the assessment of the marginal cost and marginal utility of engaging in the taxation process, from the individual firm’s perspective.¹⁶⁰ The firm must evaluate whether the marginal cost of acquiring specialised knowledge on the workings of the ALP determination process, filing the application and other associated costs, exceed the marginal utility of gaining this knowledge. The firm will only spend on the process until the marginal cost and marginal utility are equal.¹⁶¹ ‘Objective legal certainty’ on the other hand refers to whether on the broad scale, all the parties involved in the tax administration process are clear on their responsibilities.

Factors causing or affecting uncertainty include frequent changes in tax law, imprecise and vague tax laws, complexity and disjointed evolution of the tax regime, new or inexperienced tax revenue authorities and insufficient precedence in the court system on the specific tax issues.¹⁶² The main factors we consider in this study are the inexperience of the tax revenue authority in TP matters and lack of specialised staff in the dispute resolution system which delay and complicate the TP revenue authority process, thereby creating uncertainty to the MNE taxpayers.

¹⁶⁰ *ibid.*

¹⁶¹ *ibid.*

¹⁶² Kelly Edmiston, Shannon Mudd and Neven Valev, ‘Tax Structures and FDI – The Deterrent Effects of Complexity and Uncertainty’ (Georgia State University nd) 6 <<http://www2.gsu.edu/~econvtv/complexity.pdf>> accessed on 13 May 2015.

Uncertainty in the application and procedure of tax administration, specifically with regard to TP in this case, has a negative effect on FDI.¹⁶³ Uncertainty increases the risks associated with doing business in a particular jurisdiction, which increases operating costs such as employment of tax specialists to ensure compliance. Where there is uncertainty, MNEs would be hesitant to invest, and this reduces the FDI inflows of the particular jurisdiction.

The following illustration displays the influence of APAs and their effect on creating certainty in ALP determination. It shows the first state as that of uncertainty. In this state, there are diverse methods of ALP determination, high cost of information access and lengthy and costly dispute resolution process associated with imprecise methods of ascertaining ALP. The second stage, the solution, is the APA which introduces predetermined methods and procedures for ALP determination, ensures the tax revenue authority has adequate information volunteered by the MNE, all through a relatively cost-efficient process. The result of the ALP is a state of certainty in taxation which creates a favourable environment for increased FDI, higher revenues for KRA and MNE growth.

¹⁶³ *ibid.*

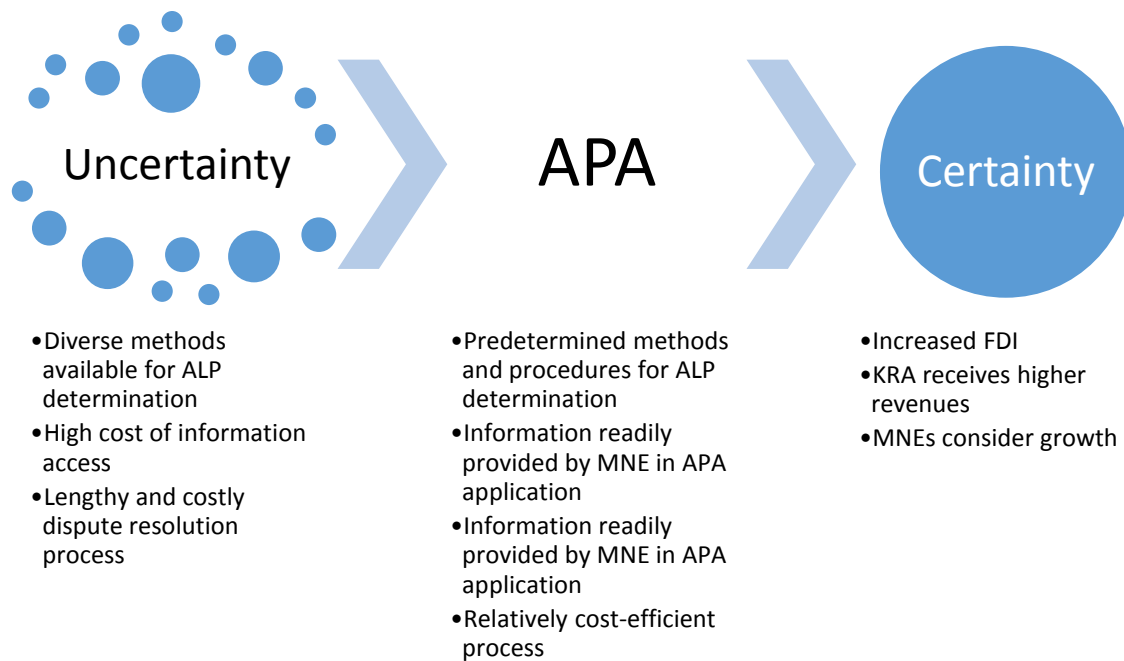


Figure 2 – Effect of APAs in ensuring certainty in ALP determination in Kenya, Source: Author

2.4 BASE EROSION AND PROFIT SHIFTING (BEPS)

2.4.1 TP and Tax Evasion

TP does not necessarily involve tax evasion.¹⁶⁴ It would only amount to an abuse of the tax laws where the MNE does not comply with the laws on TP. Where the MNE deceptively adopts transfer prices lower than the ALP, then it would be culpable for tax evasion.

¹⁶⁴ UN Tax Committee’s Subcommittee on Practical Transfer Pricing Issues, ‘An Introduction to Transfer Pricing’ *Background Paper, Working Draft* (UN 2011) 2
<http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter1_Introduction.pdf> accessed on 6 May 2015.

A company can determine where to locate the business functions, assets and risks so that it reduces its tax obligations because the tax rate applied would be that of the tax revenue authority in the country in which the factor is domiciled.¹⁶⁵ An MNE may relocate some of these business factors to the country that has the lowest tax rate. The MNE's country of origin would be at a loss because from its viewpoint the MNE is engaging in base erosion and profit shifting to evade taxation.

Some MNEs may in fact use TP to evade tax by incorporating skeleton companies in the MNE group which have a small number of employees simply for revenue authority, and attributing profits to this outfit. The low taxes paid and low expenses of the skeleton company would enable the MNE group to retain a big portion of the profits realised in that year, meet the legal requirements, but in essence manipulate the systems to evade taxation. Tax revenue authorities would consider such activities as fraudulent, commence investigations and prosecute the MNE for fraud and tax evasion.

Tax revenue authorities use terms such as 'transfer mispricing, TP abuse, profit shifting, profit splitting, income shifting, income splitting, earnings stripping, and tax base erosion' to describing aggressive TP.¹⁶⁶ These practices by MNEs reduce the profits they declare so that they pay lower taxes. Through manipulative TP and tax evasion, tax revenue authorities lose significant amounts

¹⁶⁵ HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013)

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015.

¹⁶⁶ Emmanuel Budu Addo, 'Effects of TP beyond tax revenue loss: a threat to economic development' (Action Aid Ghana 2011) <http://www.actionaid.org/sites/files/actionaid/effects_of_transfer_pricing_beyond_tax_revenue_loss-5-12-11.pdf>

of revenue that the governments could use to improve the services offered, and channel to development of their economies.¹⁶⁷

2.4.2 BEPS Defined

BEPS refers to a situation where the interaction of different tax rules from two or more jurisdictions leads to ‘double non-taxation or less than single taxation’.¹⁶⁸ It also refers to organisation of a taxpayer’s elements of production to pay little or no taxes, or moving the gains of the business away from the countries in which the gain-making processes take place.¹⁶⁹ The international community is not so concerned that businesses work to reduce the amount of taxation due and payable to the tax revenue authority. However, tax revenue authorities frown upon practices such as when a business ‘artificially’ structures its organisations by separating the taxable income from the activities generating this income with an aim to either pay no tax anywhere, or to pay unduly low taxes.¹⁷⁰

¹⁶⁷ Smitha Francis, ‘TP and Tax Evasion: Beyond the trans-Atlantic furore’ *Third World Resurgence*, No. 268 (Network Ideas 2013) <http://www.networkideas.org/news/jan2013/pdf/Tax_Evasion.pdf> accessed on 29 April 2015; Rachael Power, ‘PAC Grills HMRC and Google on TP’ (Accounting Web 2013) <<http://www.accountingweb.co.uk/article/google-hmrc-ey-appear-pac/541966>> accessed on 29 April 2015.

¹⁶⁸ Yariv Brauner, ‘What the BEPS’ *16 Fla Tax Rev* 2 (2014); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

¹⁶⁹ Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015; Sajid M Chaudhry and Andrew W Mullineux, *Taxing Banks Fairly* (Edward Elgar Publishing 2014).

¹⁷⁰ Matthew Gilleard, ‘Corporate Tax: The Impact of BEPS and Beyond’ *24 Int'l Tax Rev* 23 (2013-2014).

BEPS may arise due to ‘the existence of loopholes, as well as gaps, frictions or mismatches in the interaction of countries’ domestic tax laws’.¹⁷¹ MNEs have large amounts in terms of profits to cater for. This would translate into high stakes relating to income tax due to the tax revenue authorities in the host countries. Since there are high stakes, the MNE may hire tax professionals conversant with international tax regulations and the domestic tax rules of the different host countries. While keeping in line with the laws of the domestic countries and playing by the rules, the MNE may engage in BEPs to achieve lower or no tax payable to the respective tax revenue authorities. These professionals identify these inconsistencies and exploit them for the unfair advancement of the business.

An MNE group may have a presence in three countries. The associate enterprises operating in these three jurisdictions may charge each other for goods and services transferred from one to the other, to ensure that they record such transactions in terms of the fair value price. Take for example Country, A which has a corporate tax rate of 30%, Country B with a rate of 25% and Country C with 12%. Either of the associate enterprises may hire staff. Person X, a trained engineer in agricultural development, is required to carry out a consultancy project with the MNE. Say the enterprise decides to engage X with the associate in Country C. In a bid to erode the taxable base of the associate in Country A to reduce the taxable profits, the MNE may inflate the cost of providing X as a human resource to A. A lower profit in essence erodes the taxable base for the tax revenue authority in Country A, and deprives the state of revenue.

¹⁷¹ Sajid M Chaudhry and Andrew W Mullineux, *Taxing Banks Fairly* (Edward Elgar Publishing 2014); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

TP and enforcement of the ALP are a major issue in BEPS.¹⁷² Since TP rules allow for an MNE to transfer the income generated for the MNE group to the different jurisdictions in which it operates business, some MNEs achieve an unfair advantage by misapplying the TP rules to separate the gains from their business processes from the revenue-generating activities.¹⁷³ This is especially achievable with intangible assets such as intellectual property, or mobile assets, for less than full value; ‘over-capitalisation of lowly taxed group companies and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties’.¹⁷⁴

Exertions to combat BEPs can only be successful if the international community collaborates to guarantee certainty and predictability needed to make effective investment plans.¹⁷⁵ Further, tax revenue authorities require transparency especially on the workings of MNEs in their different host countries, to efficiently take action against BEPs.¹⁷⁶ APAs create certainty and predictability

¹⁷² Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) 19 <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

¹⁷³ Pia Kortebusch, ‘Should Multinational Companies Request an Advance Pricing Agreement (APA) – or Shouldn’t They?’ Arqus Discussion Paper No. 173 (Arbeitskreis Quantitative Steuerlehre 2014); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) 19 <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

¹⁷⁴ OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) 19 – 20 <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

¹⁷⁵ Jane Frecknall-Hughes, *The Theory, Principles and Management of Taxation: An Introduction* (Routledge 2014); Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015); Pia Kortebusch, ‘Should Multinational Companies Request an Advance Pricing Agreement (APA) – or Shouldn’t They?’ Arqus Discussion Paper No. 173 (Arbeitskreis Quantitative Steuerlehre 2014); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

¹⁷⁶ Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015); OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on 12 May 2015.

to the MNEs through predetermined formulae and procedure of arriving at the ALP.¹⁷⁷ At the same time, APAs guarantee the tax revenue authority information on the MNE which is collected during the negotiation stage of the APA. From this analysis, it is clear that APAs are a useful tool in achieving the objectives of the OECD and of tax revenue authorities across the world in revenue collection subject, of course, to limitations discussed in this study.

Kenya is among a group of 14 developing countries which have committed to participating in OECD meetings on BEPS.¹⁷⁸ This exhibits intensification in efforts of curbing tax evasion through BEPS, and a determination to increase revenues lost through this practice.

2.5 CONCLUSIONS ON TP, BEPS AND APA'S

From the above discussion, it is evident that the process of ascertaining the ALP to determine TP may be a troublesome process. When a firm is setting the TP, it should use the ALP. However, at times a firm may manipulate the computation process to arrive at a price which favours its account, conceals income through BEPS and leads to higher values of profits than in reality. BEPS is an international discussion which countries like Kenya have recently joined. APAs are hailed as a means to creating certainty in determination of the ALP, as well as a mechanism for states to collaborate in the fight against BEPS.

¹⁷⁷ Pia Korteusch, 'Should Multinational Companies Request an Advance Pricing Agreement (APA) – or Shouldn't They?' Arqus Discussion Paper No. 173 (Arbeitskreis Quantitative Steuerlehre 2014).

¹⁷⁸ Duff & Phelps Corporation, 'Transfer Pricing Times: Volume XII, Issue 3: Developing Countries Increasing Participation in BEPS Work' (Duff & Phelps Corp 2015)
<<http://www.duffandphelps.com/expertise/publications/Pages/ArticleDetail.aspx?itemid=355&list=Articles>>
accessed on 14 June 2015.

CHAPTER THREE

ADVANCE PRICING AGREEMENTS: THE INTERNATIONAL EXPERIENCE

3.0 INTRODUCTION TO THE INTERNATIONAL EXPERIENCE

TP is an international phenomenon, with countries around the globe seeking a cooperative approach to resolving issues arising from cross-border trade. While it is a novel issue to be addressed in Kenya's legal system, various countries have already established efficient workings of determination of the ALP, setting APAs in action, and resolution of administrative disputes involving TP. This study examines the TP structures, provisions on APAs and efforts of reducing BEPS, of the United Kingdom, United States and India.

The UK is an important country to draw lessons from because it has had APA systems in place from 1999 and as a result has more than 15 years of experience in their application. The US has a tax administration with a rich history, dating back to 1862; and the APA program dates back to 24 years ago (from 2015),¹⁷⁹ gaining insight over the years which are priceless to the development of an APA program in Kenya. India is particularly vital to this study because it is a developing country; has a young and budding APA programme, having implemented it in 2012; yet it is already had 232 APA applications filed as at 2014, showing the level of promise implementation of an APA would bring to the Kenyan scenario.

¹⁷⁹ Donald L Korb, Harry J Hicks and Matthew Frank, Announcement 2004-98 – Comments Regarding the Advance Pricing Agreement Program (ABA, 17 February 2015).

3.1 UNITED KINGDOM

The UK TP system employs the use of APAs and has had the system in place since 1999, making it one of the jurisdictional areas this study focuses on. Kenya is a commonwealth country with the legal system rooted in common law developed in England. Due to the wealth of experience the UK has in the area of APAs and the similarity of the legal systems, the UK is an important country to study to draw lessons for a proposed APA programme in Kenya.

3.1.1 Background of the tax system in the UK

HMRC is ‘the UK’s tax and customs authority, responsible for making sure that the money is available to fund the UK’s public services and for helping families and individuals with targeted financial support’.¹⁸⁰ HMRC was established in 2005 and includes the Commissioners and the officers of Revenue and Customs who replaced the Commissioners of Inland Revenue and the Commissioners of Customs and Excise.¹⁸¹ HMRC is a non-ministerial Department, which replaces the Inland Revenue and Customs and Excise and is responsible for tax revenue authority and reports to the Treasury Minister who supervises the government expenditure.¹⁸²

HMRC established the TP Group to assist in the specialised area of TP determination and evaluation.¹⁸³ The HMRC TP specialist group has challenged various TP agreements and from its

¹⁸⁰ HMRC, ‘About Us’ (HMRC 2015) <<https://www.gov.uk/government/organisations/hm-revenue-customs/about>> accessed on 28 April 2015; CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009).

¹⁸¹ United Kingdom, Commissioners for Revenue and Customs Act 2005, s 4.

¹⁸² HMRC, ‘About Us’ (HMRC 2015) <<https://www.gov.uk/government/organisations/hm-revenue-customs/about>> accessed on 28 April 2015.

¹⁸³ CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009).

inception in 2008 to 2013 has assisted the UK government to collect more than £1.4 billion as additional tax.¹⁸⁴ Among its total workforce of approximately 1200 people employed to support the government's efforts in securing revenues from large taxpayers, as of 2012 it had a dedicated team of 65 TP specialists recruited to assist in finding out which MNEs have a 'permanent establishment' in the UK for the purposes of assessing compliance with TP rules.¹⁸⁵

In any discussion between the HMRC and an MNE, disputes may arise especially where the tax authority seeks to increase the tax due to the state while the MNE maintaining its position on the transfer prices arrived at with relation to its transactions.¹⁸⁶ HMRC has a dispute resolution mechanism that considers the cases and makes determinations. Through discussions between the parties, the 'taxpayer's position' is established and considered against the HMRC's position, and the 'business level case board' (HMRC dispute resolution tribunal) determines if HMRC is agreeable to the taxpayer's position, and whether it is in line with the HMRC's Litigations and Settlement Strategy (LSS).¹⁸⁷

¹⁸⁴ HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013)
<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015.

¹⁸⁵ CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009); House of Commons Committee of Public Accounts, *Tax Avoidance – Google – Ninth Report of Session 2013 – 2014, HC 112* (House of Commons 2013) 13
<<http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf>> accessed on 30 April 2015.

¹⁸⁶ Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008); Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013).

¹⁸⁷ Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013); HMRC, *The Tax Assurance Commissioner's Annual Report 2013-14* (HMRC 2014)
<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/325285/4289_Tax_Assurance_Commissioner's_Annual_Report_accessible_JULY14_V2.pdf> accessed on 28th April 2015.

Every year, HMRC publishes a report of the way it handled disputes. In the year 2013-2014, HMRC's TP Board handled 36 cases, while there were 80 referrals of proposals for dispute resolution handled by the two TP Panels established as subordinate units to the Board.¹⁸⁸

3.1.2 TP practice in the UK

The Taxation (International and Other Provisions) Act (TIOPA) of 2010 provides for TP.¹⁸⁹ The Act sets out the basic TP rule and states that it applies to computation of corporation tax and income tax,¹⁹⁰ and should operate in accordance with the OECD principles on double taxation and TP guidelines for MNEs.¹⁹¹ An MNE submits its annual returns to HMRC, and if the tax revenue authority upon scrutiny of the documents establishes there is a mismatch between the transfer prices arrived at and those anticipated, it would issue a transfer price notice.¹⁹² If a taxpayer receives a transfer notice, the taxpayer may amend the returns and resubmit them to HMRC¹⁹³, but if the taxpayer disagrees with the notice, it may appeal the decision to give the notice.¹⁹⁴

¹⁸⁸ HMRC, *The Tax Assurance Commissioner's Annual Report 2013-14* (HMRC 2014) 11
<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/325285/4289_Tax_Assurance_Com_s_Annual_Report_accessible_JULY14_V2.pdf> accessed on 28th April 2015.

¹⁸⁹ Philip Spencer, *Property Tax Planning* (A&C Black 2013); Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013).

¹⁹⁰ UK, Taxation (International and Other Provisions) Act (TIOPA) (2010), s 146; Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013).

¹⁹¹ UK, TIOPA, s 164.

¹⁹² *ibid*, s 169.

¹⁹³ *ibid*, s 171.

¹⁹⁴ *ibid*, s 170.

The Finance Act 2011 updated the definition of ‘transfer pricing guidelines’ to refer to the revised OECD Guidelines published in July 2010, thereby domesticating the OECD TP Guidelines into UK law.¹⁹⁵ This effectively imports the OECD guidelines into the UK TP operations, and therefore the UK TP laws are to be construed in alignment with Article 9 of the OECD Model Tax Convention and its related TP guidelines.¹⁹⁶

The discussion of TP has intensified over the years in the UK, as with other countries in the world. TP in the UK came to the forefront in public debate late 2012 when the House of Commons Public Accounts Committee launched investigations into a number of MNEs that were suspected of using TP to evade tax.¹⁹⁷ The popular opinion in government, press and the public is that some MNEs are avoiding payment of taxes to the treasury because of globalisation, large international transactions and specifically MNE group internal transactions involving physical goods, services and intangible goods in the realm of intellectual property.¹⁹⁸ HMRC manages to rope in approximately £1 billion every year in successful TP revenues, and despite these seemingly large volumes of recovery, the tax revenue authority still maintains that this is just the tip of the iceberg in terms of redeemable funds.¹⁹⁹

¹⁹⁵ Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013); PwC, International TP 2013/14 (PWC 2013) 794 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015.

¹⁹⁶ Taxation (International and Other Provisions) Act (TIOPA) of 2010, s 164.

¹⁹⁷ PwC, International TP 2013/14 (PWC 2013) 792 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015.

¹⁹⁸ International Tax Review, *World TP 2014: A Comprehensive Guide to the World's Leading TP Firms* (ITR 2014) 218 <<http://www.internationaltaxreview.com/pdfs/wtp/world-transfer-pricing-2014.pdf>> accessed on 29 April 2015.

¹⁹⁹ House of Commons Committee of Public Accounts, ‘Evidence’, *Tax Avoidance – Google – Ninth Report of Session 2013 – 2014, HC 112* (House of Commons 2013) Ev27 <<http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpublicacc/112/112.pdf>> accessed on 30 April 2015.

Due to the large amounts of money at stake, HMRC is increasingly vigilant in scrutinising tax returns from MNEs,²⁰⁰ and as a result the MNEs need to prepare defences in advance to ensure that they can counter HMRC's position with adequate legal documentation.²⁰¹ This of course, creates the basis for a rising number of TP disputes that are settled either through alternative dispute resolution or litigation as a failsafe.

TP has been associated with tax avoidance.²⁰² Online technology companies have received their fair share of criticism of their tax and corporate structures. Since most work in a technology enterprise occurs online, the physical assets in a specific country can be minimized and the parent company registered in a low tax rate jurisdiction. Companies such as Google and Amazon have been accused by the Parliamentary Accounts Committee (PAC) of the UK House of Commons 'disguising' sales, gaining unfair profits through TP, and using jurisdictions with lower tax rates like Ireland, Luxembourg and Switzerland to divert profits from revenues earned in Britain, France and Germany.²⁰³ Google was especially highlighted as one of the MNEs using TP to unethically divert revenue from HMRC. Google was referred to as 'devious', 'calculating' and 'unethical' in

²⁰⁰ Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008).

²⁰¹ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); International Tax Review, *World TP 2014: A Comprehensive Guide to the World's Leading TP Firms* (ITR 2014) 218 <<http://www.internationaltaxreview.com/pdfs/wtp/world-transfer-pricing-2014.pdf>> accessed on 29 April 2015.

²⁰² Paul Wilmshurst, 'UK Transfer Pricing and the Tax Avoidance Debate' *65 Tax Executive* 33 (2013); Annet Wanyana Oguttu, 'Transfer Pricing and Tax Avoidance: Is the Arm's-Length Principle Still Relevant in the e-Commerce Era' *18 S. Afr. Mercantile L.J.* 138 (2006); Kirsty Keating and Mark Loveday, 'The Growing Convergence of Tax Avoidance and Transfer Pricing' *22 Int'l Tax Rev.* 44 (2011-2012).

²⁰³ Smitha Francis, 'TP and Tax Evasion: Beyond the trans-Atlantic furore' *Third World Resurgence*, No. 268 (Network Ideas 2013) <http://www.networkideas.org/news/jan2013/pdf/Tax_Evasion.pdf> accessed on 29 April 2015; Rachael Power, 'PAC Grills HMRC and Google on TP' (Accounting Web 2013) <<http://www.accountingweb.co.uk/article/google-hmrc-ey-appear-pac/541966>> accessed on 29 April 2015.

its alleged practice of executing contracts with suppliers with a Google company registered in Ireland allegedly for the sole reason of avoiding Britain's higher tax rates.²⁰⁴

Starbucks, another company summoned by the PAC to explain the basis for price shifting to countries outside the UK with an aim of avoiding payment of UK taxes was also questioned on the morality of avoiding payment to the common purse amidst its corporate social responsibility ethos.²⁰⁵ Starbucks states that its business is based on the company's commitment to good governance, ethical conduct and social responsibility.²⁰⁶ The company was put to task on the ethical considerations of its tax structure which the UK PAC claimed was hinged on BEPS.

Amazon was also questioned, because despite having a registered office in Luxemburg allowing it to generating £3.3 billion worth of sales in the UK in the year 2012 it paid no corporation tax.²⁰⁷

It transferred funds to a Dutch associate enterprise as royalty payments, bought raw materials (coffee beans) from Switzerland and paid high interest rates on intercompany loans from other countries, thus shifting its profits and using TP to avoid paying a pound to the UK government.²⁰⁸

While all this is according to the letter of the law, the UK public has raised questions on the ethics of such aggressive TP in tax avoidance.

²⁰⁴ The Guardian, 'Google branded devious over tax arrangements' (Guardian News and Media Limited 2015) <<http://www.theguardian.com/technology/2013/may/16/google-tax-arrangements>> accessed on 29 April 2015.

²⁰⁵ The Guardian, 'Google, Amazon and Starbucks face questions on tax avoidance from MPs' (Guardian News and Media Limited 2012) <<http://www.theguardian.com/technology/2012/nov/12/google-amazon-starbucks-tax-avoidance>> accessed on 30 April 2015.

²⁰⁶ Starbucks, *Corporate Social Responsibility – Fiscal 2006 Annual Report* (Starbucks Corporation 2006).

²⁰⁷ The Guardian, 'Google, Amazon and Starbucks face questions on tax avoidance from MPs' (Guardian News and Media Limited 2012) <<http://www.theguardian.com/technology/2012/nov/12/google-amazon-starbucks-tax-avoidance>> accessed on 30 April 2015.

²⁰⁸ Vanessa Barford and Gerry Holt, 'Google, Amazon, Starbucks: The rise of 'tax shaming'' *BBC News Magazine* (BBC 2013) <<http://www.bbc.com/news/magazine-20560359>> accessed on 30 April 2015.

In the midst of a heated public debate on whether businesses are paying enough tax, the UK introduced the General Anti-Abuse Rule (GAAR), which came into effect in July 2013 with the aim of preventing possible abuses of tax planning, early recognition of illegal aggressive tax avoidance and effectively addressing tax abuses.²⁰⁹ While it has been opined that the effect of GAAR is insignificant because it merely restates what is in existing anti-avoidance legislation,²¹⁰ it is evidence that the UK government seeks to assure the members of the public that there are continuing effort to ensure that MNEs do not abuse tax planning mechanisms such as TP and therefore deprive the state of much needed revenues.

GAAR was introduced to specifically target activities that MNEs engage in under ‘abusive’ ‘tax planning schemes, and while the HMRC may challenge tax planning schemes under other codes, if the scheme is ‘abusive’, it would fall under GAAR.²¹¹ Parliament, through the TP legislation, has set out recognised methods of computing transfer tax. In arriving at the taxable income, if the MNE uses the prescribed methods, different results would be derived depending on the method used. An abusive tax scheme is therefore one which employs methods which Parliament did not anticipate or prescribe as a legitimate method of reducing the MNE’s tax obligation, and therefore cannot be found to be a reasonable way of achieving tax advantages.²¹²

²⁰⁹ Association of Chartered Certified Accountants (ACCA), ‘The UK General Anti-Abuse Rule’ (ACCA 2013) <<http://www.accaglobal.com/content/dam/acca/global/PDF-technical/tax-publications/tech-tp-ukgaar.pdf>> accessed on 29 April 2015.

²¹⁰ *ibid.*

²¹¹ Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013); HMRC, HM Revenue and Customs (HMRC) General Anti Abuse Rule (GAAR) Guidance (HMRC 2015) 5 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399270/2__HMRC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf> accessed on 29 April 2015.

²¹² Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); HMRC, HM Revenue and Customs (HMRC) General Anti Abuse Rule (GAAR) Guidance (HMRC 2015) 5

If a taxpayer uses TP within the bounds of the law, the government should not allege that the individual is evading tax. In *Fisher's Executors v CIR*²¹³ Lord Summer supported this view in stating that 'the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any express terms or of any omissions that he can find in his favour in taxing Acts' and that 'in so doing, he neither comes under liability nor incurs blame'. The argument presented by most MNEs in defending their TP models would be that since there are regulations for TP, if the MNE complies with them, then HMRC should allow this tax plan since it is legal.

The MNE must show that it has organised its affairs with a view of tax mitigation and not tax evasion. The distinction was discussed in *Beneficiary v IRC*²¹⁴ where the appellant's grandfather transferred sums of money from the UK to Jersey to create a discretionary settlement there which the Revenue considered was for the purpose of ensuring that the money did not suffer UK inheritance tax on the grandfather's death. The court found that while UK tax was a consideration of the grandfather's advisers, the tax implications of siting the trust in Jersey "were a matter of indifference" to the grandfather. In holding that this was tax mitigation, the court stated that the grandfather's actions did not have the motive of tax evasion.

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399270/2__HMRC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf> accessed on 29 April 2015; Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013).

²¹³ [1926] AC395

²¹⁴ [1999] STC (SCD) 134, Quoted in *Fisher & Ors v Revenue & Customs* [2014] UKFTT 804 (TC) (14 August 2014).

The courts would generally support an aggressive tax avoidance scheme involving TP used to legitimately reduce the amount of tax paid to HMRC. This follows the long-standing position that tax avoidance is legal, but tax evasion involving deliberate misrepresentation or concealment of pertinent detail in tax returns, is illegal.²¹⁵ In *IRC v Duke of Westminster*²¹⁶ Lord Tomlin stated that ‘(e)very man is entitled if he can to order his affairs so that the tax attracted under the appropriate Act is less than it otherwise would be’ and ‘(i)f he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.’ The facts of the case are that the Duke of Westminster, knowing that there were tax advantages in entering a covenant with his gardener agreeing to pay his wages under the applicable law at the time, entered into this agreement to reduce his tax liability.

It follows that the MNE must ensure that it complies with the relevant TP regulations, otherwise if it deviates from the methods HMRC authorises in the calculation of transfer prices, the tax returns may be reviewed and the case considered one of tax evasion. Tax avoidance in the UK is therefore allowed under UK law. In enacting the GAAR, however, it appears that the UK Parliament does not consider the issue of tax avoidance to gain the most benefit for the MNE as a strictly legal matter, and brings into discussion the moral obligation of MNEs in paying taxes to the country which provides them with the public resources to operate.²¹⁷

²¹⁵ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010).

²¹⁶ [1936] AC1 (HL).

²¹⁷ Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013); HMRC, HM Revenue and Customs (HMRC) General Anti Abuse Rule (GAAR) Guidance (HMRC 2015) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399270/2__HMRC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf> accessed on 29 April 2015.

HMRC applies TP rules which are in harmony with the OECD guidelines requiring MNEs to use the arm's length principle in determining the prices.²¹⁸ Early cases such as *Watson Brothers v Hornby*²¹⁹ *Sharkey v Wernher*²²⁰ and *Petrotim Securities Ltd v Ayres*²²¹ established ALP and are now embodied in UK TP law. Since HMRC has the power to request the MNE to submit documents confirming the analysis of the transfer prices arrived at, this may include records of the transactions of the other companies in the MNE group. An examination of the group accounts of the MNE would present a global overview of its operations, and show the apportionment of business processes, assets and risks. HMRC, through these analyses and reviews of the tax returns of various MNEs has successfully managed to retrieve billions of pounds which would have remained uncollected without such TP evaluation processes.²²²

The discussion of TP generates interest principally because it appears to be a legal way for the MNE to reduce its tax liability but at the same time HMRC seeks to maximise the amount of revenue collected. There are two sides to the coin, and while HMRC concerns are legitimate, the taxpayer's position is backed up by common law. As Lord Clyde stated in *Ayrshire Pullman v CIR*,²²³ (n)o man in this country is under the smallest obligation, moral or other, so as to arrange

²¹⁸ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015.

²¹⁹ (1942) 2 All ER 506.

²²⁰ (1955) 36 TC 275.

²²¹ (1963) 41TC389.

²²² HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015; Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013).

²²³ (1929) 14TC754.

his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores’ and since ‘(t)he Inland Revenue is not slow – and quite rightly – to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer’s pocket’, ‘...the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue’. This forms the basis of public debate in the UK concerning TP, while those rooting for HMRC base their position on moral obligations while those in support of the MNEs claiming promotion of a healthy business environment through encouragement of favourable tax policy of the government.

In 2009 the Tax Tribunal heard *DSG Retail and others v HMRC*²²⁴ a landmark decision, the first case in UK litigation covering TP methodologies and the application of the OECD guidelines.²²⁵ The tribunal considered the different methods of arriving at ALP and held that for the particular nature of DSG’s structure where the profits were considered ‘supernormal’, the profit-split method was recommended. This case not only brought TP to the fore, but validated the proposition that TP is not synonymous with tax evasion.

3.1.3 How are APAs involved in TP in the UK?

The UK has had APA systems in place from 1999.²²⁶ TIOPA 2010 provides for APAs. An APA is defined as a written agreement entered into by the Commissioner and a person pursuant to an

²²⁴ (TC 00001) (2009).

²²⁵ Wolfgang Schön and Kai A Konrad, *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Science & Business Media 2012); Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010).

²²⁶ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); PwC, *International TP 2013/14* (PWC 2013) 808

application for clarification of the effect of TP for future transactions.²²⁷ While the APA is in force, either the Commissioner or a designated officer may either alter or terminate an APA.²²⁸ This discretion is specifically provided for where the applicant for an APA fraudulently or negligently provides either false or misleading information with a view of persuading HMRC to enter an APA with it.²²⁹ The Act also criminalises fraudulent or negligent misrepresentation of information in an APA application, and sets the deterrent penalty at £10,000.²³⁰

The table below shows relevant statistics of HMRC's APA program. During the year 2012/13, HMRC received 45 applications; turned down 0; had 4 applications withdrawn; and agreed to the terms of 27 APAs. The average time to reach agreement for an APA has varied over the years, with the average time being 20.3 months in 2009/2010; increasing to 22.7 months in 2010/2011; improving to 16.9 months in 2011/2012; then shooting up to 26 months in 2012/13.

	2009/10	2010/11	2011/12	2012/13
Applications made during year	32	49	32	45
Applications turned down	3	1	0	0
Applications withdrawn	2	2	1	4

<<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015; Ernst & Young, Transfer Pricing Global Reference Guide (EY 2013) 217
<[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

²²⁷ UK, Taxation (International and Other Provisions) Act (TIOPA) (2010), s 218.

²²⁸ *ibid*, s 225.

²²⁹ *ibid*, s 226.

²³⁰ *ibid*, s 227.

APAs agreed during year	20	35	32	27
Average time to reach agreement (months)	20.3	22.7	16.9	26
50% agreed within (months)	16.5	14	10.7	15

Table 1: HMRC Advance Pricing Agreements (APAs) statistics - year ended 31 March 2013²³¹

HMRC, through its APA Programme engages individual MNEs and the tax revenue authorities in other jurisdictions to agree on the TP methods and rates for future transactions.²³² HMRC allows MNEs to discuss the TP issues related to transactions carried out in the preceding year with a view of settling any outstanding matters before submission of the annual tax returns, which together with APAs ensure there is certainty for MNEs in their dealings.²³³ HMRC only agrees to APAs once it has thoroughly evaluated the MNE, its operations, financial statements and the effect of the agreement on both the MNE and the tax revenue authorities in question.²³⁴

A UK business, a UK resident carrying on business abroad, or a non-resident business with a permanent establishment or branch in the UK, may at no cost request an APA for cross border

²³¹ HMRC, 'Transfer Pricing Statistics' (HMRC 2014)

<<http://webarchive.nationalarchives.gov.uk/20140206152654/http://www.hmrc.gov.uk/international/transfer-pricing-stats.pdf>> accessed on 14 May 2015.

²³² Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); HMRC, *Taxing Multinationals – Issue Briefing* (HMRC 2013)

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193458/HMRC_Issue_briefing_-_transfer_pricing_rules.pdf> accessed on 28 April 2015.

²³³ *ibid*, 2.

²³⁴ HMRC, Corporate Report: Taxing Multinationals: Tackling Aggressive Tax Planning (HMRC 2014)

<<https://www.gov.uk/government/publications/issue-briefing-taxing-multinationals-tackling-aggressive-tax-planning/issue-briefing-taxing-multinationals-tackling-aggressive-tax-planning>> accessed on 28 April 2015.

transactions that fall under TIOPA.²³⁵ The APA may cover either all different related party transactions or specific types of transactions, thus covering either multiple TP issues or each dealing with a singular TP issue.²³⁶ Either HMRC may enter into a bilateral APA with the tax revenue authority of the country in which the related MNE group member operates, or it may conclude a unilateral APA where the other tax revenue authority has not developed an APA program, or where it establishes that there would be no benefit in a bilateral APA.²³⁷

According to section 218(1) of TIOPA, the process of establishing an APA begins when the MNE makes an application for clarification through agreement, of the way in which a particular statutory provision applies to TP. The APA process in the UK takes place in four stages:²³⁸

The first stage involves the expression of interest: The MNE makes an expression of interest in entering an APA with regard to its international transactions. At this point, HMRC has the discretion to either allow the MNE to make a formal application or deny the MNE the opportunity. Essentially, at this stage the MNE makes representations to prove that it qualifies for an APA and the nature of its transactions are such that it would be beneficial to have an APA in place.

²³⁵ Squire Sanders, *Tax Aspects of the Purchase and Sale of a Private Company's Shares* (A&C Black 2013); Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); PwC, International TP 2013/14 (PWC 2013) 808 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015.

²³⁶ CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009); PwC, International TP 2013/14 (PWC 2013) 808 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015.

²³⁷ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); PwC, International TP 2013/14 (PWC 2013) 808 – 809 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015.

²³⁸ PwC, International TP 2013/14 (PWC 2013) 809 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015

The second stage involves formal submission of application: HMRC also has the discretion to deny an application of the MNE at this stage. In doing so, it should offer reasons for the rejection of the application, and may allow the MNE to submit further representations to support its application.

While the third stage involves an evaluation of the proposed methodology and critical assumptions, the fourth stage involves drawing up the agreement.

3.1.4 Conclusions drawn from the UK experience

From the UK experience, Kenya may learn that the process of developing a coherent body of TP law is lengthy. While Kenya seeks to ‘cut and paste’ based on the developments in the developed world, it is notable that the UK law has adopted rules formed through case law, which gives the TP regulation a geographically localised specification.

With regard to APAs, the UK has used them to create a collaborative atmosphere with MNEs, where HMRC enters into talks with the taxpayer and through voluntary effort achieves its objectives of revenue maximisation. Penalties levelled against MNEs for negligent misrepresentation promote integrity in the information HMRC collects. Drawing from the structure the UK has developed for APA programme administration, KRA may develop a similar system but introducing localised provisions based on Kenya’s history in revenue collection.

3.2 UNITED STATES OF AMERICA

3.2.1 Background of the tax system in the US

The Internal Revenue Service (IRS) is the tax revenue authority in the United States, and as a bureau of the Department of Treasury is the body charged with collection of revenue for the US Federal Government.²³⁹ Based in Washington DC, the IRS carries out its functions under the supervision of the Secretary of the Treasury.²⁴⁰ The IRS has its origins in 1862 when the then President Lincoln and Congress created the position of the commissioner of Internal Revenue.²⁴¹

The agency has had a tumultuous history including a Supreme Court declaration of unconstitutionality of the collection of income tax at one point, and the current agency, renamed the IRS in the 1950s has continued to grow into an efficient organisation of tax revenue authority.²⁴² In 1998 the IRS restructured yet another time, and it made great inroads in organisational harmony, pursuant to the IRS Restructuring and Reform Act.

The Internal Revenue Code (IRC) is the principal tax legislation concerning Federal Tax in the United States, enacted in Title 26 of the United States Code.²⁴³ The IRC contains provisions regulating the determination of whether TP applications by taxpayers meet the arm's length

²³⁹ IRS, 'The Agency, its Mission and Statutory Authority' (IRS, 2015) <<http://www.irs.gov/uac/The-Agency,-its-Mission-and-Statutory-Authority>> accessed on 29 April 2015; Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009).

²⁴⁰ 26 U.S. Code, s 7801, Authority of Department of the Treasury.

²⁴¹ IRS, 'Brief History of IRS' (IRS 2015) <<http://www.irs.gov/uac/Brief-History-of-IRS>> accessed on 29 April 2015.

²⁴² *ibid.*

²⁴³ US Code, s 482, 6038A, 6038C, 6662, 7701(o).

standard through providing for the methods of computing TP and audit processes by the IRS, among other tax revenue authority activities.²⁴⁴

3.2.2 TP practice in the USA

The IRS implements TP procedures according to the requirements of the OECD Guidelines, for both cross border and domestic transactions.²⁴⁵ In order to carry out its functions and ensure that companies adhere to the taxing regulations, the IRS carries out periodic TP audits where it establishes that the taxpayer's books raise issues requiring the IRS' review.²⁴⁶ The IRS raises issues from the TP documentation presented when the MNE files the annual income tax returns, and red flags arise where there has been cost sharing agreements, licensing of intangibles, business restructurings, management charges, and especially where there are transfers of intangible assets from countries which charge high taxes to those that have lower tax rates.²⁴⁷

In 2006 the IRS announced that it had reached a settlement in the landmark TP dispute with *Glaxo SmithKline Holdings (Americas) Inc.* ("*GSK Case*").²⁴⁸ In the GSK Case, the largest tax dispute

²⁴⁴ CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009); IRS, 'Development of IRC section 482 Cases' IRS 2015) <http://www.irs.gov/irm/part4/irm_04-061-003.html#d0e2784> accessed on 29 April 2015.

²⁴⁵ Eduardo Baistrocchi and Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012); Ernst & Young, *Transfer Pricing Global Reference Guide* (EY 2013) 218 <[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

²⁴⁶ International Tax Review, *World TP 2014: A Comprehensive Guide to the World's Leading TP Firms* (ITR 2014) 224 <<http://www.internationaltaxreview.com/pdfs/wtp/world-transfer-pricing-2014.pdf>> accessed on 29 April 2015.

²⁴⁷ *ibid.*

²⁴⁸ *Glaxo SmithKline Holdings (Americas) Inc. v Commissioner of Internal Revenue*, Docket No 3-01-D., filed on July 5, Internal Revenue Service; Eduardo Baistrocchi and Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012);

in the history of the IRS, GSK agreed to pay the IRS approximately \$3.4 billion, and to abandon its claim for a refund of \$1.8 billion in overpaid income taxes, as part of an agreement to resolve the parties' long-running transfer pricing dispute for the tax years 1989 through 2005.²⁴⁹ While the matter was under consideration at the Tax Court, the IRS entered into negotiations with GSK and successfully concluded the matter out of court. The settlement by agreement exemplifies the approach the IRS takes in TP revenue authority disputes through its 'commitment to resolving transfer pricing controversies without litigation, provided that (the) ultimate goal of compliance is not compromised'.²⁵⁰

The GSK case involved a tax dispute with the IRS over transactions between GSK, a UK company, and its US subsidiary. The IRS' contention was that GSK made improper overpayments to its British parent enterprise for pharmaceutical products. The IRS argued that part of the profits arising from the sale of a UK-developed drug in the US was attributable to marketing intangibles economically owned by the US sales subsidiary, and which were therefore to be properly taxed in the US.²⁵¹ In doing so, the IRS claimed that GSK overstated its expenses leading to reduced profits

²⁴⁹ IRS, 'IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute' (IRS 2006)
<<http://www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute>> accessed on 15 May 2015.

²⁵⁰ *ibid.*

²⁵¹ Danny Beeton, 'Intangibles: What are the Restructuring Issues and how can they be avoided?' April 2011 International Bar Association, International Fiscal Association 11th Annual Tax Planning Strategies, US and Europe conference in Paris (Freshfields 2011)
<<http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/Intangibles,%20transfer%20pricing%20and%20restructuring.pdf>> accessed on 15 May 2015.

and a lower tax liability. The matter was set for trial at the US Tax Court in February 2006 but GSK opted to pursue the out of court settlement.²⁵²

While it is advisable for MNEs to sort out TP issues with the IRS, if the parties fail to reach an agreement, and especially where the taxpayer disagrees with the transfer prices as reviewed by the tax revenue authority, litigation is the cause of action in the US.²⁵³ In *DHL v CIR*²⁵⁴ the court found that there was no artificial shifting of net incomes between DHL in the US and DHL International registered in Hong Kong. The court agreed with the Petitioner that while the two entities were related, the high level of income generated by the Hong Kong counterpart was as a result of independent activities. Specifically with regard to the disagreement in the pricing determination of the DHL trademark, the Tax Court rejected both DHL's and the CIR's proposed values and set it at USD 100 million in its 'Solomonesque approach' in determining such facts-based cases which have little value-add in terms of development of the law.²⁵⁵

The Solomnesque approach referred to it the judicial approach exercised in the Hebrew story of King Solomon, who proposed that a baby be cut in half for each mother who claimed him to gain their fair share. As such, a considerable number of the Tax Court decisions in the US give 50-50 or approximately 60-40 determinations of the values claimed by the parties. In determining the amount to actually be paid by the taxpayer in settlement of the dispute, the court tends to reduce

²⁵² Robert Guy Matthews & Jeanne Whalen, 'Glaxo to Settle Tax Dispute with IRS over U.S. Unit for \$3.4 Billion' (Wall Street Journal 12 September 2006) <<http://www.wsj.com/articles/SB115798715531459461>> accessed on 15 May 2015.

²⁵³ Eduardo Baistrocchi and Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012).

²⁵⁴ *DHL Corporation and its Subsidiaries v Commissioner of Internal Revenue*, Docket Nos. 19570-95, 26103-95.

²⁵⁵ Deloris R Wright and Harry A Keates, 'The DHL Case: What Lessons Can Be Learned?' *ITPJ May/June 1999* (IBFD Publications BV 1999) 76 <http://www.wrighteconomics.com/wp-content/publications/dhl_case.pdf> accessed on 30 April 2015.

the value payable therefore satisfying the taxpayer that the challenge is successful, while at the same time ensuring the tax revenue authority doesn't go empty handed from the seat of justice.

The Tax Court in the US resolves disputes in the tax arena, including those which are merely disagreements on the value placed by the IRS in the determination of transfer prices.²⁵⁶ Upon submission of the tax returns, the IRS may question the prices as set by the MNE. If the IRS questions these and the parties fail to settle the exact value to be assigned to the transactions, litigation ensues. The Tax Court then acts as an arbiter to determine if the prices are valid or not.

3.2.3 How are APAs involved in TP in the US?

APAs in the US are governed according to the procedures of the IRS. The IRS operates the Advance Pricing and Mutual Agreement (APMA) Program, formerly known as the Advance Pricing Agreement (APA) Program.²⁵⁷ As of 2014, the APMA was constituted of 59 team leaders, 22 economists, and 10 senior managers formed into 10 groups consisting of 7 team leader groups and 3 economist groups.²⁵⁸ Team leaders are in charge of a number of countries each, and they work with the tax authorities in these countries to ensure the APMAs are in place and operational for efficient monitoring of activities of MNEs. The Model APA used in the US is shown in Appendix 3.

²⁵⁶ Eduardo Baistrocchi and Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012).

²⁵⁷ IRS, *Announcement and Report Concerning Advance Pricing Agreements* (IRS 2015) 1
<<http://www.irs.gov/pub/irs-drop/a-15-11.pdf>> accessed on 30 April 2015.

²⁵⁸ *ibid.*

An MNE may make an application for either a unilateral, bilateral or a multilateral APA,²⁵⁹ and the Revenue Procedure 2006 – 9 provides guidance on the process of applying for the APA. In 2014 alone, there were 108 APA applications filed with the APMA Program, and of the 101 agreements executed in the year, 52 of them were new APAs previously filed by MNEs for the first time unlike those which were simply renewals of existing APAs.²⁶⁰

The table below presents information on APA administration in the US. From the data presented, in 2014 the IRS received a total of 108 applications; 101 were executed, 336 remain pending, 48 renewals were executed, and 149 renewals remained pending. There was only 1 application withdrawn, while no applications were either revoked or cancelled. In the US, it takes approximately 40.5 months for a new APA to be concluded, while renewal of an APA takes approximately 35.9 months. That is an average period of 3-4 years, from the time of application to execution of the APA.

Period	1991 – 2013	2014
APA applications filed	1856	108
Executed APAs	1300	101
Pending		336
Renewals Executed		48
Renewals Pending		149
Revoked or cancelled	11	0

²⁵⁹ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); Ernst & Young, *Transfer Pricing Global Reference Guide* (EY 2013) 220 <[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

²⁶⁰ IRS, *Announcement and Report Concerning Advance Pricing Agreements* (IRS 2015) 4 <<http://www.irs.gov/pub/irs-drop/a-15-11.pdf>> accessed on 30 April 2015.

Applications withdrawn	190	1
Time Taken to Complete New APAs (months)		40.5
Time Taken to Renew APAs (months)		35.9

Table 2: IRS Advance Pricing Agreements (APAs) statistics²⁶¹

The IRS has the power to enter into APAs with MNEs primarily to ensure there is certainty in taxation. In *Eaton Corporation v Commissioner of Internal Revenue*,²⁶² the US Tax Court discussed APAs in TP and their role in taxation at length. The court held that it has jurisdiction to review the cancellations of APAs because they are administrative procedures. Further, it determined that where a person claims that an APA cancellation is due to abuse of discretion, the taxpayer must show that the IRS’ cancellations were arbitrary, capricious or without sound basis in fact.

In essence, this decision placed the operations of APAs in the realm of administrative law, and not contract law as the petitioner alleged. The court found that the APA is an agreement of sorts. However, since the IRS is a government body that offers services to the public and is bound by its obligation to serve citizens, its cancellation of an APA cannot amount to a breach of contract. Instead, the dispute would be a subject of judicial review. In establishing a case for judicial review, it follows that the petitioner must prove that the IRS did not follow administrative law requirements.

The facts of *Eaton Corporation v Commissioner of Internal Revenue* are that Eaton, an MNE, and the IRS, the tax revenue authority, entered into two APAs which put in place a TP methodology

²⁶¹ *ibid.*

²⁶² *Eaton Corporation and Subsidiaries v Commissioner of Internal Revenue*, 140 T.C. No. 18 (2013).

to apply to transactions that Eaton had made with its subsidiaries. The parties agreed in the APAs that the APAs' legal effect and revenue authority were governed by certain revenue procedures. In an evaluation of the submissions by Eaton for the determination of the tax payable, the IRS determined that Eaton did not comply with the terms of the APAs and instead of using the arranged terms, cancelled the APAs, issued a deficiency notice and proceeded to use an alternative TP methodology. Eaton, aggrieved with this, filed a petition at the Tax Court, claiming that the IRS had breached its contractual obligations by failing to uphold the APAs, and sought a determination that the IRS be compelled to enforce the APAs.

The court defined an APA as an agreement between the Commissioner and a taxpayer in which the parties set forth, in advance of controlled transactions, the best TP method within the meaning of section 482 and related regulations. The court further stated that Congress enacted section 482 of the Internal Revenue Code to ensure that there is certainty in determination of the taxable income of taxpayers, and to reduce the occasions of tax evasion through use of TP to conceal profits.

3.2.4 Conclusions from the US Experience

Kenya has a lot to learn from the US, which boasts of over 24 years of use of APAs. With TP fully integrated in the law and active litigation in the field of TP, the law has developed to appreciate the impact of APAs. From the US, it is clear that APAs are not the end to disputes. There are still occasions when the tax revenue authority and the MNE challenge the applicability of the APA. It is also notable that since most of the TP disputes in the US are fact-based, it is difficult to create a

single body of law on TP and the applicability of APAs: each situation is dealt with on a case-by-case basis.

APAs have brought certainty into the murky field of ALP determination in the US. The IRS has used unilateral, bilateral and multilateral APAs and in doing so has made progress toward combating tax evasion. Kenya may learn that through the use of APAs, while admitting their limitations, KRA may realise significant benefits in terms of tackling BEPS.

3.3 INDIA

3.3.1 Background of the tax system in India

The Department of Revenue (DOR) is the central tax authority in India, operating under the overall supervision and direction of the Secretary of Revenue under the Ministry of Finance.²⁶³ It is comprised of two statutory boards namely the Central Board of Direct Taxes (CBDT) which oversees the levying and collection of direct taxes, and the Central Board of Excise and Customs administers customs and central excise, and other indirect taxes.²⁶⁴ The Headquarters of the DOR is responsible for coordinating efforts between the two Boards and ensuring that they work in harmony toward achieving efficient revenue collection for the Government of India.²⁶⁵

²⁶³ Government of India – Ministry of Finance, ‘Department of Revenue’ (GOI 2015) <<http://dor.gov.in/>> accessed on 6 May 2015.

²⁶⁴ Ernst & Young, Transfer Pricing Global Reference Guide (EY 2013) 98 <[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

²⁶⁵ Government of India, Ministry of Finance, ‘About Us’ (GOI 2015) <<http://dor.gov.in/aboutus>> accessed on 6 May 2015.

3.3.2 How does TP occur in India?

The Income Tax Act in India provides for the operation of TP, and the methods used to arrive at the ALP in determination of whether the MNE abides by the TP rules.²⁶⁶ Rules 10A to 10T, and Rule 44GA of the Income Tax Rules 1962 further address TP and its operation in India. India's TP rules are founded on the OECD Guidelines. Out of the six methods of calculating the ALP provided under the OECD guidelines, India's TP rules offer five: an MNE may use the comparable uncontrolled price method, resale price method, cost plus method, profit split method, transactional net margin method or other method prescribed by the Board of the tax authority.²⁶⁷

India's TP rules apply to associated enterprises which are defined as companies where one owns at least 26% of the other, or where a parent company owns at least 26% in both of the subject companies; and cover various MNE cross-border transactions involving assets, services, financing, cost allocation, restructuring, and reorganisation.²⁶⁸ While the main focus in TP concerns cross border transactions, India also allows for the TP rules to cover 'specified domestic transactions' with a total transactional value of more than approximately Kshs 80 million, including payments to related parties, inter-unit transfer of goods or services of profit-linked tax-eligible units, transactions of profit-linked tax holiday-eligible units with other parties.²⁶⁹

²⁶⁶ India, Income Tax Act, s 92(1), 92(2) and 92C; Eduardo Baistrocchi and Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012); Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008);

²⁶⁷ India, Income Tax Act, s 92C.

²⁶⁸ Eduardo Baistrocchi and Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (CUP 2012); Ernst & Young, *Transfer Pricing Global Reference Guide* (EY 2013) 98
<[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015; CCH, *International Master Tax Guide* (6 edn, CCH Australia 2009).

²⁶⁹ Kaviraj Singh, *INBA Annual Report on Indian Law: Legal Issues India* (Indian National Bar Association 2015); Ernst & Young, *Transfer Pricing Global Reference Guide* (EY 2013) 98

The DOR has in the recent past actively pursued enterprises which perpetually record either low profits or losses, and performed TP audits which have led to the recovery of more than \$1.9 billion in adjustments of revenue dues in 2014; an equivalent of the accumulated collections from 6 previous rounds of audit.²⁷⁰

MNE group transactions involving services such as advertising, marketing and sale promotion in favour of an associated enterprise operating in India are considered international transaction subject to TP regulations, as held in *Sony Ericsson Mobile Communications India Pvt Ltd v Commissioner for Income Tax*²⁷¹ where the High Court of India discussed TP and its application in India, with a specific reference to advertising, marketing and sale promotion. This is a clear indication that the fight for taxable revenues by the tax revenue authority is upbeat with transfer of intangible assets a serious concern to be addressed. The court found that the tax revenue authority has jurisdiction to handle transactions of MNEs including those transactions which are not reported in the tax returns.

<[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

²⁷⁰ International Tax Review, *World TP 2014: A Comprehensive Guide to the World's Leading TP Firms* (ITR 2014) 97 <<http://www.internationaltaxreview.com/pdfs/wtp/world-transfer-pricing-2014.pdf>> accessed on 29 April 2015.

²⁷¹ High Court of Delhi at New Delhi, ITA No. 16/2014.

3.3.3 How are APAs involved in TP in India?

APAs were introduced in India in 2012 through the Finance Act of that year. The Act amended the Income Tax Act and inserted section 92CC on APAs. This section states that the CBEC²⁷² with the approval of the Central Government may enter into an advance pricing agreement with any person, determining the ALP or specifying the manner in which ALP is to be determined, in relation to an international transaction to be entered into by that person.²⁷³ The APA may be entered into and used to determine the prices for transactions dating back to not more than 5 years before the date of the agreement.²⁷⁴ APAs are binding on both the Commissioner and the taxpayer, but only with regard to the specific transactions covered under that particular APA,²⁷⁵ and consequently any transactions not covered under the APA will not be subjected to the arrangement.

An MNE may either select a unilateral, bilateral or multilateral APA, which must be for not more than 5 years with no rollback provision, subject to payment of a prescribed fee.²⁷⁶ The APA Pre-filing Meeting Application Form and Main Application Form used in India are shown at Appendix 1 and Appendix 2 respectively, of this Study.

While APAs may be entered into, and the Commissioner bound by them, the Board may cancel any APA with the approval of government if it finds the taxpayer or other applicant engaged in

²⁷² India, Central Boards of Revenue Act, 1963; (54 of 1963).

²⁷³ India, Finance Act, 2012 (23 of 2012), s 40; India, Income Tax Act, s 92CC (1).

²⁷⁴ India, Finance Act, 2012 (23 of 2012), s 40; India, Income Tax Act, s 92CC (4).

²⁷⁵ India, Finance Act, 2012 (23 of 2012), s 40; India, Income Tax Act, s 92CC (5).

²⁷⁶ Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008); Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); EY, *Transfer Pricing Global Reference Guide* (EY 2013) 100

<[http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/\\$FILE/Transfer_pricing_global_reference_guide_2013.pdf](http://www.ey.com/Publication/vwLUAssets/Transfer_pricing_global_reference_guide_2013/$FILE/Transfer_pricing_global_reference_guide_2013.pdf)> accessed on 5 April 2015.

fraudulent activities including misrepresentation of facts to achieve the requirements for a valid APA.²⁷⁷ This measure is to ensure that the government dissuades taxpayers from entering into APAs using illegal tactics which would ultimately deprive the government of the income it seeks to receive through the APAs.

In 2014, the Government of India released its first report on APAs, following the recent introduction of APAs in the TP rules. The table below shows the findings for the years 2012/13 and 2013/14. APAs have only been in operation in India since 2012, therefore there is too little information to show a trend.

	2012/13	2013/14
APA applications filed	146	232
Executed APAs	-	5

Table 3: India's CBDT Advance Pricing Agreements (APAs) statistics²⁷⁸

While India has implemented its APA program, according to the statistics recorded on APAs it would be difficult to quantify the effect of APAs on dispute resolution. However, it is expected that the implementation of the APA program will bring certainty in TP issues due to the predictability of determination of the ALP.²⁷⁹

²⁷⁷ India, Finance Act, 2012 (23 of 2012), s 40; India, Income Tax Act, s 92CC (7).

²⁷⁸ EY, 'India releases 2013-14 Annual Report Covering Transfer Pricing and International Tax Developments' *Global Tax Alert* (EY 2014)

<[http://www.ey.com/Publication/vwLUAssets/2014G_CM4702_TP_India__releases_2013_14/\\$FILE/2014G_CM4702_TP_India_%20releases_2013_14.pdf](http://www.ey.com/Publication/vwLUAssets/2014G_CM4702_TP_India__releases_2013_14/$FILE/2014G_CM4702_TP_India_%20releases_2013_14.pdf)> accessed on 14 May 2015.

²⁷⁹ Edgar Thorpe, *The Pearson Current Event Digest 2011-2012* (Pearson Education India 2012).

3.3.4 Conclusions from the India Experience

India's APA programme has not been in place for long, and the comparable data only relates to the period from 2012 to date (2015). While KRA may not have sufficient data from this to form a trend, it is insightful to note the enthusiastic take-up of the APA idea, considering the number of APA applications already filed.

APAs in India are hailed as a mechanism of reducing the uncertainty in the tax regime. With this development coming from a developing country like Kenya, KRA may learn that it is possible to implement an APA programme and cultivate the certainty desired by MNEs to invest in the country.

3.4 CONCLUSION ON THE INTERNATIONAL EXPERIENCE

TP is an international phenomenon, with countries around the globe seeking a cooperative approach to resolving issues arising from cross-border trade. The UK has applied the APA system from 1999 and boasts of over 15 years of experience. The US tax administration also carries valuable lessons, with its activities dating back to 1862; and an APA program in place for 24 years up to 2015). India, a developing country, has a nascent APA programme put into place in 2012 and showing promise.

In the UK, HMRC established the TP Group to assist in the specialised area of TP determination and evaluation. HMRC has a dispute resolution mechanism that considers the cases and makes determinations. The Taxation (International and Other Provisions) Act (TIOPA) of 2010 provides for TP. The discussion of TP has intensified over the years in the UK, as with other countries in

the world. TP has been associated with tax avoidance, with companies such as Google, Amazon and Starbucks coming under the spotlight. The courts in the UK generally support an aggressive tax avoidance scheme involving TP used to legitimately reduce the amount of tax paid to HMRC, following the position that tax avoidance is legal, but tax evasion involving deliberate misrepresentation or concealment of pertinent detail in tax returns, is illegal. It follows that the MNE must ensure that it complies with the relevant TP regulations.

The UK has had APA systems in place from 1999, and the TIOPA 2010 provides for APAs. During the year 2012/13, HMRC received 45 applications; turned down 0; had 4 applications withdrawn; and agreed to the terms of 27 APAs. The average time to reach agreement for an APA has varied over the years, with the average time being 20.3 months in 2009/2010; increasing to 22.7 months in 2010/2011; improving to 16.9 months in 2011/2012; then shooting up to 26 months in 2012/13.

There may be one APA for multiple TP issues or different APAs: one for each specific type of transactions. There may also be bilateral or multilateral APAs. The APA process in the UK takes place in four stages: the expression of interest, formal submission of application, evaluation of the proposed methodology and critical assumptions, and drawing up the agreement.

From the UK experience, Kenya may learn that the process of developing a coherent body of TP law is lengthy. The UK has used APAs to create a collaborative atmosphere with MNEs involving talks between HMRC and the taxpayer, promoting voluntary effort to achieve revenue maximisation.

In the US, the Internal Revenue Service (IRS) carries out periodic TP audits, raises issues from the TP documentation presented, and raises red flags where there are certain transactions signalling tax evasion. While administrative procedures between the IRS and the MNE are the first

consideration, litigation may ensue from the disagreement. APAs in the US are governed according to the procedures of the IRS under the Advance Pricing and Mutual Agreement (APMA) Program. An MNE may make an application for a unilateral, bilateral or multilateral APA. In 2014 alone, there were 108 APA applications filed with the APMA Program, and of the 101 agreements executed in the year, 52 of them were new APAs previously filed by MNEs for the first time unlike those which were simply renewals of existing APAs.

The IRS has the power to enter into APAs with MNEs primarily to ensure there is certainty in taxation. The US courts have placed operations of APAs in the realm of administrative law, and not contract law, finding that while the APA is an agreement, the IRS as a public body must serve the citizens and makes such decisions as the cancellation of an APA in the public interest. The US has APAs well integrated in the law and as a result of the active litigation in the field of TP the US law has developed to appreciate the impact of APAs. While APAs solve many preliminary points of potential disputes, the US experience shows that there still may be disputes that arise. Issues the courts must consider include the applicability of the APA to different types of transactions in question. However, since most of the TP disputes in the US are fact-based, it is difficult to create a single body of law on TP and the applicability of APAs and each situation is dealt with on a case-by-case basis.

In India, the Income Tax Act and the TP rules provide for TP. While the main focus in TP concerns cross border transactions, India also allows for the TP rules to cover 'specified domestic transactions' with a total transactional value of more than approximately Kshs 80 million. APAs were introduced in India in 2012 through the Finance Act of that year. The APA may be entered into and used to determine the prices for transactions dating back to not more than 5 years before the date of the agreement and is binding on both the Commissioner and the taxpayer. An MNE

may either select a unilateral, bilateral or multilateral APA, which must be for not more than 5 years with no rollback provision, subject to payment of a prescribed fee. APAs have only been in operation in India since 2012, therefore there is too little information to show a trend.

The international experience shows that APAs are used by the relevant tax revenue authorities in the UK, US and India as a means of reducing the uncertainty in the tax regime. The lessons drawn from the developed and developing country experiences present a framework that Kenya may adopt to put in place an APA program to increase certainty in TP matters.

CHAPTER FOUR

TP ENVIRONMENT IN KENYA

4.0 INTRODUCTION TO THE TP ENVIRONMENT IN KENYA

From 2006 to date, Kenya has joined the ranks of other counterparts that have adopted the OECD Guidelines in their local law. However, in the application of the TP legislation and rules, KRA and taxpayers face certain challenges in ensuring compliance with TP and determination of ALP. This chapter analyses the Kenyan situation with regard to TP, the challenges in implementation and the place of APAs in tackling the challenges.

4.1 THE TP RULES – AN OVERVIEW

KRA administers TP in Kenya, and ensures implementation of the Income Tax Act (Cap 470, Laws of Kenya) and the Income Tax (TP) rules 2006. KRA efforts are spearheaded by the Large Taxpayers Office (LTO) which has a specialised TP unit to monitor and ensure compliance with the TP rules, conduct TP audits, and collaborate with other tax revenue authorities to combine efforts on TP revenue authority.²⁸⁰ The LTO conducts regular audits on MNEs based on their risk profile, taking into consideration such factors as TP.²⁸¹

²⁸⁰ KRA, 'Large Taxpayers Office' (KRA 2015) <<http://www.kra.go.ke/index.php/large-taxpayers-office/about-lto/internal-organisation/taxpayer-services>> accessed on 12 May 2015.

²⁸¹ *ibid.*

The Income Tax Act forms the basis for TP operations in Kenya. According to section 18(3) of the Income Tax Act:

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

This is an embodiment of the arm’s length principle in determining transfer prices. While the Act provides that KRA and taxpayers should use the ALP in determining the TP, it does not offer a procedure for its application.

Kenya introduced the TP rules and modelled them according to the OECD Guidelines in reaction to the judgment in the landmark TP case of *Unilever Kenya Limited V Commissioner of Income Tax*²⁸² delivered on the 5th of October 2005. This case involved transactions between Unilever Kenya Limited (UKL) in Kenya and Unilever Uganda Limited (UUL). UKL, pursuant to a contract dated 28th August 1995, manufactured and supplied goods to UUL and at the same time manufactured and supplied goods for both local domestic and export sales. The prices for both categories of supply were different. The prices of the goods supplied to UUL were lower than

²⁸² High Court at Nairobi, Income Tax Appeal 753 of 2003 (2005) eKLR.

those for domestic and export sales, and as a result, KRA claimed that they were not set according to the ALP: the price charged to unrelated parties.

The court considered that the important section of 18(3) of the Income Tax Act is whereby the taxpayer's course of business is 'so arranged as to produce less profits'. In its determination, the court found that there was no special price fixing arrangement specifically created to evade tax. UKL used the cost-plus method to arrive at the ALP, in accordance with the OECD Guidelines, which the court reasoned were applicable in Kenya since they are merely guidelines and cannot be ignored on the basis of the arguments by KRA that they were put in place in other countries and therefore did not form part of Kenyan law. The High Court adopted a liberal view that while they are merely guidelines, business has developed considerably over the previous 20 years and the experience of countries with more expertise and insight on TP must be taken into account in setting the basis for TP regulation in Kenya.

The Income Tax (TP) Rules took effect in 2006 with a purpose to provide guidelines in determining the ALP of goods and services in transactions involving related enterprises.²⁸³ The TP Rules provide administrative regulations, including the types of records and documentation a taxpayer involved in TP agreements should submit to the Commissioner.²⁸⁴ The rules apply to transactions between associated companies where one has a base in Kenya and the other is abroad; and between an enterprise with a permanent establishment in Kenya with its head office or similar branches in another jurisdiction.²⁸⁵

²⁸³ Income Tax (TP) Rules (2006), rule 3.

²⁸⁴ *ibid.*

²⁸⁵ *ibid.*, rule 5.

The rules state that the taxpayer, in our case, the MNE may choose a method to employ in determining the ALP.²⁸⁶ The MNE may either use the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, the profit split method, the transactional net margin method or any other method prescribed by the Commissioner for Income Tax.²⁸⁷ These methods are to be used to determine the price for goods and services in transactions between related enterprises to calculate the tax payable²⁸⁸ where a non-resident person carries on business with a related resident person and the course of that business arranged in a way that it produces to the resident person either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship.²⁸⁹

In setting the ALP, the firm has the discretion to decide which method to apply by considering the nature of the transaction, class of transaction or function performed by the firm in the particular transaction.²⁹⁰ While MNE decides the method to apply, the Commissioner for Income Tax has the power to request for information including books of accounts of the firm and other documents relating to the transactions to review the considerations put into place in arriving at the transfer price.²⁹¹ The firm is under a duty to develop an appropriate TP policy when it seeks to apply arm's length pricing, to follow the guidelines in determining the ALP, and avail documentation relating to the analysis of the ALP to the Commissioner for Income tax when requested.²⁹²

²⁸⁶ *ibid*, rule 4.

²⁸⁷ *ibid*, rule 7.

²⁸⁸ *ibid*, rule 8.

²⁸⁹ Income Tax Act, s 18(3).

²⁹⁰ *ibid*, rule 8(2).

²⁹¹ *ibid*, rule 9.

²⁹² *ibid*, rule 10.

Penal provisions in the Income Tax Act Application assist the tax revenue authority to enforce taxation regulation, and apply to any person who fails to comply with the rules or is engaged in fraud, failure to furnish returns and underpayment of tax.²⁹³ Further, where a firm has set a considerably low transfer price and the Commissioner for Income Tax reviews the price upwards thereby increasing the amount of tax payable, the rules provide that this unpaid tax is to be deemed additional tax.²⁹⁴ This additional tax is subject to interest at the rate of two per cent per month.²⁹⁵

In 2010, KRA applied the TP rules to the Income Tax returns, and added a schedule to the return requiring taxpayers to indicate whether it has any related parties; the type of transactions carried between these associated parties; and whether the taxpayer has prepared documentation necessary to show the transactions.²⁹⁶ This information is important because it allows KRA to monitor MNEs dealings and use the data to assess whether the MNE is complying with the TP rules.

There is no specialised dispute resolution mechanism for TP matters in Kenya, so KRA handles such cases through the normal income tax administrative procedures.²⁹⁷ When a taxpayer submits the Income Tax Returns to KRA, which issues a notice of assessment, if the taxpayer contests the details of the assessment, it may give the Commissioner a written notice of objection.²⁹⁸ If the Commissioner does not admit the notice of objection, the taxpayer may appeal against this refusal to a Local Committee established by the Cabinet Secretary responsible for Finance, by Gazette

²⁹³ *ibid*, rule 11.

²⁹⁴ *ibid*, rule 12.

²⁹⁵ Income Tax Act, s 94 & 95.

²⁹⁶ KRA, *2013 Company Return* (KRA 2013).

²⁹⁷ PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC nd) 15 <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 13 May 2015.

²⁹⁸ Income Tax Act, s 84.

Notice,²⁹⁹ and whose decision on the matter will be final.³⁰⁰ While this marks an end to the administrative process, a taxpayer aggrieved by the decision of the Local Committee may file an application for judicial review at the High Court to have the decision brought into the Court and quashed. When a taxpayer files the dispute at the Local Committee or seeks further determination by the High Court, KRA would in practice require that the taxpayer pays into the court the assessed amount or contested balance as security;³⁰¹ and when the decision of the Court is delivered, the amount is transferred to the party deserving. Once the Court makes its pronouncements, the situation may be exacerbated by the intentional delay of payments by KRA to the taxpayer.

To avoid the lengthy process of giving the notice of objection and pursuing the matter with the Local Committee, taxpayers have in practice found it easier and more time efficient to subject the first notice of assessment by the Commissioner to judicial review, and in so doing, apply directly to the High Court.³⁰² However, in cases such as *Unilever Kenya Limited V Commissioner of Income Tax*³⁰³, the taxpayers went through the entire process.

²⁹⁹ *ibid*, Part X, s 82.

³⁰⁰ *ibid*, s 84(3).

³⁰¹ KRA, *Taxpayer's Charter, 2007 – 2008* (KRA 2007) 6 <<http://www.kra.go.ke/pdf/TaxpayerCharter.pdf>> accessed on 13 May 2015.

³⁰² PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC nd) 16 <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 13 May 2015.

³⁰³ High Court at Nairobi, *Income Tax Appeal 753 of 2003* (2005) eKLR.

4.2 CHALLENGES FACING TP REVENUE AUTHORITY IN KENYA

KRA and MNE taxpayers face a number of challenges in the revenue authority and application of TP, and these must be addressed in order for better revenue generation on the one part, and for an improved tax environment on the other part.

First, KRA only recently set up a TP unit. The team members of the unit have undergone training in other jurisdictions in order to build capacity, but this was only done lately. As a result, KRA may not have adequate expertise to negotiate effectively with MNEs with years of experience in TP. The tax revenue authority may not therefore correctly assess the tax due from all MNEs due to the limited number of team members in the TP unit.³⁰⁴ This delicate position has led to moves such as the Draft TP guidelines proposal to use the median as the appropriate ALP as opposed to the interquartile range as provided for in the OECD guidelines.³⁰⁵ While this is against the OECD guidelines, KRA may be reacting to a need for further training and development of the TP unit, against a backdrop of increasingly specialised industries and transactions of MNEs which would need individual attention. To curb this, it would appear to be an easier option to agree on the ALP *ab initio*.

³⁰⁴ PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC nd) 1 <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 12 May 2015.

³⁰⁵ Geoffrey Irungu, 'Tax Experts Fault KRA Standard Transfer Pricing' (Business Daily 27 April 2015) <<http://www.businessdailyafrica.com/Tax-experts-fault-KRA-standard-transfer-pricing/-/539552/2697914/-/h6y46a/-/index.html>> accessed on 12 May 2015.

Secondly, there is a general perception that Kenya's legislative, judicial and administrative bodies are insufficiently skilled to identify and deal with cases of TP malpractice.³⁰⁶ If the public and in particular the business community does not have faith in the government to identify and deal with TP malpractice, there would be a nonchalance in compliance with TP rules. However, KRA continues to propel such perceptions through actions. Taxpayers' opinion is that while KRA is quick to increase the TP estimates submitted by MNEs, it is extremely hesitant in reducing the TP where the ALP is clearly lower than that estimated.³⁰⁷ With a lack of confidence in the system KRA would consistently face difficulties in TP revenue authority. The Local Committees appointed by the Cabinet Secretary to determine TP issues, KRA Tax Tribunal and the judges who hear judicial review applications in TP matters, are not well placed because they do not have specialist experience in TP and therefore would be at pains to come up with well-reasoned and researched TP jurisprudence.³⁰⁸

Thirdly, KRA has inadequate information on the activities of MNEs in other jurisdictions.³⁰⁹ KRA has not yet developed an efficient system of gathering information on the profitability and performance of the MNEs in other countries. This leads to a reliance on the information submitted by the MNE which may be tactfully submitted to comply with the requirements but lead to

³⁰⁶ Mutua Ngundi, *Transfer Pricing Management Strategies by Multinational Enterprises within the Main Investment Segment of the Nairobi Securities Exchange* (Masters Thesis, University of Nairobi School of Business, 2012).

³⁰⁷ Geoffrey Irungu, 'Tax Experts Fault KRA Standard Transfer Pricing' (Business Daily 27 April 2015) <<http://www.businessdailyafrica.com/Tax-experts-fault-KRA-standard-transfer-pricing/-/539552/2697914/-/h6y46a/-/index.html>> accessed on 12 May 2015.

³⁰⁸ PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC nd) <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 13 May 2015.

³⁰⁹ Mutua Ngundi, *Transfer Pricing Management Strategies by Multinational Enterprises within the Main Investment Segment of the Nairobi Securities Exchange* (Master's Thesis, University of Nairobi School of Business, 2012).

BEPS.³¹⁰ This information imbalance puts KRA at a disadvantage in interactions with MNEs in determining the ALP.

Fourth, since there are a limited number of MNEs or local companies with similar operations, activities or economic strength as the MNEs in question, there are few or no comparable transactions for ALP determination.³¹¹ Each corporate tax return submission must be scrutinised on its own and with no similar comparable transactions, there is bound to be a disagreement on the price that KRA determines is fit to be the ALP. In addition, there are no local databases which the taxpayers or the tax administration could refer to when analysing the related party transactions. This poses a huge challenge especially when determining the arm's length price.

Fifth, poor draftsmanship of the TP regulations may lead to ambiguities in the interpretation of the methods of arriving at the ALP and show a clear departure from the disparities of Kenya's rules from the OECD Guidelines.³¹² This observation is in light of the knee-jerk reaction Kenya adopted in 2006 in providing for the TP rules. In the rush of the need for legislation and the obvious inexperience of KRA with TP as described by the Court in Unilever, the effect was that the draftsmen of the rules did not have a clear understanding of the OECD Guidelines and neither were they specialists, to appreciate the wording of the rules and their possible legal effect. While

³¹⁰ Reuven S Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015).

³¹¹ Ceteris Inc, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International, 2010); PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC nd) 1
<http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 12 May 2015.

³¹² Mutua Ngundi, *Transfer Pricing Management Strategies by Multinational Enterprises within the Main Investment Segment of the Nairobi Securities Exchange* (Master's Thesis, University of Nairobi School of Business, 2012); PwC, 'Appendix D: Country Study – Kenya' Transfer pricing and developing countries – Kenya (PwC nd) 1
<http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 12 May 2015.

this has not been tested in depth in court, it may lead to unnecessary delays due to differing determinations of ALP.

4.3 APAs – A SOLUTION TO TP REVENUE AUTHORITY CHALLENGES IN KENYA

While APAs are a potential avenue to contribute towards improving KRA's capacity to deal with TP issues,³¹³ Kenya has no provision either in the Income Tax Act or the TP rules, nor structures in place, by which taxpayers may enter into APAs; and KRA has been reluctant to set procedures, practices or policies regarding specific taxpayers or groups of taxpayers.³¹⁴ Based on previous experience, this reluctance may also be seen with endeavours to introduce APAs.

APAs are an important mechanism in TP administration, and are a potentially beneficial tool for KRA. With this, it is assumed that MNEs will welcome KRA efforts to determine Kenya as their country of permanent establishment, with the trade-off that taxation will be more certain. With efficient tax revenue authority, KRA can contribute to increased foreign investment and therefore higher levels of FDI in the economy. One of the best ways for Kenya to battle tax challenges and increase revenue collected is through improved tax revenue authority,³¹⁵ which the authority can be achieved through capitalising on the advantages of APAs.

³¹³ Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008).

³¹⁴ PwC, International TP 2013/14 (PWC 2013) 182 <<https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf>> accessed on 28 April 2015.

³¹⁵ Richard M Bird, 'Tax Challenges Facing Developing Countries' *Inaugural Lecture of the Annual Public Lecture Series of the National Institute of Public Finance and Policy, New Delhi, India* (University of Toronto 12 March 2008) 6 – 7; Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008).

The government receives sensitive information from the MNE which would have been withheld had there not been negotiations to enter into an agreement.³¹⁶ When the MNE seeks to enter into an APA, it must approach the tax revenue authority in the country or countries it would like to agree with. It presents a proposal of the methods used to determine the ALP, the controlled transactions it engages in and pertinent information such as the inner workings of the MNE group which would otherwise be closely guarded.

It takes a certain level of candidness of the MNE to reveal such information, but all this is premised on the determination for certainty of taxation. The MNE would only reveal this information and provide detailed documentation on the intricate networks if it is assured that there is a benefit. It is acknowledged, though, that the information disclosed in the APA program is just the tip of the iceberg. However, it would be a step in the right direction. This benefit, according to this study, is certainty.

APAs would also ensure there is predictability, as the tax revenue authority would have the basic assurance that the certain levels of revenue would be due from the company. The tax revenue authority would also save money, because the type of controlled transactions would be predetermined, the government would reduce the risk of losing revenue from companies that would choose other tax jurisdictions with set procedures in favour of those with possibilities of arbitrary TP determinations.

³¹⁶ Diane M Ring, 'On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation' *Michigan Journal of International Law* 21, no.2 (2000) 147 <<http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1451&context=lsfp>> accessed on 7 May 2015; Karoline Spies and Raffaele Petrucci, *Tax Policy Challenges in the 21st Century* (Linde Verlag GmbH 2014); Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008).

Through APAs, run and managed by an APA program in the relevant tax revenue authority, the government may draw lessons based on experience, on how to best apply ALP in determination of TP.³¹⁷ APAs are specialised to particular MNEs, each possibly in a different business industry with individualised operations. Tax revenue authorities use APAs for MNEs with complex internal workings, and in the development of the APA information is generated both on the specific MNE and on the industry. Through this process, the tax revenue authority would have a better view of the application of APAs in the particular industry, and use that as a backdrop to improve the rules of tax regulation. Improved tax regulation would benefit both the MNE and the tax revenue authority. This especially would benefit other MNEs which have not participated in the specific APA operation.

However, APAs also have their disadvantages. Firstly, tax revenue authorities seek uniformity to guide their processes. In offering public service, public bodies seek to offer similar treatment to individuals and consistent application of rules across the board. APAs suggest specialised treatment to individual MNEs and may raise questions in the different treatment of MNEs that may be similar in character. Due to diverse tax expertise and negotiation skills, some may opine that one MNE would receive preferential treatment over the others. The use of these 'private individualised agreements' may raise risks which the tax revenue authority may not find favourable in the administrative regime or indeed under administrative law.³¹⁸

³¹⁷ Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); Karoline Spies and Raffaele Petruzzi, *Tax Policy Challenges in the 21st Century* (Linde Verlag GmbH 2014); Diane M Ring, 'On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation' *Michigan Journal of International Law* 21, no.2 (2000) 148 <<http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1451&context=lsfp>> accessed on 7 May 2015.

³¹⁸ Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008); Diane M Ring, 'On the Frontier of Procedural Innovation: Advance Pricing Agreements and

Secondly, KRA would also likely face the challenge of insufficient resources required to set up an APA program to administer APAs.³¹⁹ KRA would need to use resources earmarked for other purposes to establish and APA program because there is no established procedure for this. Resources include staff members who would be needed to prepare and maintain the APAs and oversee the processes. KRA would also require funds to facilitate information sharing with other tax revenue authorities to assist in the harmonisation of policies on TP, and to manage the APAs.

Thirdly, the APA procedure may be too costly and time consuming for small businesses and not all MNEs may afford to pursue the application and revenue authority process.³²⁰ In filing an application for an APA, an MNE must pay the costs of the application. If any dispute arises, the MNE must negotiate with KRA for agreeable terms. Further, if any dispute arises concerning the application of the APA, the MNE would need to institute administrative or judicial proceedings to seek enforcement of the APA. All these represent the financial implications of the APA program which MNEs would need to bear. While some MNEs would have the financial muscle to participate in this process, some may not have sufficient funds to go the long-haul and as a result may shy away from APAs.

the Struggle to Allocate Income for Cross Border Taxation' *Michigan Journal of International Law* 21, no.2 (2000) 148 <<http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1451&context=lsfp>> accessed on 7 May 2015.

³¹⁹ Hadija Murangwa Ndingiza, *ATAF Regional Studies on Reform Priorities of African Tax Administrations (ATAF 2012)*; Karoline Spies and Raffaele Petruzzi, *Tax Policy Challenges in the 21st Century* (Linde Verlag GmbH 2014); PwC, 'Appendix D: Country Study – Kenya' *Transfer pricing and developing countries – Kenya* (PwC nd) 27 <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 13 May 2015.

³²⁰ Michelle Markham, *The Transfer Pricing of Intangibles* (Kluwer International 2005); Xinkui Fan, 'Difficulties in Pressing Forward Advance Pricing Agreement (APA) in China' 4 *Asian Social Science* 11 (CCSE 2008) 53 – 58; Karoline Spies and Raffaele Petruzzi, *Tax Policy Challenges in the 21st Century* (Linde Verlag GmbH 2014); PwC, 'Appendix D: Country Study – Kenya' *Transfer pricing and developing countries – Kenya* (PwC nd) 28 <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/trpr_dev_count_app_d.pdf> accessed on 13 May 2015.

The following table presents a summary of the advantages and disadvantages of APAs.

Benefits	Challenges
The MNE incurs a low reporting cost and has certainty on the ALP determination of covered transactions	The MNE may incur significant costs in preparing the initial APA application since it requires extensive research and documentation
KRA reduces the need for documentation since the information submitted during the APA application serves as a basis for future interaction	The benefits of the APA may be delayed since the negotiation process between KRA and the MNE may take a long time, even up to a number of years
Both KRA and the MNE reduce the cost of audits and appeals since there APA report assists in confirming compliance, and the predetermination of the ALP reduces room for conflict	The business environment may change during the APA term, leaving KRA or the MNE at a disadvantage depending on the effect; this may require a re-negotiation which could be a lengthy process
KRA can improve the public perception through the APA negotiation process which is cooperative and shows an appreciation for taxpayer's input	The MNE may be disadvantaged since it would need to reveal sensitive information to KRA, to satisfy the information threshold, such as trade secrets

Through the APA program KRA can build practical mechanisms for addressing complex TP issues which forms a good basis for future interactions with other MNEs	Negotiations for an APA may destabilise existing working relationships between KRA and the MNE
KRA, in appointing an APA program leader with professional expertise, would have a good ‘arbiter’ over issues as a neutral party	While it is presumed there would be good faith negotiations, the parties may reach a deadlock in the APA negotiation process especially if KRA were to assume a position which is incompatible with the MNE’s policies
KRA would reduce the amount of resources used in TP audits since the APA program and reporting procedures would deliver similar results	

Table 4 - Benefits and challenges in introduction of APAs in Kenya³²¹

³²¹ Ekkehart Reimer, Nathalie Urban and Stefan Schmid, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty, and OECD Perspective* (Kluwers Law International 2010); Shirin Rathore, *International Accounting* (PHI Learning Pvt Ltd 2008); Karoline Spies and Raffaele Petruzzi, *Tax Policy Challenges in the 21st Century* (Linde Verlag GmbH 2014); Xinkui Fan, ‘Difficulties in Pressing Forward Advance Pricing Agreement (APA) in China’ 4 *Asian Social Science* 11 (CCSE 2008) 53 – 58; Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); PWC, ‘Certainty in the Uncertain World of Transfer Pricing’ *Whitepaper on APA in India* (PWC 2011) <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 8 May 2015; Michael Lang, *Tax Compliance Costs for Companies in an Enlarged European Community* (Kluwer Law International, 2008).

4.4 CONCLUSION ON THE TP ENVIRONMENT IN KENYA

Kenya has adopted the OECD Guidelines in the national law. KRA administers TP in Kenya, and ensures implementation of the Income Tax Act (Cap 470, Laws of Kenya) and the Income Tax (TP) rules 2006. KRA through the Large Taxpayers Office (LTO) specialised TP unit monitors and ensures compliance with the TP rules, conducts TP audits, and collaborates with other tax revenue authorities to combine efforts on TP revenue authority. While the Act provides that KRA and taxpayers should use the ALP in determining the TP, it does not offer a procedure for its application.

The Income Tax (TP) Rules took effect in 2006 with a purpose to provide guidelines in determining the ALP of goods and services in transactions involving related enterprises. The rules apply to transactions between associated companies. There is no specialised dispute resolution mechanism for TP matters in Kenya, so KRA handles such cases through the normal income tax administrative procedures. Upon exhaustion of the administrative process, a taxpayer aggrieved by the decision of the Local Committee may file an application for judicial review at the High Court to have the decision brought into the Court and quashed.

KRA and MNE taxpayers face a number of challenges including the nascence of the TP unit with inadequate expertise to negotiate effectively with MNEs with years of experience in TP; the general perception that Kenya's legislative, judicial and administrative bodies are insufficiently skilled to identify and deal with cases of TP malpractice; inadequate information system on the activities of MNEs in other jurisdictions; limited number of MNEs or local companies with similar operations, activities or economic strength as the MNEs in question, therefore presenting few or no comparable transactions for ALP determination; and poor draftsmanship of the TP regulations.

APAs are an important mechanism in TP administration, and are a potentially beneficial tool for KRA. One of the best ways for Kenya to battle tax challenges and increase revenue collected is through improved tax revenue authority, which the authority can be achieve through capitalising on the advantages of APAs. The overall benefits of APAs according to this study include certainty and predictability for the MNEs, and saving money for the tax revenue authority.

However, the disadvantages of APAs include a lower standard of uniformity than a tax revenue authority would be predisposed to offer as a public body; insufficient resources required to set up an APA program to administer APAs; high cost of the APA procedure and time consumption for small businesses.

While APAs are a potential avenue to contribute towards improving KRA's capacity to deal with TP issues, Kenya has no provision either in the Income Tax Act or the TP rules, nor structures in place, by which taxpayers may enter into APAs; and KRA has been reluctant to set procedures, practices or policies regarding specific taxpayers or groups of taxpayers.

CHAPTER FIVE

RECOMMENDATIONS AND CONCLUSIONS

5.0 INTRODUCTION TO RECOMMENDATIONS AND CONCLUSIONS

This study has evaluated the TP environment from a global perspective and with specific regard to the systems of arriving at the ALP in the US, UK and India, to draw best practice in the direction Kenya should take through implementing APAs. This Chapter contains the recommendations and conclusions of the study based on the research topic.

5.1 RECOMENDATIONS

This study offers both legislative and policy recommendations on the introduction of APAs in Kenya. First, the legislative recommendations are presented, suggesting changes to the existing legislative framework governing TP in the country. Secondly, the policy recommendations are outlined, providing policy-makers with a basis for alteration of the status quo.

5.1.1 Legislative Recommendations

The Income Tax Act should be amended to make provision at the statute level, for APAs. The legislative provision would bolster the place of APAs in the country's tax regime, and set the stage for formulation of regulations to facilitate the establishment of the KRA APA program. The APA provision should state that KRA may enter into an APA with an MNE for regulation of affairs concerning TP.

Once there is the overarching legislative provision for APAs, the Cabinet Secretary responsible for Finance should formulate guidelines for the creation of APAs. These guidelines should cover unilateral, bilateral and multilateral APAs and their operation. The guidelines should be prepared in conjunction with KRA and tax specialists from Kenya and other jurisdictions, for an internationally sound basis. KRA may borrow from India's APA Pre-filing Application (Appendix 1), India's APA Application Form (Appendix 2) and US Model APA (Appendix 3).

5.1.2 Policy Recommendations

APAs are important to ensure there is certainty in TP development in Kenya. However, Kenya only recently introduced the TP rules to govern the area of taxation of MNEs. Instead of immediately delving into negotiation of APAs with MNEs which have extensive experience in APAs (which may prejudice the tax revenue authority in knowing what to look out for), it may be favourable for KRA to first invest in a pilot APA program to negotiate a few APAs before establishing a fully-fledged APA unit.³²²

The Commissioner for Domestic Tax should spearhead the creation of an APA program to research, negotiate and enter into APAs on behalf of KRA. Under the supervision of the Cabinet Secretary responsible for Finance, this APA program would participate in trainings and other capacity-building sessions both locally and abroad and give KRA an edge in TP revenue authority. KRA would need to recruit specialists in the area of TP from the private sector to build a start-up team that would specifically concentrate on APAs.

³²² UN Department of Economic and Social Affairs, Practical Manual on TP for Developing Countries (UN 2013) 348 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015.

While APAs are tax issues, the teams involved in the APA creation and management program should also include legal practitioners to consider the implications of the set-up of the program. As discussed, KRA would have the option of structuring the APAs either as contracts where both parties are required to uphold their obligations; or as administrative processes subject to judicial review and administrative law. These are just some of the considerations that would be important in establishing a KRA APA team, and the importance of performing such exercises practically cannot be overstated.

Another way in which Kenya can initiate the APA discussion is through preparing APAs with relatively few terms and leaving the rest up for determination and discussion between the MNEs and the tax revenue authority.³²³ This approach would lead to the adoption of the concept of APAs without leaving KRA open to the potential disadvantage of deciding complex issues beforehand, without an experiential perspective of the possible outcome. If the MNEs have dealt with such issues in other countries and already have developed the expertise in how to transact with tax revenue authorities, they may use their experience to gain unfair advantage in the APAs negotiated with KRA.

In keeping the terms few, KRA can ensure that the terms agreed to are not detrimental, and that they do not estop the tax revenue authority from collecting its dues efficiently. Starting on a small scale would sensitize the MNEs on the concept, and in time as KRA continues to learn from the APA in action, it can increase the scope of the APAs to cover the more technical aspects.

³²³ Xinkui Fan, 'Difficulties in Pressing Forward Advance Pricing Agreement (APA) in China' 4 Asian Social Science 11 (CCSE 2008) 53 – 58; UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 348 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015.

The APA pilot program could learn from best practice and set the period of operation of APAs to between 3 and 5 years.³²⁴ Tax revenue authorities in different countries around the world have used 5 years as the APA term and have found that this is a good middle ground between efficient use of available resources e.g. for management of the APAs, and the uncertainties of the developments in the market past the 5 year period.³²⁵ Once this 5 year period has expired, there will be room for KRA and the MNA to renegotiate the terms and set the stage for a further 5 year period based on the outcome of the reviewed APA.

When there is an APA program established and KRA invites MNEs to submit applications for an APA, KRA should request certain information as adapted from the HMRC's application requirements, including details of the parties and the MNE's financial history. The background information and the MNE's financial statements may be between 3-5 years preceding the date of application. The application should identify the issues to be covered by the APA, including a description of the functions played by the related parties, and the way in which the projected financial information is related to these issues. An overview of the global MNE structure showing the equity ownership, functional business workings and the position of the applicant in the global MNE organisation would also be of importance.

The application for an MNE should contain an explanation of the records the MNE will keep to back up the TP method the MNE proposes to incorporate in the APA, a portrayal of existing tax

³²⁴ Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Dispute Resolution: Aligning Strategy and Execution* (IBFD 2011); KPMG, *Advance Pricing Agreement Considerations for India* (KPMG 2011); PWC, 'Certainty in the Uncertain World of Transfer Pricing' *Whitepaper on APA in India* (PWC 2011) 9 <http://www.pwc.in/assets/pdfs/publications-2011/PwC_India_-_White_Paper_on_APA_in_India_2011-130112.pdf> accessed on 13 May 2015.

³²⁵ UN Department of Economic and Social Affairs, *Practical Manual on TP for Developing Countries* (UN 2013) 349 <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed on 30 April 2015.

investigations or tax authority claims that relate to the TP issues which the MNE suggests should be addressed in the APA, and the period that the APA should cover. It should have an assertion of the assumptions made in the determination of the TP method, and a proposition for a bilateral APA with the tax revenue authority in the related MNE group member's country of operation. If needed, the business may make a representation that KRA should use its discretion in sharing trade secrets. This information would benefit KRA in terms of building a database for MNEs and their interactions with TP revenue authority; thereby contributing to transparency in TP operations.

Once the APA program is set up and fully operational, KRA can then consider APAs for SMEs.

5.2 CONCLUSIONS

This section summarises the conclusions made based on the hypotheses posited at the outset of this study.

First, the challenges of complying with TP Rules will be reduced and there will be greater TP compliance with the introduction of APA. This is because, as exhibited from the results in the UK, US and India, APAs introduce certainty into TP administration. When MNEs are certain about the TP system, KRA may collect more information and the MNEs may trade in pertinent data about their firms in consideration for predictability of TP consideration.

Secondly, Kenya will greatly strengthen the tax structures around TP with the introduction of APA and create certainty for investors. KRA is still at its nascent stages in development of TP practice, and may draw lessons from UK, US and India on ways in which Kenya may improve on TP administration and ALP determination. Through creation of an APA programme, KRA may develop its own local experiences which would be beneficial in establishing a base for efficient

ALP determination, to facilitate better revenue collection mechanisms and satisfaction to potential investors.

APAs are an important part of TP revenue authority across the world. As Kenya seeks to implement the TP Rules, there should be increased efforts in establishing an APA Program to enter into and manage APAs. This would put KRA in line with the tax revenue authorities of leading economies in the world, and increase certainty in international taxation.

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APPENDIX 1: INDIA APA PRE-FILING MEETING APPLICATION FORM

FORM NO. 3CEC

[See sub-rule (2) of rule 10H]

APPLICATION FOR A PRE-FILING MEETING

To,

The Director General of Income-tax (International Taxation), New Delhi

Sir,

I propose to apply for an Advance Pricing Agreement. In this regard I give below the necessary particulars for a pre-filing meeting. This application is on anonymous basis.

1 Particulars of the applicant (Not required to be provided where the application is being filed on anonymous basis.)

- a. Full name of the applicant:
- b. Permanent account number:
- c. Address of the applicant:
- d. Location(s) of the business enterprises in India:
- e. Details of applicant authorised representative
- f. Address for communication:
- g. E-mail Id and the contact numbers of the person with whom correspondence is required to be made:

- 2 The global structure of the applicant's group and the industry in which it operates:
- 3 Names of all the associated enterprises (AE's) with which international transactions have been either undertaken or proposed to be undertaken: (Not required to be provided where the application is being filed on anonymous basis.)
- 4 Name of country(s) in which (AE's) is located: (Not required to be provided where the application is being filed on anonymous basis.)
- 5 Business model and overview of the applicant's business operations in prior 3 years:
- 6 Functional and Risk Profile of the applicant and associated enterprises:
- 7
 - a Details of all the international transactions proposed to be covered in the APA:
 - b Value of such international transactions covered under Transfer Pricing audit in prior 3 years:

Assessment Year	Value of transaction (INR)
2010-11	Approx INR million
2011-12	Approx INR million
2012-13	Approx INR million

- 8 Details of all other international transactions not proposed to be covered in the APA:
- 9 Type of APA proposed:
- a Are you proposing a unilateral APA? Yes No
- b If yes the reasons for the same:
- c Are you proposing a Bilateral or Multilateral APA? Yes No
- d If yes, provide the names of the country (ies) in which the associated enterprises are located: (Not required to be provided where the application is being filed on anonymous basis.)
- 10 Number of years for which APA is proposed to be applied:
- 11 Proposed transfer pricing methodology to be used with supporting documentation:
- 12 Identification of third party comparable:
- 13 Details of arm's length price or profit level indicator:
- 14 Details of critical assumptions that the applicant considers, may affect the business or the transfer pricing methodology:
- 15 The history of the Competent Authority issues, requests and settlements: (Not required to be provided where the application is being filed on anonymous basis.)
- 16 History of transfer pricing audits, assessments and present status of appeals:
(Not required to be provided where the application is being filed on anonymous basis.)

17 Names and designation of the representatives who would be appearing before the authorities for pre-filing discussions:

Any other relevant information:

I declare that to the best of my knowledge and belief, the information furnished in the application is correct and truly stated.

Place: Yours faithfully

Date: Applicant (If anonymous no name required)

APPENDIX 2: INDIA APA APPLICATION FORM

Form No. 3 CED

(See sub-rule (1) of rule 10 I)

Application for an Advance Pricing Agreement

To,

The Competent Authority of India

or

Director General of Income Tax (International Taxation)

New Delhi

Sir/Madam,

This is to state that(Name of the Applicant).....wishes to negotiate an APA with the Central Board of Direct Taxes. I am submitting herewith the necessary particulars hereunder:

I. General

1. Particulars of the applicant:

- a.** Full name of the applicant:
- b.** Permanent Account Number:
- c.** Address of the applicant:
- d.** Address for communication:
- e.** Location(s) of the business enterprises in India:

- f. Email id and the contact numbers of the person with whom correspondence is required to be made:
 - g. Names and designation of the authorised representatives who would be appearing before the authorities for negotiations of the APA:
2. Whether pre-filing discussions were sought by the applicant? If yes, please furnish:
- a. Date of application for pre-filing meeting:
 - b. Date of pre-filing meeting(s) with the APA Team:
3. Name(s) of the Associated Enterprises with whom the APA is requested for:
4. Name of the country(ies) in which the associated enterprises mentioned in (3) above are located:
5. a. Are you applying for a Unilateral,
Bilateral or Multilateral APA: Unilateral/Bilateral/Multilateral
- b. If you are applying for a Bilateral or Multilateral
APA, have the Associated Enterprises applied for Yes/ No
APA with the Competent Authority in the
country of its residence?:
- c. If yes, enclose evidence of furnishing such application with the other Competent
Authority:

d. If no, by what date the application is proposed to be furnished to the other Competent Authority:

e. If the application is for Unilateral APA and it involves international transactions with an entity located in a jurisdiction with which India has an agreement under section 90 or 90A of the Act for avoidance of double taxation, kindly provide explanation for why the request is not for bilateral or multilateral APA.

6. Particulars of Fee paid by the applicant: Amount in Rs.

Challan No:

Dated:

7. Period of APA proposed along with the date from which APA is sought to be applicable:

8. Details of the international transactions proposed to be covered in the APA (Description of the property or services to which the proposed APA relates):

9. Proposed Transfer Pricing Method(s):

10. Proposed terms and conditions, and critical assumptions, for the APA:

Critical assumptions could be same as in prefile application.

11. History and background of the applicant and the associated enterprise:

12. General description of business and products/services:

13. Multinational structure, organizational arrangement, operational set-up, including major transaction flows:

14. Identify all other transaction flows of the multinational enterprise (volumes, directions and amounts) that may have an impact on the pricing of the covered transactions:

15. Functional currency for each entity and the currency which is used for the proposed transactions to be covered under the APA:

16. Accounting and costing system, policies, procedures, and practices, including any significant financial and tax accounting differences that may affect the TPMs:

II. Functional analysis

17. Detailed functional analysis of the applicant and all relevant entities with respect to the covered transactions:

18. Business strategies – current and future Budget statements, projections and business plans for future period covered by proposed APA, general business and industry trends, future direction/business strategy including R&D, production, and marketing:

19. Financial and operating information, including corporate annual reports: (Please enclose copies)

- a. Financial statements on a consolidated and unconsolidated basis for the prior five years, or the most recent business cycle as appropriate (Also provide interim statements for the most recent period prior to the date of the submission):
- b. Income tax returns and related supporting schedules for the prior three years including Form 3CEB:
- c. Operating data (gross and net) segmented by product line, division, unit, and geographic region for the prior five years, or the most recent business cycle as appropriate:

20. Relevant marketing and financial studies: (Please enclose copies)

21. Copies of all relevant intercompany agreements (pricing, cost sharing, licensing, distributorship etc.):

III. Industry and market analyses

22. Detailed industry analysis:

- a. Comprehensive description of industry as well as generally accepted industrial and commercial practices:

- b. Identification and general profile of competitors, including respective market shares:
 - c. Industry and general business statistics, financial ratios, and analyses/studies:
 - d. Critical success factors:
23. Detailed analysis of the markets for all countries involved:

IV. Transfer pricing background

24. Discussion of relevant legal considerations and requirements as per:
- a. Indian law
 - b. Foreign law
 - c. Income tax treaty between India and the foreign country
25. Discussion of transfer pricing methodologies, policies, and practices used by the applicant and associated enterprises for the covered transactions during the past three years, or business cycle as appropriate:
26. Discussion of relevant rulings, APAs/BAPAs/MAPAs, and other similar arrangements entered into with foreign tax administrations, for transfer pricing or other valuation bases, or other taxation matters entered into by the applicant (or its associated enterprises) and Indian or foreign tax administrations:

27. Discussion of relevant Indian income tax audit, appeals, judicial and competent authority history:

SL No	FY	Historic information	Level of Appeal	Issues involved	Amounts Involved (NR)	Proceedings before (authority)
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28. Discussion of relevant foreign income tax audit, appeals, judicial and competent authority history:

29. Discussion of un-assessed taxation years (Indian and foreign) and related outstanding tax, legal, and other pertinent issues:

V. Transfer Pricing Methodology analysis:

30. Provide all information, including detailed analyses and explanations needed to establish the appropriateness of a proposed TPM, in accordance with transfer pricing regulations as contained in the Indian Income Tax law:

31. Discussion and analysis of each transfer pricing method, applied or rejected, for each covered transaction. In particular provide details on accepted or rejected internal comparables. (Indicate assumptions, strategies, and policies that may have influenced the acceptance or rejection of each TPM):

32. Summary of selected TPMs and secondary TPMs, if used as a sanity check:

VI. Impact of proposed TPMs

33. Application of the proposed TPMs to the covered transactions for the three prior years' operations or the most recent business cycle, and discuss results:

34. Application of the proposed TPMs to the time period applicant wants the APA to cover and discuss results:

35. Discussion and quantification of the variance, if any, from the methodology applied in section IV:

I declare that to the best of my knowledge and belief, the information furnished in the application is correct and truly stated.

Yours faithfully,

Place:

Date:

Applicant

Notes:

1. Bilateral or multilateral APA application shall be filed with the Competent Authority i.e. the Joint Secretary FT&TR-I, New Delhi in triplicate.
2. Unilateral APA application shall be filed with the Director General of Income Tax (International Taxation), New Delhi in triplicate.

3. If the space provided for answering any item in the application is found insufficient, separate enclosures may be used for the purpose. These enclosures should be signed by the person authorised to sign the application.
4. The fee shall be computed in accordance with the sub-rule (5) of Rule10 I.
5. The application shall accompany with all the relevant documents.

APPENDIX 3: UNITED STATES MODEL IRS MODEL APA³²⁶

ADVANCE PRICING AGREEMENT

between

[Taxpayer]

and

THE INTERNAL REVENUE SERVICE

PARTIES

The Parties to this Advance Pricing Agreement (APA) are the Internal Revenue Service (IRS) and [Taxpayer],

.....

RECITALS

[Taxpayer] is the common parent of an affiliated group filing consolidated U.S. tax returns (collectively referred to as “Taxpayer”), and is entering into this APA on behalf of itself and other members of its consolidated group.

³²⁶ IRS, *Announcement and Report Concerning Advance Pricing Agreements* (IRS 2015) 18 – 22 <<http://www.irs.gov/pub/irs-drop/a-15-11.pdf>> accessed on 30 April 2015

Taxpayer's principal place of business is [City, State]. [Insert general description of taxpayer and other relevant parties].

This APA contains the Parties' agreement on the best method for determining arm's length prices of the Covered Transactions under I.R.C. section 482, the Treasury Regulations thereunder, and any applicable tax treaties.

{If renewal, add} [Taxpayer and IRS previously entered into an APA covering taxable years ending _____ to _____, executed on _____.]

AGREEMENT

The Parties agree as follows:

1. Covered Transactions. This APA applies to the Covered Transactions, as defined in Appendix A.
2. TP Method. Appendix A sets forth the TP Method (TPM) for the Covered Transactions.
3. Term. This APA applies to the APA Term, as defined in Appendix A.
4. Operation.
 - a. Revenue Procedure 2006-9 governs the interpretation, legal effect, and revenue authority of this APA.
 - b. Nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Revenue Procedure 2006-9 (including any proposals to use particular TPMs),

made in conjunction with the APA Request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

5. Compliance.

a. Taxpayer must report its taxable income in an amount that is consistent with Appendix A and all other requirements of this APA on its timely filed U.S. Return. However, if Taxpayer's timely filed U.S. Return for any taxable year covered by this APA (APA Year) is filed prior to, or no later than 60 days after, the effective date of this APA, then Taxpayer must report its taxable income for that APA Year in an amount that is consistent with Appendix A and all other requirements of this APA either on the original U.S. Return or on an amended U.S. Return filed no later than 120 days after the effective date of this APA, or through such other means as may be specified herein.

b. {Use or edit the following when U.S. Group or Foreign Group contains more than one member.} [This APA addresses the arm's-length nature of prices charged or received in the aggregate between Taxpayer and Foreign Participants with respect to the Covered Transactions. Except as explicitly provided, this APA does not address and does not bind the IRS with respect to prices charged or received, or the relative amounts of income or loss realized, by particular legal entities that are members of U.S. Group or that are members of Foreign Group.]

c. For each APA Year, if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the amounts charged in the aggregate between Taxpayer and Foreign Participant[s] with respect to the Covered Transactions.

d. If Taxpayer does not comply with the terms and conditions of this APA, then the IRS may:

i. enforce the terms and conditions of this APA and make or propose allocations or adjustments under I.R.C. section 482 consistent with this APA;

ii. cancel or revoke this APA under section 11.06 of Revenue Procedure 2006-9; or

iii. revise this APA, if the Parties agree.

e. Taxpayer must timely file an Annual Report (an original and four copies) for each APA Year in accordance with Appendix C and section 11.01 of Revenue Procedure 2006-9. Taxpayer must file the Annual Report for all APA Years through the APA Year ending [insert year] by [insert date]. Taxpayer must file the Annual Report for each subsequent APA Year by [insert month and day] immediately following the close of that APA Year. (If any date falls on a weekend or holiday, the Annual Report shall be due on the next date that is not a weekend or holiday.) The IRS may request additional information reasonably necessary to clarify or complete the Annual Report. Taxpayer will provide such requested information within 30 days. Additional time may be allowed for good cause.

f. The IRS will determine whether Taxpayer has complied with this APA based on Taxpayer's U.S. Returns, the Financial Statements, and other APA Records, for the APA Term and any other year necessary to verify compliance. For Taxpayer to comply with this APA, {use the following or an alternative} an independent certified public accountant must render an opinion that Taxpayer's Financial Statements present fairly, in all material respects, Taxpayer's financial position under U.S. GAAP.

g. In accordance with section 11.04 of Revenue Procedure 2006-9, Taxpayer will (1) maintain the APA Records, and (2) make them available to the IRS in connection with an examination under section 11.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

h. The True Taxable Income within the meaning of Treasury Regulations sections 1.482-1(a)(1) and (i)(9) of a member of an affiliated group filing a U.S. consolidated return will be determined under the I.R.C. section 1502 Treasury Regulations.

i. {Optional for US Parent Signatories} To the extent that Taxpayer's compliance with this APA depends on certain acts of Foreign Group members, Taxpayer will ensure that each Foreign Group member will perform such acts.

6. Critical Assumptions. This APA's critical assumptions, within the meaning of Revenue Procedure 2006-9, section 4.05, appear in Appendix B. If any critical assumption has not been met, then Revenue Procedure 2006-9, section 11.06, governs.

7. Disclosure. This APA, and any background information related to this APA or the APA Request, are: (1) considered "return information" under I.R.C. section 6103(b)(2)(C); and (2) not subject to public inspection as a "written determination" under I.R.C. section 6110(b)(1). Section 521(b) of Pub. L. 106-170 provides that the Secretary of the Treasury must prepare a report for public disclosure that includes certain specifically designated information concerning all APAs, including this APA, in a form that does not reveal taxpayers' identities, trade secrets, and proprietary or confidential business or financial information.

8. Disputes. If a dispute arises concerning the interpretation of this APA, the Parties will seek a resolution by the Director of the Advance Pricing and Mutual Agreement Program, to the extent reasonably practicable, before seeking alternative remedies.

9. Materiality. In this APA the terms “material” and “materially” will be interpreted consistently with the definition of “material facts” in Revenue Procedure 2006-9, section 11.06(4).

10. Section Captions. This APA’s section captions, which appear in italics, are for convenience and reference only. The captions do not affect in any way the interpretation or application of this APA.

11. Terms and Definitions. Unless otherwise specified, terms in the plural include the singular and vice versa. Appendix D contains definitions for capitalized terms not elsewhere defined in this APA.

12. Entire Agreement and Severability. This APA is the complete statement of the Parties’ agreement. The Parties will sever, delete, or reform any invalid or unenforceable provision in this APA to approximate the Parties’ intent as nearly as possible.

13. Successor in Interest. This APA binds, and inures to the benefit of, any successor in interest to Taxpayer.

14. Notice. Any notices required by this APA or Revenue Procedure 2006-9 must be in writing. Taxpayer will send notices to the IRS at the address and in the manner set forth in Revenue Procedure 2006-9, section 4.11. The IRS will send notices to:

Taxpayer Corporation

Attn: Jane Doe, Sr. Vice President (Taxes)

1000 Any Road

Any City, USA 10000

(Phone: _____)

15. Effective Date and Counterparts. This APA is effective starting on the date, or later date of the dates, upon which all Parties execute this APA. The Parties may execute this APA in counterparts, with each counterpart constituting an original.

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: _____ Date: _____, 201__

Jane Doe

Sr. Vice President (Taxes)

IRS

By: _____ Date: _____, 201__

Hareesh Dhawale

Director, Advance Pricing and Mutual Agreement Program