TRANSFER PRICING REGULATION IN KENYA: A CRITIQUE

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BY

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DECLARATION

I, JOASH RATEMO MOSOTA, do hereby declare that this Research Paper is my original work and has not been submitted for a degree in any other University.

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DEDICATION

This work has been dedicated to my dear mother Priscah Moraa and my dear deceased father Paul Mosota Onchiri who sacrificed so much to give me the light of education and has been a constant inspiration in my life. May this small achievement be a beacon of light for many of their off springs to see the light at the end of the tunnel and then move beyond.

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Lastly, and most importantly, I wish to acknowledge God for granting good health and a sound mind and seeing me through. This far, He has guided me.

ABSTRACT

This study analyses the current Transfer Pricing ('TP') legal framework in Kenya, the challenges experienced by the Kenya Revenue Authority (KRA) in evaluating the transfer price and proposals for redressing them. This is benchmarked against international best practices provided by the Organization for Economic Co-operation and Development Transfer Pricing Guidelines ('OECD TP guidelines'), the United Nations Tax Model Convention on Transfer Pricing ('UN Tax Model') and guidelines from the World Trade Organization ('WTO') on customs valuation. The key argument made is that there is a very weak legal framework in the area of transfer pricing that threatens to make the current Kenya TP legislation not be able to withstand legal challenges.

The study critically evaluated the existing institutional framework for the implementation of transfer pricing regulations. The study analyses the institutions vis a vis the transfer pricing application in other jurisdictions and provides areas for reform.

The study also analyses the Unilever case and its aftermath as a case study. The study highlights the inadequacies of the Income Tax (TP) regulations. These rules also differ from the Customs valuation methods posing a challenge while dealing with adjustments by revenue authorities. The study also looks at some of the challenges faced by Kenya in implementing the OECD approach. This study therefore explores the differences between UN model and OECD model and recommends areas of synergies.

In conclusion, the study established that the current legal and institutional framework for TP in Kenya is inadequate and in need of reforms. As such, recommendations are made for strengthening the legal, policy and institutional framework for TP in Kenya in line with international best practices.

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GLOSSARY/LIST OF ABBREVIATIONS

Detailed descriptions and explanations of terms and abbreviations relevant to this study are listed below. These descriptions and explanations serve to clarify the paper and are not intended to be authoritative:

Term	Description
'Arm's Length Principle'	The Arm's Length Principle requires that transfer prices charged between related parties are equivalent to those that would have been charged between independent parties in the same circumstances.
'ALP'	Arm's Length Principle
'ALS'	Arm's Length Standard
'APA'	Advance Pricing Agreement
'ATAF'	Africa Tax Administration Forum (ATAF)
'CDT'	Commissioner of Domestic Taxes
'CIT'	Corporate Income Taxes
'Controlled Transaction'	A transaction affected by TP provisions of the Act and TP rules
'Cost Plus Method'	A method of pricing based on costs incurred plus a percentage of those costs
'COMESA'	Common Market for Eastern and Southern Africa (1994)
'CUP'	Comparable Uncontrolled Price method- A method of pricing based on price charged between unrelated parties in respect of comparable transactions in comparable circumstances
'DTA'/'DTT'	Double Taxation Agreement or Treaty
'EACCMA'	East African Community Customs Management Act, 2004
'FY'	Financial Year
'HMRC'	Her Majesty's Revenue and Customs
'ITA'	Income Tax Act (Cap 470, Laws of Kenya)
'ITSA'	IT Systems Administrator
'KES'	Kenya Shilling
'KRA	Kenya Revenue Authority
'LIBOR'	London Interbank Offered Rate
LDC	Least Developing Countries
'Ltd'	Limited
'MNC'	Multinational Corporation
'NSE'	Nairobi Stock Exchange
'OECD'	Organisation for Economic Corporation and Development
'OECD Guidelines'	OECD's TP Guidelines for Multinational Enterprises and Tax Administrations
'PBIT'	Profit Before Interest and Tax
'PE '	Planning Engineer
'PLI'	Profit Level Indicator/Net Profit Indicator
'Profit split method (PSM)'	A TP method used to evaluate whether the allocation of combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each participant's contribution to that profit or loss.
'Resale Price Method'	A method of pricing based on the price at which a product is resold less a percentage of the resale price.
'ROTC'	Return on total cost
'Tested	Transactions in this report tested for

Transactions'	consistency with the TP provisions of the Act and the TP Rules
'TIEA'	Tax Information Exchange Agreements
'TP'	Transfer Pricing
TP Rules	Kenya Income Tax (TP) Rules, 2006 , Legal Notice No. 67 of 2006
'TSO'	Transport & Security Officer
'Transactional net margin method ("TNMM")'	A TP method based on an analysis of the operating profit delivered by a business from a particular related party transaction or group of transactions.
'UKL'	Unilever Kenya Limited
'UUL'	Unilever Uganda Limited
'UN'	United Nations
'USD'	US Dollars
'VAT'	Value Added Tax, a tax on products or services charged at a point of sale.
'WTO'	World Trade Organization

TABLE OF CASES AND STATUTES

List of Cases

1. Unilever Kenya Ltd (formerly East Africa Industries Limited) v Commissioner of Income Tax.
2. IRC v Duke of Westminster.
3. Ayrshire Pullman Motor Services & Ritche v Inland Revenue Commissioners.

List of Statutes

1. Income Tax Act as amended by Finance Act 2012.
2. Finance Bill 2012/2013.
3. The Income Tax Act (Transfer Pricing) Rules, 2006
4. Customs & Excise Act.
5. East African Customs Management Act, 2004.
6. Value Added Tax Act.
7. The Constitution of Kenya, 2010.

Conventions and International Instruments

1. The Organisation of Economic Co- operation and Development (OECD) Model Tax Convention on Income and Capital.
2. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995.
3. United Nations Conference on Trade and Development, 'Transfer Pricing' United Nations Publication.
4. The United Nations Model Double Taxation Convention between Developed and Developing Countries.
5. General Agreement of Tariffs and Trade (GATT).

CHAPTER ONE: SETTING THE AGENDA FOR THE STUDY

1.1 BACKGROUND OF THE STUDY

This study analyses the current Transfer Pricing ('TP') legal framework in Kenya, the challenges experienced by the Kenya Revenue Authority ('KRA') in evaluating the transfer price and proposals for redressing them. This is benchmarked against international best practices provided by the Organization for Economic Co-operation and Development Transfer Pricing Guidelines ('OECD TP guidelines'),[1] the United Nations Tax Model Convention on Transfer Pricing ('UN Tax Model')[2] and guidelines from the World Trade Organization ('WTO') on customs valuation.[3]

TP can be defined as the allocation of profits for tax and other purposes between parts of a Multinational Corporation ('MNC').[4] TP also refers to the setting, analysis, documentation and adjustment of charges made between related parties for a good, service, or use of property (including intangible property). There is a risk that the prices may be manipulated by business entities, which trade in more than one country to raise prices in a tax favourable regime in order to compensate the losses on profits they have suffered in unfavorable regimes. TP has evolved because of the necessity by tax authorities and governments to arrive at the 'right' price.[5]

The rationale behind reforming the TP legislation is that if not checked, a large proportion of the income of MNCs, which have affiliates in Kenya, would be shifted to jurisdictions or countries

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[1] OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, available at: www.oecd.org/ctp/tp/guidelines, (last accessed 15th November, 2012).

[2] United Nations (2011), *Model Double Taxation Convention between Developed and Developing Countries*, available at: http://unpan1.un.org/intradoc/groups/public/documents/un/unpan002084.pdf, (last accessed 15th November, 2012).

[3] WTO (1998), *Agreement on Implementation of Article Vii of the General Agreement on Tariffs and Trade 1994 (WTO Valuation Agreement),* available at: http://www.worldtradelaw.net/uragreements/customsvaluation agreement.pdf, (last accessed 15th November, 2012).

[4] OECD (January 2002), *Transfer Pricing: Keeping it at Arm's Length,* available at: http://www.oecdobserver.org/ news/ archivestory.php /aid/670/ Transfer_pricing:_Keeping_it_at_arms_length.html, (last accessed 15th November, 2012).

[5] UN (2011), *An Introduction to Transfer Pricing: Background Paper and Working Draft*, paper prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, p. 6, available at: http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter1_Introduction.pdf, (last accessed 15th November, 2012).

with lower tax rates and deny the country its fair share of revenue.[6] As such, TP can also be used by MNC to deprive recipient governments such as Kenya of their fair share of taxes from global corporations and expose MNCs to possible benefits of double taxation which they have not negotiated for.

The OECD and the UN have provided guidance that countries can adopt on tax related issues in order to prevent double taxation and loss of revenue. This is in form of OECD TP Guidelines for Multinational Enterprises and Tax Administrations ('OECD TP Guidelines') based on the OECD Model Tax Convention on Income and Capital ('OECD Tax Model') and the UN Tax Model respectively.

The substantive law governing TP in Kenya is Section 18(3) of the Income Tax Act (ITA).[7] This section requires business carried on between a non resident and a related Kenya resident person to be conducted at arm's length. The commissioner has powers to adjust the profits of the Kenya resident from that business to the profits which would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length. Section 18(8) of the ITA gives the Minister power to make rules to provide guidelines of the arm's length value of transactions for purposes of the section and to specify requirements necessary for the better carrying out of the provisions of the section. The Minister published the Income Tax (TP) Rules in 2006.[8]

The decision in the *Unilever Kenya Limited v The Commissioner of Income Tax (Unilever case)* [9] provided the impetus for the introduction of the said rules which provide a frame work on the application of the arm's length principle ('ALP'). The court in the Unilever case endorsed the use of the OECD guidelines in the absence of detailed guidelines from the KRA. The KRA

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[6] Ratemo Joash (2011), *Minister's Tax TP Proposal Short of Expectations*, available at: http://www.businessdaily africa.com/Opinion+++Analysis/Ministers+tax+transfer+pricing+proposal+short+of+expectations/539548/949884/-/item/0/-/6f30cc/-/index.html, (last accessed 15th November, 2012).
[7] Section 18(3), *Income Tax Act*, available at: http://www.kra.go.ke/notices/pdf2011/it-act-2010.pdf, (last accessed 15th November, 2012).
[8] *Income Tax (Transfer Pricing) Rules 2006*, Legal Notice No. 67 of June 2006, available at: http://www.kenyalaw. org /klr/index.php?id=619, (last accessed 15th November, 2012).
[9] H.C. Income Tax Appeal No. 753 of 2003, [2005] eKLR 1, delivered by Visram J on 5 October 2005, Available at: http:/.www.kenyalaw.org/klr/index (last accessed 15th November, 2012).

responded with the introduction of the said rules. These rules provide guidelines on the application of the ALP.

Despite the statutory provisions, it is becoming increasingly difficult to regulate TP, not only in Kenya, but also in many developing countries.[10] It is difficult to determine the standard to be applied in determining the Arm's Length Standard ('ALS') and the appropriate adjustments that need to be made to be able to recover tax lot from transfer prices. Given the differential corporate tax rate in various countries, it is difficult to regulate TP as there is no internationally accepted tax rate that is binding. There are loopholes in the existing TP regulations that undermine the legal validity, effectiveness and pose administrative challenges. These challenges include ambiguities in the provisions, general ignorance of the stakeholders on TP issues, lack of technical capacity among others. There are also other rules under the customs laws and the WTO Agreement on Customs Valuation, which differ from the TP rules, posing confusion in the application especially between the customs revenue officers and domestic tax revenue officers. In addition, TP adjustments would affect the prices declared for customs purposes and in turn affect the base for Value Added Tax ('VAT') and excise duty on imported goods.

The OECD published its guidelines based on the ALP.[11] This study interrogates the suitability and application of the OECD guidelines in the Unilever case because these guidelines greatly influenced the decision of the judge, analyses the value of adopting the OECD guidelines and analyses the effectiveness of the TP legal and institutional regime in Kenya. This study is motivated by my experience as a TP Consultant and Tax Manager at Ernst & Young and PricewaterhouseCoopers respectively. During my experience, I have noted that arriving at ALS under Kenya's current TP legislation is a very subjective process leaving room for many disputes on whether the price adopted in a transaction meets the ALS hence the need to look further into best practices. I have also noted differences between the TP methods and Customs valuation methods which often pose challenges in cases of adjustments by the revenue authority.

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[10] European Union (2010), *Transfer Pricing and Developing Countries: Final Report*, p. 5, available at: http://ec.europa.eu/europeaid/what/economic-support/documents/transfer-pricing-study_en.pdf (last accessed 15th November, 2012)
[11] *ibid*, p. 8.

The study highlights the inherent weaknesses in the current TP framework and makes suggestions on the way forward while borrowing from best practices internationally.

1.2 STATEMENT OF THE PROBLEM

Before the promulgation of the Income Tax (TP) guidelines in 2006, TP in Kenya was regulated under the anti- avoidance provisions in sections 18(3) and 23 of the Income Tax Act. The VAT and the Customs legislation had general provisions that implied the use of the ALS for inter-company transactions. These provisions set out the general provisions of anti- avoidance and TP manipulation but do not offer sufficient guidance on how to arrive at the ALP for TP purposes. It was also not clear whether the international legal instruments and conventions could be applicable.

After the decision of the Unilever case, the Income Tax (TP) regulations were enacted in 2006 as guidelines in determining the ALP of related party transactions which are largely similar to the OECD regulations. The court held that the OECD guidelines would be applied in the absence of express domestic provisions and as such tax would not be levied against a tax payer who had properly demonstrated the application of the OECD guidelines in their TP documentation.

The inadequacy of the Income Tax (TP) regulations there forms the research problem for the study. Firstly, it is not clear how legally enforceable the regulations are as they seem to be mere guidelines. This implies that MNC's have an option to apply them or dis-apply them.

Second, there was no attempt to domestic the rules to suit the special circumstances of the Kenyan economic and taxation environment. The unavailability of local comparable transactions to determine the ALP also poses challenges.

Thirdly, these rules differ from the Customs valuation methods posing a challenge while dealing with adjustments by revenue authorities. The regulations need to be aligned with the Customs valuation methods to ensure harmonization of the inter company transfer prices.

There is also a challenge in the approach that Kenya adopted the OECD approach. This approach favours MNCs as opposed to developing countries like Kenya. This study therefore explores the differences between UN model and OECD model and recommends areas of synergies.

The study also identifies some need for enhance ment of both institutional and technical capacity at KRA and also of tax payers to enable them deal with the TP question. The focus of this study is to evaluate these challenges within the existing TP legal framework and suggest ways of redressing them in line with international best practices in order to beef up the legal framework.

1.3 SIGNIFICANCE OF THE STUDY

As noted above, the current TP legal framework is inadequate in dealing with the TP problem. On losing the case, KRA dropped a similar case against Sara Lee before it developed national rules on transfer pricing in the 2006/7 financial year that have guided self-evaluation by companies to the present time.[12] Up to date, there is no similar case that has been filed again, partly due to lack of vigilance in enforcing the rules by KRA and also the presence of rules, guiding the players in such transactions. However, the rules adopted after the Unilever case continue to create more confusion and cannot withstand legal controversies.

This study is critical at this point in time because, with the increased level of cross border transactions and advancement in technology, Kenya needs to be ready to deal with TP challenges and disputes that will arise. Therefore, the study appraises the legal and institutional framework on TP in Kenya and compares it with other countries that have successfully adopted workable TP solutions. The findings of the study will form the basis for proposals to strengthen the legal and institutional framework for TP and customs valuation in Kenya.

This study also makes recommendations which, if acted upon, will contribute to transforming the existing regime and make it more relevant and acceptable. It is intended to contribute not only in highlighting those loopholes that exist but also suggest areas to strengthen TP legislation.

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[12] The Standard (28th August, 2012), *Court Case Changed KRA's View on Transfer Pricing*, available at: http://www.standardmedia.co.ke/index.php?articleID=2000064922&pageNo=2&story_title=Court-case-changed-KRA%E2%80%99s-view-on-transfer-pricing, (last accessed 15th November, 2012).

1.4 OBJECTIVES OF THE STUDY

The main objective of the study is to identity the inadequacies and challenges in the Kenya legal and institutional framework of TP and make recommendations for reform. The study applies the Unilever case, its aftermath as well as borrowing from International instruments.

The study has the following specific objectives:

1. To examine the historical application of TP methods in Kenya through analysis of the Courts decision in Unilever case;
2. To evaluate the current legal regulatory framework for TP in Kenya, in comparison with relevant aspects from international instruments and best practices; and
3. To propose reforms necessary in the regulatory framework on TP in Kenya.

1.5 RESEARCH QUESTIONS

The study addresses the following questions:

1. Was the Court right in applying the OECD guidelines in the Unilever case?
2. Is the legal and institutional framework on TP in Kenya adequate?
3. How does the TP legislation in Kenya compare with relevant international best practices?
4. What is the relationship between the TP methods and the Customs valuation method?
5. What legal reforms are necessary to address the shortfalls of the current TP legal framework in Kenya?

1.6 RESEARCH METHODOLOGY

The TP area of tax law is a very novel area. This study employed a qualitative approach in the collection and analysis of the data necessary for the research, due to its suitability for analyzing perceptions of persons. The study required data on the Unilever case, including the arguments in court and the court decision. It also required data on how TP is treated in other jurisdictions. It finally required data on weaknesses within the Kenyan legal and institutional framework on TP.

The data was sourced from various sources. The study analyzed primary sources of data including; the Income Tax Act, the Income Tax (Transfer Pricing) Rules, 2006, Finance Act

2012, East African Customs Management Act, 2004, Value Added Tax Act, the Constitution of Kenya, 2010, the OECD Model Tax Convention on Income and Capital, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995, the UN Model Double Taxation Convention between Developed and Developing Countries and General Agreement of Tariffs and Trade (GATT). These were analyzed to establish the legal rules, regulations and guidelines on transfer pricing. The study also relied on secondary sources of data. These include books, journal articles, newspaper articles and even theses written by others. These materials provided useful information regarding the regulatory framework, practical considerations, indicators and impact of TP. They established the views of other persons on transfer pricing regulatory regime in Kenya.

In the qualitative approach, there are three main methods for collecting data; focus groups, direct observation and in-depth interviews.[13] This study shall apply the method of in-depth interviews. Such interviews collected information from respondents as to what their views are on challenges that have faced TP regulation in Kenya. Their opinion on the reforms Kenya needs to effect so as to have an efficient TP system were also sought.

In depth interviews were conducted with three persons knowledgeable on Transfer Pricing. The respondents were selected through judgment sampling method. This method was used as it helps identify the respondents with most information. Three persons were interviewed. The first respondent (TMP) was a Senior Manager at PricewaterhouseCoopers (PwC) Kenya. The second respondent (PCP) was a Senior Assistant Commissioner and a manager in charge of the TP Unit in KRA. PCP provided useful information on the impact of TP in Kenya, the challenges and proposed reforms of TP regulation under the income tax law. His insights were based on his practical experience at KRA and interactions with other revenue bodies and other stakeholders at various international forums. The third respondent (STP) was a Senior Manager in the International Tax and Transfer Pricing Advisory Services of Ernst and Young[14].

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[13] Pennisula Research Development & Support Unit (2011), *Qualitative Research Methods*, p. 2-44, available at: http://projects.exeter.ac.uk/prdsu/helpsheets/Helpsheet09-May03-Unlocked.pdf, (last accessed 9th February 2012).
[14] Ernst and Young is an audit firm of International practice (www.ey.com).

Justification for Interviewees

The first and third respondents (STP and TMP) were chosen because of their practical experience in audit and tax advisory firms. Due to the accountancy nature of the legal implications of TP, audit and tax advisory firms in the researchers' opinion, are representatives of the stakeholders involved. PCP's practical experience in KRA represented the perspective of the tax administrators. All the respondents are persons who apply TP regulations and therefore have first hand information on the challenges.

1.7 HYPOTHESIS

The study sets out to test the following hypothesis;

The legislative framework on TP in Kenya is poorly equipped to deal with many of the legal challenges that arise from TP disputes in a globalized economy.

1.8 CONCEPTUAL FRAMEWORK

This study deals with the concept of TP and the weaknesses in the TP legislation. Ideally, taxation is an important process in the economic development of any state since it is a source of revenue to support government expenditure on social welfare services and infrastructure development. It must therefore have both a strong theoretical and practical foundation. A wholesome perspective requires a government to observe the canons of taxation by avoiding arbitrariness and ambiguity, while setting tax regulations that are certain, clear and equitable for the corporations to observe.[15] Such a view conforms to the provisions of the Constitution of Kenya, which provides that, 'every person has the right to administrative action that is expeditious, efficient, lawful, reasonable and procedurally fair'.[16]

MNC's show more interest in investing in countries where the legal framework, inter alia, allows them to repatriate the bulk of their profits. One way in which this has been accomplished is through investing in low tax countries or states which display little regulation of TP mechanisms. Evidence shows that many of them take advantage of the ineffective legal regulatory mechanisms

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[15] Chris Wales (ed) (2008), *Fair Tax: Towards A Modern Tax System*, p. 5, Published by the Smith Institute ISBN 1905370342, available at: http://denning.law.ox.ac.uk/tax/documents/FairTaxTowardsamoderntaxsystem.pdf, (last accessed 17th November, 2012).

[16] Constitution of Kenya 2010, Art.47 (1), available at: Kenyalaw.org

to pay less tax than they are required to.[17] This wrecks havoc on the recipient (developing countries) in terms of balance of payments distortions and resulting to foreign loans to fill in the shortfall which further translates into poor infrastructural development or lack thereof.[18]

Few tax payers enjoy paying taxes, although many regard it as a public duty to pay their fair share of the money required by the government to provide social services. This is also true about MNC s. If they were to work with the tax authorities in good faith, TP would be a boon but it has an added risk that it could be used to shift profits into low tax jurisdictions even if little business is carried on.[19] This necessitates trade and tax distortions.

The concept of TP is informed by the awareness that MNC can evade a large portion of their statutory tax burden by manipulating transfer prices in cross border. The reason for the shifting of the profits between jurisdictions using TP is due to the differences in corporate tax rates between nations.[20] By under pricing intra-company sales and over-pricing intra-company purchases, a subsidiary located in a high tax country can increase the multinational's overall profit since the parent's gain in after tax profit is higher than the subsidiary's net of tax.

MNCs based in the developing world set artificial transfer prices due to the existence of tariffs, especially if it is based on the price of a commodity.[21] When such a commodity is under invoiced in the course of intra-company sales it serves as a tax saving device. A third motivation for using transfer prices to shift profits arises when international tax codes imply double taxation of a subsidiary's distributed profits.[22] This occurs when the host country of an affiliate collects withholding taxes on dividends that are not credited in the home country. Similarly it may occur when the home country employs a deduction rather than a credit system to tax foreign income.[23]

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[17] McNair David, Dottey Rebecca and Cobham Alex (2010), *Transfer Pricing, and the Taxing Rights of Developing Countries*, p. 7, available at: http://www.christianaid.org.uk/images/CA_OP_Taxing_Rights.pdf, (last accessed 17th November, 2012).
[18] Agrawal Mayank K. (2010), *TP: A Beginners Perspective*, p. 2, available at: www.sars.co.za/Tools/Documents/DocumentDownload.asp?FileID (last accessed 17th November, 2012).
[19] Weichenrieder, Alfons J (1996), *TP, Double Taxation and the Cost of Capital*, p. 446, Scandinavian Journal of Economics 98 (3), 445-452, available at: www.jstor.org/stable/3440737, (last accessed 17th November, 2012).
[20] *ibid*, p. 447.
[21] *supra*, note 17, p. 3.
[22] *ibid,* p 4.
[23] *supra,* note 10, p. 8.

In both cases, a multinational saves if it repatriates profits by setting artificial transfer prices rather than pay dividends.

The effect of this type of arrangement[24] is the loss of government tax and custom duty, which further leads to a burden on the rest of the population through over taxation and borrowing by the governments in order to meet the expenditure gaps It may also lead to the distortion in the balance of payments in the host country, as well as challenge the sovereignty of such nations given the large size of some MNCs. Furthermore the emphasis on the overall global profits makes these corporations take business where the tax burdens are low which ultimately affects the location of international production and employment. This partly explains why Hong Kong and Singapore up to very recently did not have TP controls which made them attractive destinations for FDIs as tax havens.[25]

For Kenya to get its fair share of revenue from two related parties one of which is resident, it must be based on ALP. ALP is a well accepted principle by countries that have encapsulated the approach taken by the OECD[26] and the UN Model Convention on Double Taxation.[27]

The idea behind ALP is that transactions within a group are comparable to those between unrelated entities in order to determine acceptable transfer prices. Therefore, the market acts as the benchmark for verification of transfer prices for intra-entity and intra-group transactions for the purposes of taxation. The rationale for this principle is that it is a common sense one where the market generally governs transactions in an economy, therefore both intra-entity and intra-group transactions should be equivalent to those between independent entities.[28] That is why the principle is acceptable across the board.

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[24] For more on effects of profit repatriation, see NBS Television (August 7, 2012), *The Rate of MNC's Profit Repatriation Worry Ugandans*, available at: http://www.nbs.ug/2012/08/07/the-rate-of-mncs-profit-repatriation-worry-ugandans, (last accessed 18th November, 2012).
[25] *supra*, note 17, p. 2.
[26] Article 6, OECD Guidelines, *supra*, note 1.
[27] Article 9, UN Model Convention, *supra*, note 2.
[28] *supra*, note 5, p. 9.

Besides that the ALP is geographically neutral, as it treats profits and investments in both source and resident jurisdictions equally. The neutrality can only be sustainable if all players are using consistent rules and administration of the ALP throughout the jurisdictions in which international enterprises operate. The absence of this provides the MNCs with an incentive to avoid taxation through TP manipulation.[29]

The existence of low tax jurisdictions also known as tax havens motivates MNCs to engage in intra-firm shifting of profits. MNCs have no incentive to shift profits if the tax obligations and structures in the home country are the same as those in the host or recipient countries. Existence of tax havens is one of the factors that motivate MNCs engagement in TP manipulation.[30] TP can directly affect the amount of profit reported in a country by an MNC which in turn affects the tax revenues of that country. Of concern to regulatory organs is transfer price manipulation and not TP.[31] The governments driven by this motive have put in place measures to address TP manipulation.

The study will therefore deal with the concepts of MNC, tax haven, ALP, TP and TP manipulation in light of the existing legal framework and best international practices.

1.9 LITERATURE REVIEW

Empirical analysis of TP within Kenya has been severely limited by the lack of literature, this is partly because Kenya's tax authority's experience with TP has been fairly short going back to 2006 when the Income Tax (TP) Rules were introduced. Locally, only three research papers have attempted to comprehensively address this subject.

Mwangi[32] focuses on the extent to which Kenya's tax law caters for TP. The paper explores the inadequacy of the legal framework on TP encapsulated in Section 18 (3) of the Income Tax Act

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[29] *ibid*, p. 10.
[30] Bhat Ganapati (2009), *Transfer Pricing, Tax Havens and Global Governance*, German Development Institute, p. 16, available at: http://www.tax justice.net/cmc/upload/pdf (last accessed 19 November, 2012).
[31] Eden Lorraine (2001), *International Taxation, TP and the Mutinational Enterprise*, In Alan Rugman and Thomas Brewer (eds.), Oxford Handbook of International Business (Oxford Univeristy Press, London, UK), p. 598.
[32] Mwangi, Rispah M (2008), *Transfer Pricing: Does Kenya's Law Provide Adequately for This?* LLM Thesis, University of Nairobi (unpublished).

which displays the lack of clarity in its provisions. The other issues dealt with include the operationalization of the ALP which in the opinion of the author has brought more confusion for both the taxpayer and tax authorities. Since litigation in this area is rare, the Unilever case is considered as relevant in so far as it was the first step in the domestication of the OECD TP Guidelines in Kenya. However the paper does not extensively benchmark with best practices in other jurisdictions as a yardstick to measure the effectiveness and efficiency of the Kenya's TP mechanism. This study goes further to focus on the wider ramifications of the confusion created by the lack of clear TP guidelines and makes recommendations that would improve the system.

Githinji[33] analyses the legal and administrative challenges in the implementation of the TP legislation. The paper emphasizes more on administrative reforms and falls short of making comparisons between the current legal regime in Kenya and various regimes applicable under best international practices. This study shall go further to demonstrate additional considerations required from a legal perspective, than the ones discussed by Githinji's paper.

Mbiuki[34] discusses the Unilever Case. The paper highlights the significance of the ruling in the Unilever case and considers whether the existent legal and institutional framework is adequate to deal with TP manipulation. In comparison, this study is more extensive in analyzing the Income Tax Act and TP regulations, the Unilever case and aspects of the OECD model convention and UN model convention with the aim of identifying gaps and making suggestions on the way forward. The study introduces a new dimension, that is, the interplay between customs valuation methods and TP and makes recommendations for harmonization of the legislation.

The reasons for the increasing interest in TP in Kenya and other jurisdictions have been properly canvassed above. Globally, there exists rich literature on the issue. Alecu (2010)[35] examines the triggers and responses to TP. Apart from the effects of globalization, the paper views the other trigger as being forced on tax authorities and governments by the tough economic times

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[33] Githinji Ann J. W Ng'ang'a (2011), *The Kenya Income Tax Law: Its Inadequacies in the Regulation of Transfer Pricing*, LLM Thesis, University of Nairobi (unpublished).
[34] Mbiuki Jasper (2011), *The Legal and Institutional Framework of Transfer Pricing in Kenya: A Case Study of the Unilever Case and its Aftermath*, LLM Thesis, University of Nairobi (unpublished).
[35] Teodora Alecu (2010), *TP in 2010 and Forwards*, economics of Knowledge, *2010*, vol. 2, issue 4, pages 23-31, available at: econpapers.repec.org/RePEc:eok:journl:v:2:y:2010:i:4:p:23-31, (last accessed 18th November, 2012).

experienced during the global economic down turn. This has translated into less tax for tax authorities because companies are experiencing slashed profits, rising unemployment and diminishing incomes.[36] In response, tax authorities have intensified their efforts to collect revenue, conducting more frequent audits and clamping down on tax avoidance and evasion in an effort to increase the tax base. The recession has witnessed more events that prompt tax authorities to conduct audits such as corporations reporting substantial losses, closures that alert the tax authorities to the existence of masking tax liabilities.[37]

The concept of TP is viewed in accounting terms by the MNC s as a technique for optimal allocation of costs and revenue among divisions, subsidiaries and joint ventures among related entities. According to Sikka,[38] MNCs are always looking for opportunities to allocate resources to where they will earn the greatest advantage in order to reduce the taxable income.[39] MNC's abuse TP for private gain and have been criticized for contributing to social impoverishment. Baker[40] argued that TP is used by every MNC to shift profits at will around the globe due to the absence of a strict international TP regime

A PricewaterhouseCoopers report[41] highlights the importance of the legal regulation of TP to the Kenyan economy, the legislative foundation of TP in Kenya and the capabilities of KRA in effectively monitoring TP practices. The key issues discussed in this report include; the economy being largely driven by the private sector with a large contribution by MNCs whose total share of government revenue in terms of taxation being equally large. The inability of the tax authorities to effectively monitor and assess complex cross-border transactions provides a loophole that is exploited by MNC s to pay less than the expected amount of tax due. The report estimates that there is also the lack of financial information on the performance and profitability of MNC s outside Kenya but having holding companies in the country. This is beside the unavailability of local comparables to the home companies which impedes the ability of KRA to effectively

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[36] *supra*, note 35, p. 24.
[37] *ibid*, p. 28.
[38] Sikka, Prem and Hugh Wilmott (2010), *The Dark Side of TP: Its Role in Tax Avoidance and Wealth Retentiveness*, Critical Perspectives on Accounting Vol. 21, p. 42.
[39] *ibid*, p. 33
[40] Baker, R.W (2005), *Capitalism's Achilles Heel*, (New Jersey: John Wiley), p. 30.
[41] PwC (2011), *Transfer Pricing: Africa Regional Report*, p. 36, available at: http://www.pwc.com/gx/en/international-transfer-pricing.pdf, (last accessed 18th November, 2012).

identify and address incidences of TP manipulation (TPM). The close scrutiny by the Kenyan tax authorities for documentation has resulted into MNC paying keen attention to and being more careful in their pricing of Kenyan related party transactions.

The present study borrows from findings of the report save for the fact that the analysis herein seeks to explore how the adoption of the OECD guidelines has contributed to the realization of an adequate framework of regulating TP. The present study also compares the current OECD approach and the UN approach taken on TP and makes recommendations.

Agrawal[42] analyses TP, its relationship to foreign direct investment (FDI) and its effects on developing countries. The paper argues that countries like Kenya attract foreign investments because their TP regime is either unregulated or has the least controls.[43] Therefore MNCs are assured of maximum profits arising from the low tax tariff in such jurisdictions. The effect of this approach to developing countries has been loss of government tax and custom revenue, hence more borrowing which leads to a distortion in the balance of payment.[44] The paper notes that other countries that practiced this, such as Hong Kong and Singapore, have abandoned this approach in favor of a regulated TP legislation modeled on the OECD guidelines.[45] The present study agrees with the need for regulating TP and seeks to show gaps in the current legal framework in Kenya that require to be addressed to ensure that there are no further leakages in revenue.

Waegenaere[46] writes on challenges to TP regulation. The paper notes that the greatest challenges to TP regulation are information imbalance between the taxpayer, the tax authority and inconsistent TP rules. The latter creates the possibility of each country trying to tax the same income. This paper shows that tax authorities that show high TP inconsistency display a higher probability to aggressive TP audits thereby discouraging MNC s from shifting income to the

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[42] *supra*, note 17.
[43] *ibid,* p. 2.
[44] *ibid,* p. 3.
[45] *ibid*, p. 4.
[46] Waegenaere, Anja (et al) (2006), *Who Benefits from Inconsistent Multinational Tax TP Rules?* Contemporary Accounting Research Vol. 23, No. 1, p. 103, available at: http://www.caaa.ca/CAR/CurrentIssue/exeart YpTNqLHeZG.html , (last accessed 18th November, 2012).

country with lower tax rate. This study therefore offers a justification and vindication of the recent aggressive nature of the KRA in carrying out audits. The present study borrows from the approach and widens the debate to include best practices internationally.

The abuse of TP is made possible not only by the absence of a global legal framework but also by the lack of ethics in this area. Very little studies exist on the ethical side of TP. In exploring this subject, Mehafdi[47] views the pursuit of economic opportunity by MNC as putting them in the spotlight, accusing them of contributing to economic hardship, social deprivation, unsustainable growth, labour exploitation, blundering and ecological degradation in home as well as host countries.[48] Whereas TP can be a legitimate business, MNC s often misrepresent financial success or lack of it to evade taxes. Although this present research will not study the ethical aspects of international TP, it is submitted that the neglect of ethics in international TP legal regime plays havoc on third world countries economies including Kenya's.[49]

Under the 2010 Action Aid report on the tax operations of SABMiller in Ghana[50], the tax operations of SABMiller, a notable beer producer are criticized. The report states that developing countries lose more revenue from repatriation of profits my MNCs than they receive in aid.[51] Further, the report notes that TP is a lucrative practice by companies as well as experts who are called upon to examine ways of avoiding tax. The report criticizes the negative impacts of TP mispricing on Ghana's national revenue.[52] The report reiterates the social-economic impact of TP mispricing in undermining public facilities like schools, roads and hospitals. The report proposes stricter vigilance by countries in regulating TP.[53]

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[47] Mehafdi, Messaoud (2000), *The Ethics of International TP*, Journal of Business Ethics, Vol. 28, No. 4, p. 365-381, available at: philpapers.org/rec/MEHTEO, (last accessed 18th November, 2012).
[48] ibid, p. 366
[49] Ibid, p. 370.
[50] ActionAid (2010), *Calling Time: Why Sabmiller Should Stop Dodging Taxes in Africa*, available at: http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf, (LAST ACCESSED 18TH November, 2012).
[51] *ibid*, p. 6.
[52] *ibid*, p. 15.
[53] *ibid*, p. 39.

The government and MNCs have conflicting views on the role of TP. Eden[54] explains that the government's perspective on taxing profits arising from cross border trade presents challenges of jurisdiction, allocation and valuation. The MNCs on the other hand views the government's concerns as further barriers to trade and in conflict with their stated goal of maximizing profits.[55] Also explored is the information imbalance between developed countries and developing countries in terms of TP. The developed countries have solved this by developing an extraordinary web of bilateral agreements (within the framework of the OECD) among themselves to deal with the likely conflicts in the application of national tax laws. In dealing with double taxation, they have agreed on a fair share division of the obligations.[56] The way the jurisdictional challenge has been dealt with is a lesson to developing countries that are currently experiencing similar problems. The significance of this write up is that it shows the way forward for developing countries and recommends the establishment of an international TP legal regime as a way of addressing these challenges on the same lines as the OECD members.[57]

The OECD is the premier trend setting organization providing TP guidelines and international best practices globally.[58] It was established in 1961 with three objectives; to achieve the highest maintainable economic growth and employment and sustained rising standard of living in member countries, sound economic expansion and contribute to expansion of world trade multilaterally and on a non discriminatory basis.[59] In the 1960 and 70s tax authorities in the USA and Europe began paying attention to TP and the result was the OECD report and guidelines on TP first issued in 1979, revised and updated in 1995 and the latest update in 2010.

The main features of the OECD 2010 guidelines are; the affirmation of the ALP as the fairest and most reliable means of determining where profits fall for purposes of taxation.[60] Removal of hierarchy of methods contained in earlier versions, elevation of the standing of the transactional net margin method (TNMM) to be on equal footing with other methods. In addition to giving

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[54] Eden, Lorraine (1998), *Taxes, TP and the Multinational Enterprise*, Chapter 2 in Eden L, *Taxing Multinationals: TP and Corporate Income Taxation in North America.* (Toronto: University of Toronto Press, 1998).
[55] *ibid,* p. 24.
[56] *ibid,* p.30.
[57] *ibid,* p. 42.
[58] OECD (2012), *About Us*, available at: http://www.oecd.org, (last accessed 18th November, 2012).
[59] *ibid.*
[60] Article 9, OECD Guidelines on Transfer Pricing, *supra*, note 1.

more emphasis on the use of the profit split method as the most appropriate method where inter-company transactions show the use of 'valuable intangibles' there is also emphasis on data analysis and use of adjustments and statistical methods to draw conclusions and to introduce a step process for the establishment of TP policies and procedures. However these guidelines are more appropriate for the OECD members who through bilateral and multilateral agreements have streamlined TP amongst themselves unlike developing countries that are outside the organization.

Nick[61] discuses the ALP, the factors that can trigger a TP audit, TP policy and TP methodologies. He discusses in depth maintenance of an up to date TP policy and documentation. It gives the status of TP legislation and regulation in many countries where PwC has a presence. The book does not discuss the reasoning behind the Unilever case nor does it discuss the rationale behind the OECD guidelines in Kenya and other guidelines provided by other bodies such as the UN. This present study borrows much from this book but also addresses the challenges facing the application of TP in Kenya.

The UN published a draft Practice Manual on TP for Developing Countries to give clearer guidance to assist policy makers, administrators and tax payers in dealing with complex TP issues.[62] The manual provides guidance to countries that adopt the ALP in adjusting for TP. It asserts that TP should be responded to effectively avoid loss of legitimate revenue.[63] In drafting the manual, certain principles were observed to preserve the sustainability of the proposed guidelines. They include a recognition that the guidelines have to be tailored to meet the objectives of individual countries, the need to address TP concerns in a cost effective manner that is development conscious and maintaining capability in enforcing TP regulations by developed countries.[64] The manual is critical in elaborating practical aspects that surround TP audits, compliance and analysis. This study borrows from this literature the UN angle to the TP debate and broadens the debate to include even the WTO.

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[61] Raby Nick (2012), *International Transfer Pricing*, available at: http://www.pwc.com/gx/en/international-transfer pricing, (last accessed 18th November, 2012).
[62] UN (2012), *Practical Transfer Pricing Manual for Developing Countries*, available at: www.un.org/esa/ffd/tax/ documents/bgrd_tp.htm, (last accessed 18th November, 2012).
[63] *ibid,* chapter 4.
[64] *ibid,* chapter 1.

In summary, the above literature does not fully address the issue to be explored in this study, namely, the challenges in TP regulation both from a Kenyan perspective and from an international perspective. As such it is evident that no scholar has comprehensively and authoritatively written on Kenya's TP regulation challenges while considering international best practices. The current study is therefore an additional contribution to the tax law scholarship in Kenya as it discusses the challenges and gaps that need to be addressed in the current TP legislation in the case of the recent changes introduced by the Unilever case, the promulgation of the new Constitution of Kenya and the new guidelines being adopted by international bodies such as the UN and WTO.

1.10 RESEARCH LIMITATION

This study faced four types of limitations, considering that TP is a fairly new area of study in this country. Firstly, despite there being a good number of international literature on this subject globally, there exists limited local literature on the subject. As such, heavy reliance was made on literature, laws and best practices from other jurisdictions that may not necessarily share the same experiences as Kenya.

Secondly, there are very few domestic experts in TP, limiting the number of respondents for the study. Thirdly, both the domestic and international laws on TP mechanisms lack clarity on a number of matters and only provide a myriad of alternatives. Finally, even as the East African Community countries move forward with harmonization of tariffs, very little mention is being made on TP as an important component of regional integration.

1.11 WORK PLAN OF THE STUDY

Chapter one: Setting the Agenda for the Study

Chapter one is devoted to setting the agenda. The chapter introduces the concept of TP generally. The chapter gives the statement of the problem, the significance and justification thereof. It also discusses the research methodology, theoretical foundation and literature review to be used in the study.

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Chapter two: Current TP Legal Framework in Kenya

Chapter two explores the legal foundation of TP in Kenya and gives a detailed analysis of TP rules in Kenya and the challenges posed in the implementation of the ALP in Kenya. This chapter also discusses the Unilever case as well as a critique of the case majoring on the attempt by the High Court to apply the OECD TP Guidelines for Multinational Enterprises and Tax Administrations 2006 which were not law in Kenya at the time. The chapter also analyses the various key findings of the court regarding TP.

Chapter three: Transfer Pricing Regimes

Chapter three analyses international best practices in TP under the OECD Guidelines and the UN Model Convention on TP and how Kenya's legal framework can benefit from these models. The various methods adopted in arriving at the arm's length price such as; CUP, RPM, CPM, PSM, TNMM, Berry method and other methods are discussed. The chapter also discussed the strength, weaknesses and suitability to Kenya of the methods highlighted.

Chapter four: Nexus between OECD and WTO guidelines on TP

Chapter four discusses the WTO rules of valuation and their nexus with TP in the application of the ALP. The chapter analyses the applicable Customs laws in East Africa and checks whether they are in tandem with the TP legislation and makes recommendations on any gaps that may be existent.

Chapter five: Conclusions and Recommendations

Chapter five draws conclusions on the status of TP legal framework in Kenya and makes recommendations on what needs to be done to improve adherence to and tax compliance with the arm's length price for entities that are engaged in cross border with the overall objective of increasing the tax base. In summary, the chapter concludes that the Kenya TP regime is weak and requires radical improvements to be able to withstand legal challenges and to realize its objectives.

CHAPTER TWO: CURRENT TP LEGAL FRAMEWORK IN KENYA

2.1 INTRODUCTION

Section 18(3) of the ITA[65]does not provide clarity on how the ALP is to be applied. The Unilever case[66] was instigated by the absence of this clarity and in the judgment of Visram J, the vacuum that existed in the law could be filled by the OECD TP Guidelines notwithstanding the fact that it did not form part of the Kenyan Law. This led to the promulgation of the Income Tax (TP) Rules[67] by the Minister of Finance in the year 2006.

The commonest scenario of TP in Kenya is the determination of the correct price for sales between subsidiaries of an MNC. MNCs often use TP manipulation to shift profits to tax favored jurisdictions (low tax states).[68] In transactions between companies in a high tax jurisdiction and another in a low tax jurisdiction, a high tax subsidiary charges a price below the market price, which means that any transfer of goods is not subject to the full play of market forces. The end result is that profits are dumped in low tax subsidiaries with the objective of always reducing taxes payable.

Where TP is not regulated or minimally regulated, MNCs pay the lowest taxes through the manipulation of prices. To forestall this possibility, the tax authorities now rely on the ALP in implementing TP. The gist of this principle is that transactions between related entities should be treated similar to those of comparable transactions between independent enterprises. This is the cornerstone of Kenya's legislation on TP.

This chapter discusses the substantive law on TP under the ITA as read together with the ITA (TP) Rules and the effect of the Unilever case on TP legislation in Kenya. The challenges faced by the KRA in implementing this law and the loopholes therein are also analyzed.

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[65] Cap 470, Laws of Kenya.
[66] *supra*, note 9, Unilever case.
[67] *supra*, note 8. Legal Notice No. 67, of 2006,
[68] *supra*, note 18, Weichenried, Alfons J. (1999), *Double Taxation, and the Cost of Capital,* p. 445.

2.2 UNILEVER KENYA LTD v COMMISSIONER OF INCOME TAX (UNILEVER CASE)[69]

The contribution of case law in the development of a legal framework on TP in Kenya cannot be underestimated. The Unilever case is credited for introducing the OECD guidelines on TP into Kenya which brought some semblance of clarity in the operation of the ALP. It serves as a platform and a benchmark through which future dispute resolution in TP would be settled.

Facts of the Case

The Unilever case was an appeal from the decision of the Local Committee of the Income Tax Department which was delivered on 17th September 2003. The facts of the case were as follows;[70] the Appellant, Unilever Kenya Limited (UKL) was part of a global company substantially owned by the Unilever Plc, incorporated in the UK. It was engaged in the business of manufacture and sale of various household goods including detergents and personal care items. In 1995 it entered into a contract with another of its related company, Unilever Uganda Limited (UUL) to the effect that the Kenyan subsidiary would manufacture goods on behalf of UUL and supply the goods to UUL in accordance to orders issued by UUL and as per the agreement entered *inter se*. UKL supplied products during the years 1995 and 1996. At the same time, UKL was manufacturing and selling goods to the Kenyan domestic market and the export market, to customers not related to UKL.[71]

In selling their products, UKL charged different prices for identical goods on the domestic export sales from those for local domestic sales. Prices charged by UKL to UUL differed from the above sales and were lower than those charged in domestic sales and domestic export sales for identical goods, i.e. UKL charged lower prices to UUL than it charged to domestic buyers and importers not related to UKL. The Commissioner of Income Tax ('CIT' or 'Commissioner'), while relying on Section 18(3) of the ITA raised assessment against UKL in respect of the years 1995 to 1996 on the basis that UKL sales to UUL were not at arm's length prices pursuant to Section 18(3) of the ITA.[72]

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[69] *supra*, note 9, Unilever case.
[70] *ibid*, p. 1.
[71] *ibid.*
[72] *ibid*, p. 2.

The Court observed that reading Section 18(3) of the ITA, it literally means that a seller in Kenya is bound to pay income tax on profits which he /it would have earned had he/it sold his/its products to an out of country buyer at such a price as would be' arm's length price', UKL would be entitled to calculate the tax-payer's profits on such basis.[73] The important and most relevant words under Section 18(3) are:

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

Key TP issues

The court had to decide on two major issues; whether the OECD guidelines adopted by other countries or guidelines adopted by other countries are applicable in Kenya in the absence of Kenyan guidelines on TP and whether the arrangement between UKL and UUL was deliberately done to report lesser earnings.[74]

The analysis of the arguments by both the appellant and the respondent are as follows:

Appellant's argument[75]

The appellant's argument was that the respondent had not issued guidelines on how companies were expected to comply with the TP requirements and he had not responded to the submissions made by the appellant on the main issue whether the absence of guidelines from the KRA on the issue, the OECD guidelines and methods prescribed there under for the calculation of an arm's length price are a proper, reasonable and objectively acceptable basis for the determination of an arm's length price as required under section 18(3) of the ITA. The appellant argued that in the absence of guidelines from the respondent, the OECD guidelines and methods for determining arm's length price are proper, reasonable and objectively acceptable as a basis for determination of arm's length price as provided under section 18(3) of the ITA.[76]

The appellant submitted that in arriving at the arm's length price, the transfer prices adopted by a multinational in respect of transactions between its various subsidiaries and affiliates have a

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[73] *supra,* note 9, p. 2.
[74] *ibid,* p. 3.
[75] *ibid,* pp. 4-9.
[76] *ibid,* p. 4.

direct bearing on the proportional profit it derives in each country in which it operates. As such, a state is entitled to make appropriate adjustments to tax charged on profits of multinationals enterprises in its jurisdiction. The appellant noted that Kenya had promulgated TP legislation adopting the ALP which enables Kenya to adjust the transfer price charged on sales between related companies by involving the ALP in the Income Tax Act. However, the provisions merely empower the revenue authority to make such adjustments as may be considered necessary to ensure adherence to the ALP. In the absence of specific guidelines issued by the KRA under the ITA, the appellant's contention was that the determination of these principles ought to be made in accordance with the OECD guidelines. The appellants also quoted South Africa, Tanzania and the United Kingdom as having promulgated similar TP legislations to ITA in Kenya. However, TP guidelines adopted by other countries endorse the OECD guidelines and require that these be followed in determining arm's length prices. Even countries who are not members of the OECD have adopted the guidelines.[77]

The appellant disputed KRA's basing of its determination of arm's length prices on 'comparable prices' which is in fact endorsed by OECD but was being applied erroneously. The KRA Commissioner had attempted to apply the first and most recommended method under the OECD guidelines, that is, the Comparable Uncontrolled Price Methods (the CUP method) which compares prices charged in a controlled transaction to those charged in a Comparable uncontrolled transaction. Having applied the CUP, the Commissioner ought to consider whether the average price charged by the appellant in domestic sales in a comparable uncontrolled price transaction to the prices charged by the appellant on its sales to UUL, and whether the average price charged by the appellant in Domestic Export Sales is a comparable uncontrolled price to that charged by the appellant to UUL. It was contended that neither of these prices were comparable since there were wide differences in selling prices per unit weight of the different products and no two sales would comprise a similar mix of products in similar proportions.[78]

Further the appellant felt that KRA erred by making no allowances for the cost of marketing the goods in Kenya with all resultant overheads and the price of selling the goods to UUL, for UUL to market in Uganda. Similar principles applied to foreign countries where Unilever has no sister

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[77] Supra, note 9, p. 4.
[78] *ibid*, p. 5.

company and if the appellant was to sell to UUL at prices comparable to local or other foreign buyers, the buyers would result in buying the goods from Unilever India or Unilever South Africa and the appellant would consequently lose the Ugandan market. The appellant noted that it was not possible for it to estimate the with accuracy the additional costs incurred in Uganda and the only way to make such adjustments was to assume that the appellant bore additional costs and to add the aggregate of these to the transfer price to see if the price equated with Domestic Sales price or export price. If neither the Domestic Sales price nor the Domestic Export Sales prices are comparable for purposes of section 18(3) of the ITA, then there was no Comparable Uncontrolled price applying the CUP method.[79]

The appellant contended that it was its onus to demonstrate the consistency of its TP policy within OECD guidelines. The guidelines provide a detailed description of various methods to be used to apply the ALP, namely traditional transaction methods and transactional profit methods. In the absence of a Comparable Uncontrolled transaction, the OECD lays down the Resale Minus Method and the Cost Plus Method which should essentially achieve the same result from opposite approaches.[80] The appellant submitted that it is the Cost Plus method that was adopted on its prices to UUL and that even though its internal policy is not binding on the KRA, it is the proper method to be applied in assessing further tax liability in the absence of any guidelines. The appellant explained that the Unilever TP policy requires that pricing between companies in the Unilever Group be based on market prices, where it is possible to establish such market prices and where neither the CUP or market price are available, the companies would apply one of the other two internationally accepted principles, of which the Cost Plus method is the preferred one.[81]

The appellants summary position was that unless the Commissioner demonstrates that the appellant did not correctly apply the TP policy or that the price charged to UUL was not the standard transfer price, then the court must find that the prices and that the profits resulting to the appellant during the 1995 and 1996 years of income were not less than ordinary profits which

[79] *supra*, note 9, p. 6.
[80] *ibid,* p. 7.
[81] *ibid,* p. 8.

would have been expected to accrue to the appellant had the company been dealing with unrelated party and thus the Commissioner's assessment should not stand.[82]

Respondent/Commissioner's Argument[83]

The respondent/ Commissioner argued that the transaction between UKL and UUL resulted in less taxable profits to UKL and that the lower price comparable to prices charged to Kenyan buyers or to outside Kenya importers represents a transfer price and hence the difference becomes subject to taxation on the basis of sales at arm's length prices.[84]

The Commissioner further argued that the prices charged by UKL and UUL are nothing but 'discounted' prices. The respondent/ Commissioner submitted that the OECD Model Tax Convention on Income and on Capital (OECD Convention) and its related guidelines such as the 'TP guidelines for MNCs and administration' did not have any application in the appeal because they are used to guide other countries entering into double taxation agreements which was not the case here. Secondly, they argued that the guidelines were not part of the law of the country and that UKL was working on hypothetical figures in comparing the prices.[85]

Thirdly, the respondent argued that UKL had sold its products to buyers in Somalia and Tanzania at higher prices than those charged to UUL and that the two entities had arranged between them as two related enterprises to fixing or setting prices of goods between themselves without considering market forces. Lastly, the respondent submitted that UKL had not demonstrated that the Unilever group TP Policy did not offend the provisions of Section 18(3) of the ITA, and that in fact, the Policy offended the requirements of Section 18(3) of the ITA.[86]

Judgment/ Holding of the Court[87]

In his judgment, Judge Alnashir Visram held that he was unable to see the arrangement between UUL and UKL that was to enable UKL make no or less profits, and that the OECD guidelines

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[82] *supra*, note 9, p. 9.
[83] *ibid*, the arguments are summarized in pages 10-12 of the judgment.
[84] *ibid*, p.10.
[85] *ibid*, p. 11.
[86] *ibid*, p. 12.
[87] *ibid*, the *ratio decidendi* and the decision of the court are captured in pages 12-15 of the judgment.

were not primarily for countries with double taxation guidelines.[88] He also held that the ways of doing modern business has changed very substantially in the last 20 years or so and it would be foolhardy for any court to disregard internationally accepted principles of business as long as these do not conflict with Kenyan laws and to do otherwise would be highly short sighted.[89] He also held that the language of Section 18 (3) of the ITA was obscure and a tax payer is entitled to demand that his liability to a higher charge should be made out of reasonable clarity, before he is adversely affected.[90]In addition, he said that in the absence of the guidelines provided by the ITA, other guidelines should be looked at.

In disagreeing with the respondent's and the Local Committee's method of arriving at the arm's length method for computation of tax, Visram J said, that, based on the reasons provided, he did not think that the cost plus method used by UKL was a wrong method of arriving at an arm's length price in the particular circumstances of the case.[91] The appeal was allowed with costs with the result that the assessment in question be ordered to be annulled to the extent of tax levied by the respondent in accordance with Section 18(3) of the ITA arising from deemed profits from UKL's business with UUL in 1995 and 1996.[92]

Implications of the Outcome of the Case

The case raises a number of fundamental questions relevant to Kenya's TP legislation such as; the role of OECD guidelines, Kenya's approach towards Advance Pricing Agreements ('APA') and the steps the country can take to limit the dumping of profits in its jurisdiction through tax avoidance mechanisms.

The outcome of this case showed how critical it is for the country to put in place a serious TP legislation in order to reduce the incidences of profit dumping through various types of transfer price manipulation. After this holding, the tax authorities moved quickly to fill up the apparent void.

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[88] *supra,* note 9, p. 12.
[89] ibid, p. 13.
[90] In laying this principle, he relied on the following precedents; *Scott v Russell* (1948) 2 All ER 1 and *Kanjee v Income Tax Commissioner* (1946) E.A. 257.
[91] *ibid*, p. 14.
[92] *ibid*, p. 15.

It is as a result of this case that TP guidelines were introduced in the budget reading of June 2006 and came into effect on 15 June 2006 through Legal Notice No 67. In effect, the court ratified the application of OECD guidelines in the absence of our own guidelines. The OECD TP Guidelines are a set of guidelines established by the members of OECD to regulate TP and ease the incidences of disputes among them. These guidelines are not rules but a set of voluntary international best practices. Many countries have taken up these guidelines, while others like Kenya have actually made some of them part of the law. The objective still remains the same i.e. to bring clarity to TP regulation in transactions that exhibit a foreign component. It is for this reason that Kenya has elected to adopt them though not being a member of the OECD.

Anti-avoidance legislation has always existed in Kenya under Section 18(3), 23 and 24 of the ITA but without a framework through which the arm's length can be achieved. The OECD recognizes six methods through which this can be done namely the; the comparable uncontrolled price, resale price, the cost plus, profit split, transactional net margin and any such method as maybe prescribed by the CDT from time to time.[93]

Areas of divergence

While the ruling of the Unilever's case was good from the tax payer's perspective, the question that still remains is whether the mere absence of guidelines on a subject should lead to blanket importation of guidelines from developed economies whose economic circumstances are largely different from the developing world.

The other question that arises is why we should protect the OECD approach and not any other approach such as the UN approach or the WTO approach.

2.3 INCOME TAX ACT[94]

Section 18 (3) of the Kenyan ITA empowers the Commissioner to adjust the profits accruing to a resident from a course of business conducted with related non-resident persons to reflect such profit as would have accrued if the course of business had been conducted by independent

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[93] Rule 7, Income Tax (TP) Rules, 2006, *supra,* note 8.
[94] ITA, *supra*, note 7.

persons dealing at arm's length. This amounts to powers to adjust the transfer price in international transactions between connected parties to reflect an arm's-length price.

For the purposes of Section 18 (3) of the Act and with specific reference to companies, a company is related to another company if:-

i) it participates directly or indirectly in the management, control or capital of the business of the other
ii) a third person participates directly or indirectly in the management, control or capital of the business of both of them[95]

2.4 INCOME TAX (TP) RULES, 2006[96]

2.4.1 Manner of Adoption

After the Court in the Unilever case ratified the application of the OECD guidelines in the absence of specific TP guidelines in Kenya, this prompted immediate action by the government by enacting Income Tax (TP) Rules, 2006 effective 1 July 2006 which are largely a replica of the OECD guidelines.[97]

Section 18 (8) of the Act makes provision for the issuance of guidelines for the determination of an arm's length value of a transaction for purposes of Section 18 and for the specification of such further requirements as the Minister may consider necessary for the better carrying out of the provisions of the Section. The purpose of the rules is to provide guidelines to be applied in TP,[98] which raises a question as to the extent of enforceability of the guidelines. What legal force do the guidelines carry? The wording of Section 18(8) is confusing as it states that the Minister is to make rules to provide guidelines'. Are guidelines which are made to have effect as rules? What would be the rules then?

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[95] *supra*, note 7.
[96] Income Tax Rules, *supra*, note 8.
[97] *ibid.*
[98] *ibid,* rule 3.

The New Zealand TP guidelines provide that they are guidelines which should be read as supplementing the OECD guidelines, rather than superseding them.[99] This applies for the domestic application of New Zealand's rules.

2.4.2 Synopsis of the Rules

Section 18 (8) of the Act makes provision for the issuance of guidelines for the determination of an arm's length value of a transaction for purposes of Section 18, and for the specification of such further requirements as the Minister[100] may consider necessary for the better carrying out of the provisions of the section.

Such guidelines have been issued by the Minister in the form of The Income Tax (TP) Rules, 2006 ('TP Rules'). The stated purpose of the TP Rules is to provide guidelines to be applied by related enterprises in determining the arm's length prices of goods and services in transactions involving them and to provide administrative regulations, including the types of records and documentation to be submitted to the Commissioner by a person involved in TP arrangements.[101]

The transactions as which to the TP rules will apply include:

i) transactions between associated enterprises within a multinational company, where one enterprise is located in, and is subject to tax in, Kenya, and the other is located outside Kenya;
ii) transactions between a permanent establishment and its head office or other related branches, in which case the permanent establishment shall be treated as a distinct and separate enterprise from its head office and related branches[102]

The transactions which may be subject to adjustment of prices under the TP Rules include; the sale and purchase of goods, the sale, purchase or lease of tangible assets, the transfer, purchase or

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[99] Muchlisnki Peter (1999), '*Multinational Enterprises and the Law,*' (Blackwell Oxford,UK and Cambridge, USA), p12.
[100] Refers to the Kenya Minister for Finance
[101] *supra*, note 8, rule 3.
[102] *ibid,* rule 5.

use of intangible assets, the provision of services, the lending or borrowing of money and any other transactions which may affect the profit or loss of the enterprise involved.[103]

The rules require a person who avers the application of arm's length pricing to develop an appropriate TP policy, to determine the arm's length price in accordance with the guidelines provided in the TP Rules and to avail documentation evidencing their analysis upon request by the Commissioner.[104] In addition the Commissioner of KRA has powers to request information, including documents relating to transactions where TP is applied.[105]

2.4.3 TP Documentation

The TP rules do not make it an express statutory requirement for tax payers to complete supporting TP documentation. However, rule 9(1) gives the Commissioner permission to request for documentation, including documentation relating to transactions where TP issues arise and a non-comprehensive list of the documents which the Commissioner may request is provided under rule 9(2).

Rule 10 of the TP Rules requires a person who avers the application of arm's length pricing to develop an appropriate TP policy, to determine the arm's length price in accordance with the guidelines provided in the TP Rules and to avail documentation evidencing their analysis upon request by the Commissioner. The requirement for taxpayers to complete TP documentation is therefore implied in the rules and it is in the tax payer's best interest to complete and maintain such documentation.

Whilst no hard and fast rules for compiling documentation or for the process that taxpayers should follow are laid down in the TP Rules, the documents which the Commissioner may request include documents relating to: the selection of the TP method and the reasons for the selection, the application of the method including the calculations made and price adjustment factors considered, the global organization structure of the enterprise, the details of the

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[103] *supra*, note 8, rule 6.
[104] *ibid*, rule 10.
[105] *ibid,* rule 9(1).

transactions under consideration, the assumptions, strategies and policies applied in selecting the method and such other background information as may be necessary regarding the transaction.[106]

The effect of the above express and implied statutory requirements is to place the burden of proving that prices are arm's length on the taxpayer. A taxpayer who fails to provide TP documentation to support the arm's length nature of its prices is therefore at risk that the KRA will conduct a TP audit and examine its TP policies in detail. In the event that the KRA, as a result of the examination, adjusts the transfer price adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut the adjustment.

The TP documentation requirements are not elaborate enough. There is no specific requirement that the documentation be maintained which means that fiscal documentation relating to TP can only be done by implication. There is no requirement as to the time and periodic intervals upon which documentation should be prepared. It seems maintaining documentation is only done by tax payers in their own interests. As such there are no guidelines on what documents and in what manner they should be maintained.

Regarding the requirements as to when to maintain documentation, the regulatory framework should provide that documentation be contemporaneous. Experience shows that it is more difficult and time consuming to collect and prepare documentation with a retrospective approach. As a result, contemporaneous documentation is recommended in order to facilitate audits and avoid the risk of rejection of TP policy for want of documentation.[107]

The unclear documentation requirements make the process costly, complex and time consuming.[108] To this end it would seem that it will only have to be done under the threat of request from KRA in a haphazard manner.

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[106] *supra,* note 8, rule 9(2).

[107] Stephen Schorberger and Juliana Rosenkranz (2006), *Transfer Pricing Documentation:The EU code of conduct compared with Member State Rules (Part 2),* INTERTAX Journal, Volume 34, issue 8/9, p.423, available at: http://www.faqs.org/abstracts/Law/Transfer Pricing Documentation-EU code of conduct compared with member state rules-part 2.html (last accessed 20th November, 2012).

[108] International Chamber of Commerce, Commission on Taxation (2008), *Transfer Pricing Documentation Model,* Policy Statement, P.1 available at:http://iccwbo.org/uploadedFiles/ICC/Policy/taxation/Statements/Transfer Pricing/final.pdf (last accessed 20th November, 2012).

2.4.4 The Arm Length Principle/ Standard

Pursuant to the Kenyan TP regulations and the OECD Guidelines, a controlled transaction meets the arm's-length standard, if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances.[109] In order to be comparable to a controlled transaction, an uncontrolled transaction needs not be identical to the controlled transaction, but must only be sufficiently similar that it provides a reliable measure of an arm's-length result.[110] To meet the arm's-length standard a controlled taxpayer's results need only be within the range of results determined by the results of two or more comparable uncontrolled transactions.[111] These concepts of results, comparability, reliability and range are critical to the application of the arm's-length standard.

The TP Rules provide that a taxpayer may choose a method to employ in determining the arm's length price from among a list of methods including; the Comparable Uncontrolled Price method (CUP), the Resale Price Method (RP Method), the Cost Plus method (CP Method), the Profit Split Method (Profit Split Method), the Transactional Net Margin method (TNMM) and such other method as may be prescribed by the Commissioner from time to time.[112]

The TP Rules provide that a taxpayer shall apply the method most appropriate for her enterprise having regard to the nature of the transaction, class of transaction or class of related persons or functions performed by such persons in relation to the transaction.[113] The rules also provide that the Commissioner may, from time to time, prescribe other methods where in her opinion and in view of the nature of the transactions, the arm's length price cannot be determined using any of the above methods.[114] The most appropriate TP method will depend on the relevant facts and circumstances as well as the reliability and availability of the data on which to base a comparability analysis.

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[109] USTransferPricing.com (2012), *Arm's-Length Principle: What Would a Product Cost if Transacted by Unrelated Parties?* Available at: http://www.ustransferpricing.com/arms_length_principle.html, (last accessed 20th November, 2012).

[110] Clifton Gunderson LLP (2011), *Understanding Transfer Pricing*, available at: http://www.cliftoncpa.com/publications/enewsletters/TaxInsight/issues/June2011/TransferPricing.asp, (last accessed 20th November, 2012).

[111] *ibid.*

[112] *supra*, note 8, Rule 7. The rule lists the methods.

[113] *ibid,* Rule 8(2).

[114] *ibid,* rule 7(f).

2.5 RECENT AMMENDMENTS THROUGH FINANCE ACTS

2.5.1 Finance Act 2012[115]

The Finance Act 2012 amended the ITA by substituting the words 'so arranged' with 'such.'[116] This amendment was to extend TP beyond the scope of tax avoidance. The study opines that the contribution of this proposal to TP legislation is nil. This is because what the amendment does is to allow KRA to tax companies based on their inter-company pricing policies whether or not they aimed at avoiding tax.[117] The effect of this proposal is to make MNCs even keener on their inter-company pricing arrangements. Therefore this proposal does not help in tightening up the loopholes in TP legal framework in Kenya.[118]

2.5.2 Recent Changes in Finance Bill 2012/2013

The Finance Bill 2012/2013 amended the powers of the Commissioner under the ITA to expand the powers of the Commissioner to issue guidelines on the selection of arm length methods. This contributes to the lack of clarity in Kenyan law on the appropriate methods to determine arms length transactions.

2.6 CHALLENGES FACING TP REGULATION IN DEVELOPING COUNTRIES GENERALLY

Developing countries are highly vulnerable to TP manipulation and tax avoidance and their ability to check aggressive practices is often handicapped by lack of financial resources and consequently possibility of hiring expert labour to scrutinize corporate practices more closely.[119] In a meeting to discuss TP issues the key challenges of TP in developing countries were identified. Developing countries experienced difficulties in six different areas. These include; findings of an appropriate TP regime that fits the experiences and situations of a developing country, regulating TP in an effective manner in terms of costs of compliance, integrating the TP regime to fit the general investment promotion policy; dispute settlement norms, risk assessment

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[115] Act no. 4 of 2012, available at: www.kenyalaw.org/klr/fileadmin/.../Acts/Finance_Act_2012.pdf, (last accessed 2th November, 2012).

[116] *ibid,* Section 22.

[117] *supra*, note 6, Ratemo Joash (2011), *Minister's Tax TP Proposal Short of Expectations.*

[118] *ibid.*

[119] Sikka Prem & Willmott Hugh (February 2010), *The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness*, University of Essex, p. 10, available at: http://www.essex.ac.uk/ebs/research/working_papers/WP2010-1%20-%20PSikka%20Transfer%20Pricing%20Paper.pdf, (last accessed 20th November, 2012).

and audit capabilities and norms of the country, implementing ALP in the most cost effective manner, addressing fairly the impression of ALP and applying the traditional TP methods.[120]

The difficulty in ALP has led some to propose other approaches to make ALP more workable. The Action Aid report on SABMiller Group proposes the' fixed margin' approach like that used in Brazil to fix prices for companies.

2.7 CHALLENGES FACING TP REGULATION IN KENYA

In spite of the promulgation of the TP rules as part of the ITA, the implementation of these rules in Kenya still presents a major challenge in various ways. This is due to a weak regulatory framework, poor quality of documentation, lack of comparable databases, the poor reception of advance pricing agreements (APAs), limited financial resources, lack of technical capacity among others. For this reason, Kenya TP regime is wanting.

2.7.1 Weak Legal Framework

Although Kenya's legislation has adopted the OECD Guidelines on TP, the legal regime is still very weak. It would appear that the regulations were merely adopted wholesome, without consideration of their applicability and suitability for the domestic market.[121] The weaknesses in the legal framework make it easy for the MNC to manipulate the loopholes to deny the country its revenue through complex tax avoidance schemes that cannot be detected by KRA. A keen analysis of the Income Tax (TP) Rules reveals the lack of detail and inability by the tax authorities to monitor and identify TP scenarios and practices.

The continued reliance on the databases of the developed countries puts KRA at a disadvantage. In such an environment, leeway is given to poor quality of documentation, inadequate information sharing between the various tax agencies, it lacks the tools such as up to date databases for comparable corporations. Besides that, weaknesses are also noticeable in the record keeping, the extent of acceptance to advance pricing arrangements and the inadequacy of penalties for the breach of these provisions.

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[120] UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues (2011), *Draft Secretariat Practical Manual on Transfer Pricing for Developing Countries*, p. 1, (UN TP Practical Manual) available at: www.un.org/esa/ffd/tax/.../TP-Manual_DraftForeword_Oct2011.pdf, (last accessed 20th November, 2012).

[121] This is cited by PGP, during an Oral interview on 10th April 2012.

2.7.2 Unclear and Inadequate Provisions

The Kenyan law defines a party to be related to another if it directly or indirectly participates, by itself or through a third party, in management, control or capital or capital of the other party.[122] The provisions, however do not define the threshold of 'management', 'control', or 'capital' of the other party. The scope of the relationship for purposes of applying TP legislation is therefore ambiguous.

The definition of related party was amended by Finance Act 2012 to include corporations or businesses owned by persons that are related either through blood relationship or by marriage or even friendship.[123] However, the limits to the relationships and friendships are not explained. This seems to be an attempt at lifting the veil of incorporation.[124] Although the amendment might have been borrowed from countries like China and Russia where family relations count when evaluating related parties, the amendment has complicated and further distorted the application of anti-avoidance legislation mechanisms in Kenya[125].

2.7.3 Extent of Enforceability of the Guidelines

The wording of Section 18(8) is confusing as it states that the Minister is, 'to make rules to provide guidelines.' Further, the purpose of the Kenyan TP rules is captured as being, 'to provide guidelines to be applied in TP.'[126] This raises a question as to the extent of enforceability of the guidelines. A guideline is simply a recommended practice that allows some discretion or leeway in its interpretation, implementation, or use.[127] The designation of the Kenyan TP rules as guidelines raises several questions. What legal force do the guidelines carry? Are these guidelines which are made to have effect as rules? What then would be the rules? All the above questions remain unanswered, casting into doubt the enforceability power of guidelines.

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[122] Section 18(6) of the ITA and rule 2 of the TP rules.
[123] *supra,* note 113, Section 18.
[124] View expressed by STP during an Oral Interview on 15th October 2012.
[125] *Ibid.*
[126] Rule 3 of the Income Tax TP guidelines.
[127] See Business Dictionary, *Guideline*, available at: http://www.businessdictionary.com/definition/guideline .html#ixzz2CianXnLQ, (last accessed 20th November, 2012).

companies in any given sector than in developed countries. Second, problems exist in gathering taxpayer information due to the absence of documentation requirements or the inability to enforce existing requirements. Third, tax administrations 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. Fourth, there exists no database for TP analysis focus on data from developed countries. They are thus forced to rely on data from developed nations. This data may not be comparable or useful in performing benchmarking studies for companies operating in developing countries (at least without resource and information-intensive adjustments) and, in any event, are usually costly to access. Finally, the economies of developing countries may just have opened up or be in the process of opening up. There are many 'first movers' who have come into existence in many sectors and areas hitherto unexploited or unexplored; in such cases, there is an inevitable lack of comparables.[133]

While we can debate the necessity of local comparables, clearly the availability of such data would make analysis simpler. One possible solution, at least in the near term, is to use non-local comparables, a practice that has been implemented in other developing regions, such as Latin America.

A number of African countries are starting to address the issue of a lack of local data and are reviewing the available alternatives. Many of the companies are considering external databases, such as SMART or Amadeus, as well as the idea of developing its own software. One possibility would be to subscribe to an external basis short-term with a vision of creating proprietary software long-term. This would allow immediate adjustable data, albeit imperfect, as well set in place a long-term plan. Yet, an attempt at developing proprietary software should be undertaken by a coalition of African nations rather than unilaterally.[134]

The Africa Tax Administration Forum (ATAF) may be an ideal identity to undertake efforts to address the issue of non-local comparables, whether by subscribing to an external database or leading the coalition to develop software. Currently, the ATAF is considering purchasing rights to use a commercial database for collective use by its members or developing its own database.

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[133] *ibid,* p. 9.
[134] PwC (2011), *Growing Scrutiny: International TP*, p. 36, available at: http://www.pwc.com/en_GX/gx/international-transfer-pricing/assets/itp-2011.pdf, (last accessed 20th November, 2012).

The need for a computerized database of financial data of African companies is widely recognized to the extent that it has prompted a discussion regarding the creation of a tax-data center 'cloud' over Africa.[135]

The ITA grants the Commissioner of Income Tax the power to adjust levies that do not conform to the arm's length mode. This could only be possible if the Commissioner has accurate information to make the adjustments. This complicates the benchmarking exercise initially intended as well as producing inconsistent results.[136] Given this scenario, it puts into question the appropriateness of the OECD's ALP to countries such as Kenya. It is apparent that the system was tailor made for the rich OECD countries that have the resources to implement the complex tax avoidance schemes.

There also exists information asymmetry between MNCs and KRA which is considered a major hindrance to an effective TP regime. In as much as KRA may wish to be efficient and effective in its TP practice, it lacks information on the trading results of the various companies within the MNC. This is one big gap through which revenue leakage occurs. The current law does not require MNCs to make full country by country disclosures of their activities and results. The KRA is not in a position to query the activities of the MNC in the country/other countries.

2.7.6 Advance Pricing Arrangements (APAs)

Although KRA has selectively adopted some OECD guidelines, it is still reluctant to adopt those pertaining to APA's as well illustrated in the Unilever case.[137] The tax authorities lack specific provisions on APA's yet it is a widely accepted as an international best practice as a way of creating not only certainty but building good will as well.

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[135] Rick Mitchell (2011), *OECD Tax Rules Called Too Complex, Costly to Help Developing Countries Nab Evaders*, 194 Daily Tax Report J-1, Quoting Jeffrey Owens, director of OECD's Center for Tax Policy and Administration, available at: http://www.rick-mitchell.com/developing.pdf. (last accessed 20th November, 2012).

[136] *ibid.*

[137] *supra*, note 9, *Unilever Kenya Ltd v. Commissioner of Taxation*. KRA in its arguments in court points out to such a position.

Countries which prescribe to APA's have preferred two types of APA's; those formed through entering into bilateral agreements and those formed via multilateral agreements.[138] APAs are an internally agreed form of tax administration recognized by the OECD and the UN Model Convention.[139] Under the OECD Model, a taxpayer may request that the tax authority enter into an advance tax arrangement with him to determine appropriate criteria for determining the arm's length conditions for future controlled transactions.[140] Such applications must be accompanied by a detailed and relevant description of the taxpayer's activity. The tax administrator may agree to enter into such an arrangement either alone or in consultation with competent authorities of the associated enterprises identified by the tax payer. Where a breach occurs on the part of the tax payer, such an arrangement may be cancelled.[141] The advantages to be derived from APA's are varied: they save time on the part of the tax authority involved in the tabulation. On the part of the taxpayer, certainty and clarity is created.[142]

Therefore, if KRA was to embrace APAs, more achievements will be realized in attaining their stated tax targets.

2.7.7 Lack of Knowledge and Resources

There is a general consensus that one of the main challenges facing developing countries in order to implement the ALS is lack of resources.[143] Tax authorities of many African nations lack auditors experienced in TP, financial databases used in TP analyses, and sufficient staff to process TP compliance and disputes.[144]

To address compliance and complexity concerns, developing countries may introduce a number of simplifying measures. For instance, safe harbors, fixed margins or other simplification measures may be employed to allow taxing authorities to build technical capacity while simultaneously allowing MNCs to have certainty that a certain tax position will be respected.

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[138] PwC (2012), *Transfer Pricing: Advance Pricing Agreements*, available at: http://www.pwc.com/gx/en/tax/transfer-pricing/advance-pricing-agreements.jhtml, (last accessed 20th November, 2012).
[139] Article 25, OECD and Article 12 of the UN Model Tax Convention on TP.
[140] *supra,* note 1, OECD guidelines, Article 25.
[141] *ibid.*
[142] Thakkar Hemali Deepak (December, 2011), *An Insight into Advance Pricing Agreements*, Institute of Chartered Accountants Journal vol. 2, available at: http://220.227.161.86/25039cajournal_dec2011_15.pdf, (last accessed 20th November, 2012).
[143] Different authors point to this. It was also highlighted by all the three interviewees.
[144] *supra*, note 130, p. 5.

The best approach would be to have certain safe harbors which allow companies to elect to use the safe harbors to demonstrate the reasonableness of their TP.[145] For example, distributors earning a certain ROS or contract manufacturers within a certain cost plus percentage could be free from adjustment under an applicable safe harbor.

A more complex approach would be to apply default fixed margins for certain routine functions. Companies would then have the option to apply the default fixed margin or to choose a different result based on arm's length arguments. As tax administrations develop capacity, these countries may transition into a more full-fledged arm's length model. Nevertheless, if African countries attempt these simplifying measures, it is important that they do so under the breadth of the ALS so that MNCs are comfortable operating within the nation's tax system and FDI is undisturbed.[146]

One key to developing expertise in TP is to create TP-specific audit teams and committees, recognizing that TP expertise differs from general corporate tax expertise. To this end, Kenya has formed a TP unit within the KRA. Similarly, Ghana has created a committee to develop TP legislation.[147] A critical challenge, however, is for the government or taxing authority to retain the individuals it grooms to be TP-specialists.

2.7.8 Lack of Technical Capacity

The complexity in the implementation of the ALS is apparent in the inability of tax authorities to get sufficient skills to apply it. On the other hand MNCs have access to super expertise.[148] Due to this loophole MNCs pay more attention to the application of the principle in developed countries (to possibly risk erring and over-compensating companies in developed countries) where MNCs consider there is a higher risk of falling foul of the law and tax authorities than in developing

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[145] View expressed by PGP, during an Oral interview on 10th April 2012.

[146] H. David Rosenbloom (2009), *Where's the Pony? Reflections on the Making of International Tax Policy*, Canadian Tax Journal, Vol. 57, No 3, pp. 489-493, available at: https://www.ctf.ca/ctfweb/Documents/PDF/.../09ctj3-rosenbloom.pdf (last accessed 20th November, 2012). The drafters are likely to find that policies they thought clear in concept may not be so easily expressed. And formulations, when chosen, may meet with distorted interpretations.

[147] PwC (2011), *Spotlight on Africa's Transfer Pricing Landscape*, Transfer Pricing Perspectives: Special edition, p. 5, available at: http://www.pwc.com/gx/en/tax/transfer-pricing/management-strategy/assets/pwc-transfer-pricing-africa.pdf, (last accessed 20th November, 2012).

[148] *supra*, note 131, p. 10.

countries where the risks are minimal due to the inability of the tax authorities to effectively monitor their transactions[149]

Lack of expertise in this area is more noticeable in the audit functions of the tax authority. KRA does not have a TP audit function and staff who are specialized in these audits. They lack an understanding of certain principles necessary to apply a variety of skills given the complexity and detailed nature of TP.[150]

The skills required of the TP staff include;[151] a proper understanding of the domestic law, income tax law together with a working knowledge of related fields such as intangibles. This is because where a resident uses intangibles belonging to a non resident, the issue becomes more complicated than other ordinary transactions. Knowledge of the OECD principles is key in as much as they relate with domestic legislation and more so because it is the source of TP law in Kenya.

Before commencement of an audit, a clear understanding of the business must be made by KRA staff, beside the commercial environment which they operate. This would help avoid the tendency by auditors to carry out stereotyped audits forgetting that the nature of business environment of one business is different from that of the other types of businesses. Apart from understanding the realities of the business world, auditors must have investigative skills and interrogative skills. These would need practical training. In the absence of these skills, auditors do waste a lot of time by attending to inappropriate enquiries, asking unnecessary questions and pursuing unjustified arguments. They may as well continue an audit when it is clear that they are pursuing nothing.[152]

As a way forward it would be necessary for KRA to put in place an audit function specifically dedicated to TP to be carried out by experienced staff or by TP specialists. Best practices from other jurisdictions (e.g. the UK) show that every stage of the inquiry is reviewed by senior staff

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[149] *supra,* note 131, p. 11.

[150] UoN (2010), *Group 5: TP in Kenya*, Advanced Tax Law Seminar group LLM class presentation, 15th April 2010, p. 26 (unpublished).

[151] These captured in the views of TMP, during an Oral interview on 2nd July 2012.

[152] *ibid.*

that specialize in TP.[153] From the time a case is taken up, an audit time table is drawn up, it is reviewed after every six months and a negotiated agreement reached which either seeks to make an adjustment or go for trial.

2.7.9 The 'Intangible Economy'

Value attributable to intellectual property (IP), the "intangible economy," may skew more taxable income to developed countries at the expense of developing countries.[154] There is a sentiment among some developing countries including Kenya that the certain applications of the ALS are not in their best interest, as most corporate value is often attributable to IP. Since developing countries generally lack valuable IP, in certain circumstances little income is attributable to these countries under the ALS.[155] While it is widely agreed that for very profitable companies, the presence of IP is one main reason for their sustained profits and as such it is reasonable for the owners of IP to retain the profit associated with their investment, the lack of value for IP in Africa makes gaining support for the use of the ALS more difficult[156].

Resource-rich African nations have expressed particular concern regarding applications of the ALS that attribute significant value to IP.[157] In the context of mining sector and the oil and gas sectors, there has been significant debate surrounding the appropriate share of revenues between MNCs and African governments. South Africa recently passed several amendments to its TP legislation, in part, to protect the country's natural resources. As other African nations, such as Ghana and Nigeria, pass TP legislation, it is expected that certain protectionist provisions will be put in place for resources-intensive industries so that tax authorities can ensure the collection of tax revenues based on their nation's natural resources.[158]

2.7.10 Location Savings

Location savings is generally defined as the net cost savings realized by a party in a high cost location through outsourcing a certain activity to a low cost location.[159] Tax authorities in

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[153] View expressed by PGP, during an Oral interview on 10th April 2012.
[154] *supra*, note 144, p. 11.
[155] *ibid,* p. 12.
[156] *ibid,* p. 13.
[157] *ibid.*
[158] ibid, p. 15.
[159] *supra,* note 128, p. 12.

countries that have relatively low costs of labor, such as India and China, often take the position that, due to location savings, routine activities should earn a higher margin than similar activities in jurisdictions that do have location savings.[160] In addition, in the context of business restructurings such as outsourcing, tax authorities in countries with low costs of labor often claim that some of the excess profits as a result of the outsourcing should be taxable within their country.[161]

The OECD Guidelines address location savings in the context of business restructurings thus:

> Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be shared among the parties. The response should obviously depend on what independent parties would have agreed in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers."[162]

As the tax authorities of African nations become more experienced and sophisticated in terms of TP audits, it is likely that location savings will become another central point in the debate on how would companies at arm's length share such savings.

2.7.11 Tax Treaties

Many African countries lack a comprehensive tax treaty network.[163] On average, most African countries have a handful of treaties within Africa and several with non-African countries. This lack of a comprehensive treaty network places Africa at a disadvantage compared to other developing countries. Treaties are crucial in developing economies as they reduce double taxation, increase information exchange, and allow for standardization.[164]

Negotiating tax treaties requires a certain level of technical knowledge on behalf of the taxing authorities and some African countries may not currently be in a position to negotiate double tax treaties.[165] Nevertheless, African nations with limited capacity should be encouraged to negotiate

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[160] *ibid.*
[161] *ibid*, p. 13.
[162] *supra,* note 1, OECD Guidelines Article 9.
[163] *supra,* note 144, PwC (2011), *Spotlight on Africa's Transfer Pricing Landscape,* p. 15.
[164] Hora do Paco Daniel & Rosenbloom H. David (2009), *Thoughts on the Brazil-U.S. Tax Treaty Negotiations*, 56 Tax Notes Int'l pp. 475-520, available at: http://law.lexisnexis.com/author-center/Tax-Analysts-Editorial-Staff/TAX-NOTES-INTERNATIONAL---WEEKLY-ANALYSIS-Thoughts-on-the-Brazil---US-Tax-Treaty-Negotiations,(last accessed 20th November, 2012).
[165] *supra,* note 144, PwC (2011), *Spotlight on Africa's Transfer Pricing Landscape,* p. 16.

double taxation treaties among themselves. Such practice would not only minimize double taxation within Africa and ease commerce between the nations, it may also help the participating nations gain experience in double taxation treaty negotiations and develop expertise in common issues that arise based on competing interests.[166]

As the tax authorities of Africa continue to gain expertise, their ability and desire to negotiate double taxation treaties will increase. Creating a tax treaty network can help standardize the manner in which MNCs are taxed in Africa.[167] By negotiating tax treaties, African countries may be able to induce further investment by enjoying the efficiency gains from entering into the "international tax regime."[168]

2.7.12 Record Keeping on TP transactions

Proper record keeping is the cornerstone of an effective and efficient TP legislation and related tax authorities. The Kenyan TP rules require enterprises to which the rules apply to supply information including books of account and documents relating to:

> "Selection of TP method and the reasons for selection, application of the method, including calculations made and price adjustments factors considered, the global organization structure of the enterprise, details of transaction under consideration assumptions, strategies, and policies applied in selecting the method and such other background information as may be necessary regarding the transaction."[169]

The weakness with this kind of requirement is that these are documents of a general nature as the rules do not specify specific documents to be maintained by the taxpayer. This leaves the taxpayer with the leeway of deciding which records to keep and in which format. In contrast,

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[166] View expressed by STP, during an Oral Interview on 12th October 2012.

[167] Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 Tul. L. Rev. 125, 145-6 (2009), available at: papers.ssrn.com/sol3/papers.cfm?abstract_id=1520696, (last accessed 20th November, 2012). The paper posits that double-tax treaties take two tax regimes that are similar and refine those similarities. Their coordination function and the viral process through which those treaties propagate mean that they encourage harmonization in two ways. First, double-tax treaties create a limited, international law sphere of substantive harmonization that prevents double taxation by ensuring that each state limits the application of its tax system in accordance with the same conception of the benefits principle. The other process by which tax treaties promote harmonization is incidental to the elimination of double taxation. Because those treaties are reciprocal, essentially making each treaty a barter arrangement, they work best when each state's tax regime is similar. Because the costs of not having access to treaty benefits can be significant, treaties provide an incentive for nations to standardize their tax systems. This two-part process creates a pattern in which double-tax treaties both invite and produce symmetry.

[168] Reuven S. Avi-Yonah, *Commentary*, 53 Tax Law Rev. 167 (2000) (Arguing that the network of 1,500 bilateral tax treaties constitutes an international tax regime).

[169] *supra*, note 8, Rule 9, Income Tax (TP) Rules, 2006.

other countries like India require a comprehensive list of documents to be maintained. The UK and Australia have adopted the OECD Transfer Guidelines as their guide on record keeping.[170] I therefore submit that for purposes of compliance and certainty, the documents to be maintained should be prescribed to avoid penalties for failure to maintain documents required by KRA. One way of circumventing this is by the use of the OECD guidelines as has been ably demonstrated in UK and Australia.[171]

2.7.13 Poor Quality of Documentation

The Kenyan Income Tax (TP) Rules require corporations subject to a transfer price to compile documents. The question that arises is when such documents should be compiled? The rules are not clear on this and therefore have led to a situation where such documents are compiled in preparation of an audit or when the CDT requires such information.[172] This is not an effective way of preparing this documentation because with hindsight, some corporations may be tempted to withhold some information or some may disappear altogether and thus distort the process, delays could occur and in the worst case scenario lead to a loss in revenue.[173]

The approach taken in other jurisdictions contrasts sharply with the Kenyan one. In Hungary for example, documents must be in place when the tax returns are due, in the USA and India documents should be compiled contemporaneously.[174] It would be advisable to have our regulations amended to provide that the TP documentation should be filed to the KRA contemporaneously and not when under preparation of an audit or when the CDT requests for the information.[175]

2.7.14 Prescription and Types of Penalty

The ITA requires taxpayers to keep books of accounts,[176] with failure to adhere being classified as an offence.[177] The Act also penalizes late payment of tax by levying interest of two per cent per month on the amount of tax remaining unpaid for more than one month after the due date

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[170] *supra*, note 128, EuropeAid/PwC (2011), *TP and Developing Countries*, p. 18.
[171] *ibid*, Appendix D; Country Study, Kenya, p. 20.
[172] *supra*, note 144, PwC (2011), *Spotlight on Africa's Transfer Pricing Landscape*, p. 14.
[173] *ibid.*
[174] *ibid*, p. 15.
[175] View captured by TMP, during an Oral interview on 2nd July 2012.
[176] *supra*, note 7, Section 54 of the ITA.
[177] *ibid*, Section 109(d), ITA.

until the full amount is recovered.[178] The above penalties are general provisions and do not provide clarity as to the type of penalties to be imposed on taxpayers who fail to comply with TP regulations. This study opines that since these entities are aware that very little will done to them whether or not they comply, the level of compliance by these entities is generally very poor.

In other jurisdictions, specific penalties are prescribed for corporations which fail to maintain books in a certain format.[179] In Australia for example, incentives are provided for and penalties may even be reduced if a corporation has a reasonably arguable case that is evidenced by documentation.[180] The USA approach is that if the audit leads to a TP adjustment then a penalty is imposed.[181] This study opines that Kenya's legislation needs to consider imposing specific penalties to corporations that do not maintain proper documents regardless of whether an audit is envisaged or not. In addition, the specific documents required to be maintained by a tax payer should also be well specified in the Kenyan law.

2.7.15 Cost Implications

Upon assessment, the costs in terms of time and money are expensive for both KRA and the tax payer. The requirement for the taxpayer to deposit security of the full contested amount[182] to appeal from the Local Committee is punitive. The taxpayer may also prefer to seek judicial review as opposed to Local Committee because of the security upon appeal as well as the perceived bias of the Committee in favor of KRA.[183]

2.8 CONCLUSION

In conclusion the legal foundation of TP is the ITA as read together with the ITA (TP) Rules of 2006. The rules which domesticated the OECD Guidelines on TP after the Unilever case stated that these guidelines can be applicable to bring clarity and certainty to Section 18(3) of the ITA on the ALP. International best practices in the form of the OECD Guidelines and the UN Model law also form an important part of the law in so far as shaping TP legislation in Kenya is

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[178] *ibid*, Sections 94(1) and 95.

[179] Highlighted by TMP, during an oral interview on 2nd July 2012.

[180] Autralian Taxation Office (2012), *Administrative Penalties: Voluntary Disclosures*, available at: http://law.ato.gov.au/atolaw/view.htm?Docid=MXR/MT20123/NAT/ATO/00001, (last accessed 20th November, 2012).

[181] USTransferPricing.com (2012), *Noncompliance Penalties under US Transfer Pricing Law*, available at: www.ustransferpricing.com/noncompliance_penalties.html, (last accessed 20th November, 2012).

[182] *supra*, note 7, Section 82 ITA, on Appeals to Local Committees.

[183] View expressed by STP during an oral Interview on October 2012.

concerned. However the TP legal regime in Kenya still faces some challenges that arise as a result of a weak legal regulatory framework, limited resources and lack of skilled manpower to effectively and efficiently devise and implement the complex TP regulations.

CHAPTER THREE: TRANSFER PRICING REGIMES

3.1 INTRODUCTION

Most of weaknesses of the current TP framework in Kenya as discussed in the previous chapter were mainly due to the fact that Kenya adopted a model similar to the OECD model and yet there are broader lessons Kenya can learn from other TP regimes.

In the international tax area there are a variety of bilateral tax treaties (BTT), and model treaties and guidelines developed by institutions such as the Organization of the Economic Cooperation and Development (OECD), and the UN. International bodies of experts such as the OECD Committee on Fiscal Affairs (CFA) and the International Fiscal Association (IFA) have played important roles in developing international policies and norms of TP[184]. This chapter focuses on the OECD, UN and WTO valuation guidelines which have the greatest influence on TP in Kenya. It will also address how some of the best practices have been applied elsewhere in other jurisdictions such as South Africa and India.

Tremendous growth in cross border trade and the effects of globalization has brought about problems in the taxation of entities that belong to one corporation but have subsidiaries in different countries. For example, in countries like Kenya, the challenge is on how to allocate a transfer price to the profits of the entities in a way that reduces double taxation, protects its tax base, and increases tax revenues while at the same time encourages investment in the form of foreign direct investment (FDI). The overall aim of the OECD and UN TP models is basically to bring clarity, uniformity and thus reduce disputes between and amongst states over TP.

The problem of TP is not particularly serious between the developed countries[185]. For example, Canada is able to sell and import products from the USA without much of a problem. This is because they have been able to form bilateral and multilateral TP agreements under the umbrella

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[184] Supra, note 31, Eden Lorraine (2001), *International Taxation, TP and the Mutinational Enterprise*, Chapter 2.

[185] Kudrle, Robert T and Lorraine Eden, (2003). *The Campaign Against Tax Havens: Will It Last? Will It Work?* Stanford Journal of Law, Business & Finance, Vol. 9, p. 50, available at: voxprof.net/eden/Publications/Kudrle-Eden-SJLBF-2003.pdf, (last accessed 20th November, 2012).

body of the OECD to not only eliminate those conflicts but regulate their TP legal regimes.[186] However, the growth in trade between the developed countries and least developing countries (LDC) has not corresponded with TP regulations in the latter. Thus due to the under-developed nature of TP regulations in the LDC, MNCs have been able to take advantage and either dump profits in Kenya, over-charge Kenyan subsidiaries for goods, services and loans which ultimately leads to higher tax profits for the MNC , but less tax revenue for Kenya. With this in mind, the UN Model Convention was tailor made to address the weaknesses in the global state of TP regime between the developing countries and LDC. Of great concern was the imbalance in the application and implementation of the ALP as the preferred mode of TP.[187]Its focus is on developing capacity in the areas of technical expertise, information sharing and disclosure and documentation, not to mention the reform of the TP legal framework.

The alignment of domestic TP rules with the internationally accepted principles set forth in the OECD TP Guidelines promises certain advantages which include:-[188]providing countries with the tools they need to fight artificial shifting of profits out of their jurisdictions by MNCs; provide MNCs with some certainty of treatment in the country concerned; reduce the risk of economic double taxation; provide a level playing field between countries, which is less likely to distort the pattern of international trade and investment; and provide a level playing field between MNCs and independent enterprises doing business within a country

3.2 THE AFRICA TP LANDSCAPE

For many investors, Africa is increasingly being viewed as a region of opportunity and growth. Despite the recent global recession, between 2001 and 2010, Africa averaged GDP growth of 5.2 percent annually.[189] In its December 3, 2011 edition, The Economist summed up the global

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[186] Rosenbloom, H. David (1983), *Tax Treaty Abuse: Policies and Issues,* 15 Journal of Law and Policy in International Business, p. 763, available at: heinonlinebackup.com/hol-cgi-bin/get_pdf.cgi?, (last accessed 20th November, 2012).

[187] An arm's length price is the price payable in a transaction between independent enterprises i.e. willing buyer and willing seller.

[188] OECD (June 2011), Transfer Pricing Legislation- A Suggested Approach, p. 2, available at: www.oecd.org/dataoecd/41/6/45765682.pdf, (last accessed 21st November, 2012).

[189] World Bank and the African Development Bank (2011), *The Africa Competitiveness Report 2011*, p. 18, available at: http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Africa_Competitiveness_Report_2011-1.pdf, (last accessed 22nd November, 2012).

sentiment regarding the outlook for Africa's economy in its cover titled, "Africa Rising."[190] Clearly, Africa's economy is expected to grow considerably in the future. As that happens, multinational corporations ("MNCs") will expand their footprint on the continent. The prospect of their increased investment has elevated a discussion about the state of TP in the region.

The development and implementation of TP regimes in Africa has become a focus of the UN, OECD, European Commission ("EC"), as well as many African governments. International organizations consider TP a financing for development issue because, without due tax revenues, a country's ability to mobilize domestic resources for development is hampered.[191] Recently, there has been increased scrutiny of MNCs tax footprints in Africa.

Over the past several years, there has been considerable debate surrounding the most appropriate TP regime for developing countries. Some consider implementation of the arm's length standard ("ALS"), the central tenant of the TP regimes of most developed nations as well as the TP Guidelines of the OECD ("OECD TP guidelines"), prohibitively resource-intensive and costly for developing countries. Alternative approaches, such as formulary apportionment or fixed margins of returns for intercompany transactions have been suggested, but have not sufficiently been worked out in practice at the international level and are not currently a viable substitute to the ALS.[192] Even the UN, which has been historically hesitant to recommend the ALS, has recently endorsed the ALS stating that the ALS is, "the approach which nearly every country seeking to address such (TP) issues will decide to take."[193]

Although there are significant challenges associated with the implementation of the TP regimes based on the ALS in developing countries, the benefits likely outweigh the perceived risks. Stable TP regimes have the potential to increase much needed tax revenues and attract foreign direct investment ("FDI").[194] In addition, MNCs often perceive operating in countries with

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[190] The Economist (December 3, 2011), *The Hopeful Continent: Africa Rising*, available at: www.economist.com/node/21541015, (last accessed 21st November, 2012).
[191] Sundarm, Jomo Kwame (February 2012), *Transfer Pricing is a Financing for Development Issue*, p. 1, available at: library.fes.de/pdf-files/iez/global/08938.pdf, (last accessed 21st November, 2012).
[192] *ibid*, p. 6.
[193] *supra*, note 120, *UN Practical Manual of TP for Developing Nations*, p. 5.
[194] *supra*, note 41, PwC (2011), *Transfer Pricing: Africa Regional Report*, p. 1.

comprehensive TP regulations as presenting less tax risk than countries in which the characterization and tax treatment of a MNCs' intercompany transactions are uncertain.

Several African nations, most notably Kenya, Egypt and South Africa, have broad TP regimes based on the ALS and several other African countries, such as Uganda, have recently passed legislation adopting TP regulations based on the ALS.[195] Still other African nations, which do not have comprehensive TP regimes, such as the Democratic Republic of Congo and Mozambique, have provisions in their tax code that reference the ALS.

Although many African nations have TP regimes or provisions in their tax code based on the ALS, there are often special tax rules and considerations for particular industries, especially mining, oil, and natural gas. Recently, many African governments have taken the position that existing contracts allow MNCs to exploit their country's natural resources without providing adequate compensation. As a result, there has been speculation that some resource-rich nations, such as South Africa and Ghana, may impose a 'super tax' on excess profits from mining.[196] Nigeria, a nation that is expected to pass TP legislation soon, claims that it has lost $5 billion in tax revenue due to off-shore oil contracts.[197]

As Africa continues to grow and become more integrated into the global economy, it is anticipated that an increasing number of African nations will adopt TP regulations based on the ALS. Although TP regimes in Africa are expected to be based on the OECD Guidelines and the UN TP Practical Manual, 2011, African governments' desire to protect revenues from natural resources will probably influence future TP legislation. In addition, African nations that have already adopted the ALS will likely move toward legislation that will allow for Advanced Pricing Agreements ("APAs"), tax treaties, and safe harbors as these nations seek to increase domestic tax revenue and make their countries more attractive to MNCs.

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[195] PKN Alert (March 8, 2012), *Uganda - New TP Regulations*, available at: www.tpanalytics.com/uganda-new-transfer-pricing-regulation, (last accessed 20th November, 2012).
[196] The Economist (February 11, 2012), *Resource Nationalism in Africa: Wish You Were Mine*, available at: www.economist.com/node/21547285, (last accessed 20th November, 2012).
[197] *ibid.*

Globalization has caused MNCs to play a significant role in the economy of most nations. Worldwide, it is estimated that approximately two thirds of all business transactions take place between related parties.[198] African nations are no exception. In 2000, the UN developed Millennium Development Goals ("MDGs") to tackle extreme poverty and share the benefits of globalization more equitably.[199]In order to meet the MDGs, it is generally accepted that developing countries need to strengthen their tax systems and increase domestic revenues.[200] To this end, the development or expansion of TP regimes in developing nations, including many African nations, has become a priority.

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 disincentivizing international trade and FDI. Jeffrey Owens, Director of the Centre for Tax Policy and Administration at the OECD, identifies the issue in the context of developing countries in the following words:

> Developing economies in particular are increasingly aware of the importance of establishing a robust legislative and administrative framework to deal with TP issues. The challenge for these countries is in essence the same as for OECD countries: protecting their tax base while not hampering foreign direct investment and cross-border trade.[201]

Although protectionist TP policies can certainly impede FDI and cross-border trade, it is likely that the adoption and development of reasonable TP regimes in African countries, especially in countries which historically did not have TP rules, will attract FDI and increase cross-border trade by creating certainty and legitimacy. International consistency in TP regimes is beneficial in creating a basic worldwide structure and facilitating international trade. The UN has stressed that:

> "...consistency is an important goal to be aimed at in terms of encouraging investment in a country and international trade that assists a country's development..."[202]

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[198] World Bank (2011a), *Transfer Pricing Technical Assistance Global Tax Simplification Program*, Presentation given by Rajul Awasthi in Brussels, 24 February 2011, available at: http://www.taxcompact.net/documents/WB-IFC-TP-RA-ITC-EU-event_Feb-2011.pdf, (last accessed 23rd November, 2012).

[199] *supra*, note 131, EuropeAid/PwC (2011), *TP and Developing Countries*, p. 5.

[200] *ibid*, p. 6.

[201] Jeffrey Owens (2009), *Transfer Pricing and Treaties in a Changing World*, OECD Conference Opening Speech, Pairs 21-22, September 2009, available at: http://www.oecd.org/dataoecd/18/25/43744164.pdf, (last accessed 23rd November, 2012).

[202] *supra*, note 62, UN (2012), *TP Practical Manual for Developing Countries,* Chapter I, note 8.4.

As African nations adopt TP standards that are consistent with international norms, MNCs will likely perceive less tax risk associated with operating in those countries, causing increasing levels of FDI. Concurrently, TP rules will allow African nations to protect their domestic tax base by collecting appropriate revenues from MNCs operating within their countries' borders.

The World Bank and African Development Bank have noted that measures to encourage regional integration and trade in Africa are likely to attract additional market seeking FDI.[203] Similar taxing regimes and certainty as to how MNCs will be taxed can be expected to increase regional trade and interaction. As more African countries adopt the ALS, MNCs will be able to determine where to invest based on differing comparative advantages, rather than being deterred from certain markets due to uncertainties in the tax regime.

3.3 EXISTING TP FRAMEWORKS

There are three predominant international players that have and will continue to play a crucial role in the TP policies of African nations. These are: the OECD, the UN and the African Tax Administration Forum ("ATAF"). Each of these organizations have distinct charters and goals, however, it appears that all three support the ALS as the foundation for TP policy.

3.3.1 The OECD Framework

Introduction

The OECD is a grouping of 33 countries,[204] and was formed in 1961 to establish policies within its member countries that would; achieve the highest maintainable economic growth, employment and a sustainable rising standard of living in member countries. The idea behind it was that it would not only result into a sound economic expansion but contribute to the expansion of world trade multilaterally and on a non discriminatory basis.[205]

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[203] *supra,* note 189, p. 3.

[204] OECD comprises of the following countries;-Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxemburg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom and the USA.

[205] *supra*, note 131, p. 34.

The growth in world trade in the 1960's and 1970's created challenges that had not been envisaged. This was more pronounced in the effects of double taxation that adversely affected international trade. Thus the USA and some European countries began paying attention to TP. The result of this effort was the OECD Tax Model was brought into force with a major revision in 1977 and 1992, and the OECD TP guidelines under this convention released in 1979. The objective of the OECD TP guidelines is to find mutually satisfactory solutions for tax administrations and MNCs to TP cases[206].

Since then, there have been revisions to the OECD TP Guidelines in 1995 and 2010 to ensure relevance of the guidelines in a changing business environment. For example, the 2010 update provided detailed guidelines on how to improve comparability analysis. There are guidelines on the appropriate adjustment methods to use, depending on the circumstances of the case and the revised guidelines elaborate the use of transactional profit methods. The transactional methods are used to adjust prices to be at arm's length. The 2010 updates include a new chapter with detailed guidance on TP aspects of business restructurings[207]

As part of their general remit, the OECD member countries recognized that it would be helpful to provide some general guidance on TP in order to avoid the damaging effect double taxation would have on international trade.

The OECD has made considerable efforts to establish the ALS as the worldwide standard in TP regimes. Although TP regimes based on the OECD Guidelines have been implemented in several African nations, many African nations have been slower to implement comprehensive TP regimes. This is often due to lack of capacity and resources or hesitation to adopt a model based solely on the OECD TP guidelines. The main features of the OECD TP guidelines:-

i) the ALP as the fairest and most reliable basis for determining where profits fall to be taxed;

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[206] OECD, 2010, *Preface by the Secretary-General of the OECD*, p 20, available at: www.oecd.org/sti/1893999.pdf, (last accessed 20th November, 2012).
[207] *ibid*, p.21

ii) to remove the hierarchy of methods in earlier versions of the OECD guidelines, which had expressed preference for the use of traditional transaction based methods in favor of a new "most appropriate method rule[208]"

iii) to elevate the standing of the transaction net margin method (TNMM) to be on an equal footing with other TP methods and provide detailed guidance on the use profit less indicators (PLI) including return on sales, return on cost, return on capital or assets and the Berry ratio (i.e. markup on operating expenses).

iv) to place additional emphasis on the use of the profit split method, which is suggested to be likely to be the most appropriate method where inter-company transactions involve the use of "valuable, unique intangibles"

v) other than the five comparability factors that were added in 1995, to place ever more emphasis on the data analysis and use of adjustments and statistical methods to draw conclusions, and

vi) to introduce a nine step process for the establishment of TP policies and procedures[209].

The Arm's Length Standard /Principle (ALS/ALP)

The ALS is the cornerstone of the OECD TP rules. The gist of this principle is that related taxpayers must set TP for any intercompany transaction as if they were unrelated entities but all other aspects of the relationship were unchanged. The import of Article 9 is to the effect that the transfer price should be equal to the price determined by reference to the interaction of unrelated firms in the market place.

OECD TP methods

There are four major methods of ascertaining the arm's length price,[210] namely, Comparable uncontrolled price (CUP), The cost plus method (CPM), The profit split method (PSM) and the transactional net margin method (TNMM). There also exist other TP methods known as Berry ratios.

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[208] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 34.
[209] *ibid.*
[210] *supra,* note 8, *Income Tax (Transfer Pricing) Rules 2006,* Rule 7.

Although the rules provide that the above order is not mandatory the taxpayer may choose a method to employ in determining the arms price from the methods set out in rule 7."[211] However, the CUP is preferred to other methods since it uses evidence most closely related to the arm's length price, but cases could arise where the resale price markups, production costs or other data may be more complete, more conclusive and more easily obtainable than undisputable evidence of open market prices. The bottom line is that the method selected should be able to provide the most cogent evidence in every case.[212] It must be remembered that the arm's length is not an exact science and therefore a reasonable approximation of ascertaining the transfer price may use more than one method in reaching an arm's length price.

In spite of the fact that Kenya has fully embraced these guidelines, it still faces many challenges in their implementation. These guidelines were designed to serve the interest of the advanced countries that are unwilling to not only share information but are reluctant to make the system work efficiently in LDC. Besides the system is complex and expensive to operationalize for these countries that are financially unstable. As outlined in chapter 2, tax authorities may and do need a substantial amount of reliable information about the activities of the MNC in question. Many tax authorities in Least Developed Countries (LDC) lack this information and instead have more about transactions and conditions concerning market prices and markups in their own countries than in other countries and may rely on this information rather than trying to calculate the cost and profit markups of related sellers abroad.[213] In certain transactions comparable entities may not be found in LDC which may complicate the entire TP assessment.

3.3.1.1 The Comparable Uncontrolled Price Method (CUP)[214]

Theoretically CUP is touted as the most objective method in determining the arm's length price.[215] This is because it makes reference to comparable transactions between buyers and sellers who are independent of each other. Comparability maybe between sales by a member of the MNC to an unrelated party and sales to parties that have no relation with the MNC whatsoever.

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[211] *supra,* note 8, *Income Tax (Transfer Pricing) Rules 2006,* Rule 4.
[212] OECD (1979), *Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs,* (OECD: Paris), p. 33.
[213] *ibid,* p. 32.
[214] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* Paragraph 2.13.
[215] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 36.

Therefore uncontrolled sales are sales in which at least one party to the transaction is not a member of the taxpayers affiliated group but they could include only bona fide transactions and not sales of the unrepresentative of the market, e.g. as those made in a limited quantity at unrealistic prices to an unrelated buyer, for the purpose of establishing an arm's length price on a larger transaction.[216] Rule 7 of the Income (TP) Rules 2006 which heavily borrows from the OECD guidelines defines CUP as a TP method "in which the transfer price in a controlled transaction is compared with the prices in an uncontrolled transaction and accurate adjustments made to eliminate material differences"

That notwithstanding, CUP is affected by a number of factors which include but are not limited to the following: economic comparability, comparable market levels and other considerations.

Economic Comparability

Prices of goods can be comparable only if they are sold on markets which are economically comparable. The growth in international trade has led to an expansion of trade to countries that cannot be said to be operating under the same economic conditions. Geographically different markets can be satisfactorily compared when the economic conditions are either the same of there are any differences; they are the type that can only be eliminated. The economic and social structures, geographical situations and consumer habits play an important role in determining the supply and demand of a product from one country to another. Individual country's policies also affect the value of the currency, taxes, competition policy, policy, price or exchange control, size and efficiency of the market and degree of concentration, do affect the price levels. Where a corporation enjoys a monopoly or any dominant market position, it will charge uniform prices to all unrelated customers as opposed to a competitive market.[217]

Comparable Market Levels

The concept of comparability largely depends on the point at which goods are sold in the chain from producer to consumer and quantification of different points in the chain. For example there will be a difference between the wholesale and retail price of a commodity but if the retailer's

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[216] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 34.
[217] *ibid*, p. 35.

markup is readily ascertainable, it shouldn't be difficult to make the necessary adjustment. This will further depend on the nature of products.

Comparison of controlled sales with the sales in the uncontrolled manner is readily acceptable if the goods concerned are as physically identical but if the differences are important, a useful comparison may still be possible so long as appropriate adjustments can be reasonably made to the uncontrolled price to take account of the differences.[218] Likewise it may be possible to derive the same from sales of substitute goods depending on the circumstances. Mass produced goods display CUP, although quality is a factor in the pricing. Thus the less standardized the goods, the unlikelihood of finding CUP. This is also true of open market prices of semi finished goods which due to the level of specialization are less likely to be found on the open market.[219]

How consumers accept a product also affects its price. Buyers show certain biases towards a particular product for various reasons such as: - its executive patented container, trademarks, and trade names, peculiarities of the package design, colour and style. Such differentiation maybe fancy but regrettably affects price, thus goods that prima facie look similar attract varied prices depending on whether they are branded or not.[220] A direct comparison with the prices of identical goods may be misleading if identical guarantees do not form part of the conditions of sale for example, identical goods with patented products that are counterfeit, illegally copied or smuggled goods (sell at lower prices) are not comparable and therefore irrelevant to determine the arm's length price of the patented product. However ineffective protection of the patented product may force its price down closer to the counterfeit, whose relevance would be relevant in determining its production cost.

Comparability of controlled and uncontrolled sales are affected by the volume of sales which must be comparable (if the volume has an effect on price), the uncontrolled sales must have been realized at a time reasonably close to the period during which the transaction under consideration were made, due to seasonal price fluctuations arising from changes in the economic situation. The terms of sale may also justify price variations, costs of transport, packaging, advertising

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[218] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report*, p. 3.
[219] *ibid,* p. 36.
[220] *ibid.*

marketing, guaranteeing may or may not be included in the deal. The terms of payment, foreseeable or expected fluctuations in exchange rates or in rates of inflation may be expected to have been taken into account (for example by invoicing in a hard currency or by indexing or by advance payment).

Intra group sales may involve tangibles thus it becomes necessary to determine whether intangibles have also passed. These would include patents, goodwill, know-how and trademarks. The nature of MNC transactions is that transfers of intangibles become a factor in the pricing of the goods or as an alternative and may be invoiced separately.

Other considerations

CUP is not useful where no comparable uncontrolled prices are available or not truly comparable because they relate to purely marginal uncontrolled sales. In this case other methods maybe used of which cognizance must be taken of the nature of the product in determining a reasonable profit margin. For example, if the product is an important innovation, a greater proportion of its profit must be attributed to the enterprise concerned with production, research and development. This entity would also have to bear the losses if the market rejects it. This is unlike other products in the MNC whose pricing is a factor of marketing than anything else.[221]

In such situations it is submitted that tax authorities must take account of the following market conditions:-[222]

i) custom of the trade and all other relevant facts and circumstances of each individual case in determining what would be an appropriate price,
ii) an analysis of how the MNC is organized, the economic functions of the different associates, the members that contributed to the research and design undertaken by the corporation and
iii) the consistency of pricing as a pricing policy.

However granted that pricing policies vary from one period to another, the possibility cannot be ruled out that tax administration is the motive for such variations which may make it necessary for an explanation.

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[221] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report*, p. 35.
[222] *ibid,* p. 38.

3.3.1.2 The Resale Price Method (RPM)

This is the second and alternative method of arriving at an arm's length price of a commodity. The resale price method in which "...the transfer price of the produce is compared with the resale price at which the product is sold to an independent enterprise; Provided that in the application of this method the resale price shall be reduced by the resale margin (the profit margin indicated by the reseller)"[223]

Whereas the CUP calls for comparable price, resale price calls for comparable markup. It works on the principle of deducting an appropriate discount for the activities of the reseller from the actual resale price.[224] The appropriate discount is the gross margin expressed as a percentage of the net sales earned by a reseller on the sale of property that is both purchased and resold in an uncontrolled transaction in the relevant market. Such a discount must be derived from unrelated party purchases and sales for the reseller involved in the inter-company transaction. In the event that such a transaction does not exist, an appropriate discount may be derived from sales by other resellers in the same or similar market. This method is more preferred where the buyer and seller have not added value to the product and in cases where no usable evidence of comparable uncontrolled sales and the associate seller contributed the greater part of the value of the goods.[225]

However this method is not without its problems for the OECD guidelines have conceded that there may not be any comparable transaction, besides movements within the group such as foreign exchange fluctuations, interest rates, recession in the economy may cause a distortion in arriving at the transfer price.

The resale price may be less useful where: -[226]

i) the value of the product before resale is enhanced for example through further processing which transforms it into a new product.

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223 *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 2.21. see also Rule 7(b), Income Tax (TP) Rules, 2006.
224 *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report*, p. 38.
225 *ibid,* p. 38.
226 *ibid,* p. 39.

ii) the amount of time taken before the controlled sale, the shorter the time the better. More time translates into variations created by changes in the market and exchange rates[227].tax authorities have to consider whether the value of the product is affected at resale by the use of a trade mark or other intangible quality which may change the products as to distort applying the resale price

iii) other considerations will include the amount of risk taken by the person reselling the product. This may arise where a forwarding agent takes a risk of ownership, advertising, marketing, distribution, guaranteeing the goods financing stocks among other services. Where a reseller takes minimal risk, the profit will equally be minimal. A reseller who adds value through carrying on substantial activities involving, packaging, advertising, marketing, storage, transport, distribution will reflect this in the pricing[228] resale price in goods whose distribution chain incorporates a corporation in a tax haven or low tax country, would necessitate the tax authority to look at not only the resale price of goods purchased from the corporation but at the price to its supplier. The difficulties inherent here are getting this information and the true function of the intermediate corporation.

iv) the exclusivity of the reseller to deal with the goods may affect the profit markup. The value attributed to this exclusive dealing depends on its geographical scope and the competitive nature of the possible substitute goods. The effect of this factor on the vendor and the reseller with regard to the arm's length price will therefore need to be examined very carefully.

It can therefore be said that the profit markup of a distributor maybe estimated by reference to the profit markup which he earns on items purchased and sold on uncontrolled transactions. Failing that, the profit markup earned by totally uncontrolled party may serve as a guide, this will need to be approached very carefully.

3.3.1.3 The Cost Plus Method (CPM)

The cost plus method has been described as one;-

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[227] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* para 2.30.
[228] *ibid,* para. 2.32.

> "...in which costs are assessed using the costs incurred by the supplier of a product in a controlled transaction, with a markup added to make an appropriate profit in light of the functions performed and the assets used and risks assumed by the supplier."[229]

This method presents certain problems with regard to assessing costs, the appropriate markup for profit. However, it has been found to be an appropriate method in determining the arm's length price in specific situations and as a means of verifying provisionally acceptable prices after other methods have been applied.

CPM is helpful in estimating arm's length price when semi-finished products are sold between related parties or when different entities within an MNC have concluded joint facility agreements or long term buy and supply arrangements or when the subsidiary essentially performs the role of sub-contractor. Prices fixed on cost plus basis are a feature of arm's length transactions especially where a contract is for a special product tailor made to suit an individual customer alone and costs of production are heavy and unpredictable. Examples of this include government contracts for the supply of military equipment and particular turnkey factory projects.[230]

The CPM of determining arm's length has been criticized for over-emphasizing historical costs, ignoring demand, failure to reflect competitive conditions and being unrealistic because it assumes that profit is made all the time, while in a business cycle, profits are not always guaranteed. Besides allocating costs to particular production may be problematic while other costs may be abnormal on account of mismanagement.[231]

The difficulty in this scenario is in determining the relevant cost, since cost accounting methods are not universal, they vary from country to country and from business to business. The challenge for tax authorities is to discern which costing method has been used. If an enterprise consistently uses one method, the tax authority will use it (whichever method is used), the costing methods for intra-company transactions will indicate not only the direct cost of raw materials, salaries, components and goods but overheads such as indirect costs such as research and design.

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[229] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 2.39.
[230] *ibid*, para. 2.43.
[231] *ibid,* para. 2.46.

The cost of a product will also include historical costs over a period of time, over a group of products and over a particular line of production. Allocation of costs will have to be made i.e. costs of fixed assets where different products are processed simultaneously or volume of activity fluctuates and it may include arriving at an average cost[232].

The other challenge concerns the question of how to allocate costs between vendors and purchasers? To answer this, the functions performed and risks undertaken by corporations have to be considered. Such risks will include the purchase of exceptionally heavy costs in expenditure on capital equipment, research projects and advertising companies have to be attributed to different units. Apportioning of overhead costs is a related problem and should be done in reference to the turnover, to the number and cost of employees.

Apart from the problem of identifying appropriate costs, there is the problem of determining an appropriate markup. The seller's mark up should be determined in reference to the seller's markup on similar items purchased and sold in uncontrolled transactions. However if the seller makes no uncontrolled sales, its gross profit will have to be estimated from that earned by uncontrolled sellers performing similar activities. Just as in resale price method, it is important to analyze the actual economic functions of the associated enterprise.

3.3.1.4 Profit Split Method (PSM)

The profit split is a method of arriving at an arm's length price;-

> "...in which the profits earned in very closely inter-related contracted transactions are split among the related enterprises depending on the functions performed by each enterprise in relation to the transaction and compared with a profit split among independent enterprises in joint venture."[233]

This method is more appropriate where transactions are so related that it is not possible to identify closely comparable transactions especially where both parties' in a related party transaction have contributed valuable intellectual property. It is only conducted at the operating income level i.e. income that is attributable to operations only with the exclusion of all non-

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[232] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* para. 2.43.

[233] *ibid,* para. 2.108.

operating income. The OECD guidelines state that expected profits should be used rather than actual profits so as to avoid hindsight.

The problem with computing arm's length using this method is that the tax authority has to know how profits would be split between unrelated parties that are based on the same facts and circumstances as in the related party situation. This information is always never in public domain, therefore reliance has to be placed on judgment of the user to determine appropriate split formulae that would reflect the contributions of tangible and intangible assets made by each party to the transaction.[234] To arrive at a profit split, revenues and costs of each legal entity have to be computed. The difficulty with this method is that it involves extensive disclosure requirements to ensure that the transfer price documents standards are met.

3.3.1.5 Transactional Net Margin Method (TNMM)

The TNMM is one "…in which the net profit margin is attained by a multinational enterprise in a controlled transaction as compared to the net profit margin that would have been earned in a comparable transaction by an independent enterprise."[235] This method was the OECD's response to the US's comparable profits method (CPM). The method considers the net profit margin relative to an appropriate base such as costs, sales and assets that a taxpayer makes from a controlled transaction. The OECD guidelines stress that there should be sufficient comparability in the enterprise being compared so that there is no material effect on the net margins being used or affect the adjustments.

Other Arm's Length TP methods

Apart from the five arm's length TP methods discussed above there are other methods not as prominent that are least used. They are either derivatives of the four above or refinements of the same. They include but are not limited to: - return on assets (ROA) and berry ratio.

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[234] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 42.

[235] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* para. 2.58.

3.3.1.6 Return on Assets

The return on assets is the method most preferred by economists as it is based on a return on capital (equity). However, it is less used because the capitalization of affiliated entities to MNCs is determined by the parent company and not market forces of banks or shareholders who ordinarily control the capitalization of quoted companies. This is an instance of non conformity with the ALP. However in other jurisdictions, ROA is applied as part of the TNMM or CPM[236]

ROA is more appropriately applied in manufacturing activities. The challenge in using this method is on how to define assets used in the manufacturing process. This is solved by using return on net book value (NBV) of all assets, the numerator being the operating income before interest and taxes while the denominator is the NBV of all assets reported on the balance sheet (statement of financial position) excluding the financial and non-operating assets. Besides the age of the plant and equipment, must be considered when comparing the ROA in a related party with those earned by independent companies. For example if the manufacturing company in a MNC group has a new plant with very high depreciation expense, its ROA may not represent a valid comparison with independent companies that operate with old, fully depreciated plants (or vice versa) unless the assets are all revalued to a current basis.

3.3.1.7 Berry Ratios

The berry ratio method is a derivative of the return on sales (ROS) method in application to the profitability of distribution operations in order to arrive at an arm's length price for inter-company pricing arrangements. Berry ratios are defined as ratios of gross profit to operating expenses.[237] The berry ratio however focuses on comparing the gross profitability of an activity and operating expenses necessary to carry it out i.e. gross profit divided by operating expenses. In essence it is seen as a cost plus method applied to selling entities.[238]

The effectiveness of this method depends on three factors:-[239]

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[236] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 44.
[237] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* para. 2.100
[238] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 45.
[239] *supra,* note 1, OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* para. 2.101.

i) the value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses,
ii) the value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, *i.e.* it is not proportional to sales, and
iii) the taxpayer does not perform, in the controlled transactions, any other significant function (*e.g.* manufacturing function) that should be remunerated using another method or financial indicator.

3.3.2 African Tax Administration Forum (ATAF)

The ATAF is a platform created to promote and facilitate mutual cooperation among African Tax Administrations with the goal of improving the efficiency of their tax legislation and administration. ATAF brings together Heads of African Tax Administrations and their representatives to discuss the progress made, challenges faced and possible new direction for African tax policy and administration in the 21st Century. ATAF was set up by 34 African Tax Commissioners to provide an African voice in taxation and promote learning and capacity-building in African tax Administrations.

The ATAF should encourage African countries to adopt a pragmatic approach to TP. Critical to this concept is recognition that TP tends to be more of an art than a science. Developing countries must become adept at negotiations with taxpayers as there is generally no single correct answer in TP, and thus, most disputes are resolved through negotiation and compromise.

Furthermore, African countries should seek to create a compliance regime that is proportionate to the perceived risks from a MNC's perspective and also considers the realistic capacity and capability of the tax administration. Thus, African economies should avoid creating unilateral, burdensome compliance requirements as anticipated benefits will probably be outweighed by lost revenues from MNCs avoiding the market.

The tax authorities in the US and a handful of other countries started to pay considerable attention to TP in the 1960s and 1970s. As part of their general remit, the OECD member countries recognized that it would be helpful to provide some general guidance on TP in order to

avoid the damaging effect double taxation would have on international trade. The result was the OECD Report and Guidelines on TP, issued in 1979 and subsequently revised and updated in 1995 and again in 2010.

The OECD has made considerable efforts to establish the ALS as the worldwide standard in TP regimes. Although TP regimes based on the OECD Guidelines have been implemented in several African nations, many of these countries have been slow to implement comprehensive TP regimes. This is often due to a lack of capacity and resources or a hesitation to adopt a model based solely on the OECD Guidelines.

3.3.3 UN Model Convention on TP

The UN Tax Model of 1980 was published with the aim of promoting bilateral tax treaties between developing and developed countries that would prevent double taxation and promote economic relations through fair and certain rights among member countries. The Model was formulated from guidelines prepared by Ad Hoc Group of Experts on Tax treaties between Developed and Developing Countries.[240]

A revision of the Tax Model was undertaken and completed in 1999 to take into account developments since 1980 in the globalization of trade and in the international tax policies between developed and developing countries. The UN Tax Model is based on the OECD Tax Model but is modified to take into account special issues affecting developing countries. In particular, the UN Tax Model gives additional tax benefits to source countries.[241]

Concerned that the OECD Guidelines protect the interests of OECD member-countries, the UN sought to create a TP framework that would better suit the needs of developing countries. To this end, in 2009, the UN Expert Committee initiated its work on the UN TP Practical Manual, 2011.

The UN Tax Model is the first real attempt at an international TP legal regime that addresses TP challenges in both developing countries and developed countries. The other regimes are regional

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[240] In 1980, the Group of Experts was renamed: *'Ad Hoc Group of Experts on International Cooperation in Tax Matters.'*

[241] For example, by making it easier for a foreign person to have a permanent establishment and leaving reduction in withholding tax rates to bilateral negotiations.

and country specific such as the one for OECD countries. A majority of developing countries (Kenya included) have reluctantly adopted the OECD TP guidelines which have been developed to serve the member countries. This is so because they share many attributes as developed countries, and because of their historical and economic backgrounds. Now, many developing countries face similar conditions as the OECD countries did in the 1970's through 1990's and which are discussed in the OECD Guidelines. Thus, when it comes to the evolution of the UN Models and Guidelines, attention has been focused on the many developing countries which are encountering difficulties with administering the ALP.[242]

The OECD TP Guidelines have been widely accepted in principle including the UN Model Double Tax Convention but some countries, especially developing countries, find it very difficult to implement such guidelines in practice. There are five different prescribed TP methods to arrive at an arm's length price, but though all these methods may be able to provide a computation of the arm's length price (i.e., a "proper" transfer price) within the MNC, in practice they may end up with figures of profits between two MNCs being either more than 100% or less than 100% due to adjustments carried out by the tax authorities without "corresponding adjustments" by the other country on transactions within the MNC group.

The UN for its part published an important report on "International Income Taxation and Developing Countries" in 1988. The report discusses significant opportunities for TP manipulation by MNCs to the detriment of developing country tax bases. It recommends a range of mechanisms specially tailored to deal with the particular intra-group transactions by developing countries. The UN Conference on Trade and Development (UNCTAD) also issued a major report on TP in 1999. The UN is again taking a leadership role, through this TP Manual, in trying to arrive at updated global TP guidelines which can be used by countries all over the world in developing (or calibrating) their TP regulations. Such guidelines which are arrived at through detailed debate and discussion amongst all the UN member nations, including both developed and developing countries, aims at reflecting an overall global consensus with respect to TP. It is important to highlight this since, in many developing countries, TP legislation is introduced in

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[242] *supra*, note 5, UN (2011), *An Introduction to Transfer Pricing: Background Paper and Working Draft*, Chapter 1, page 26.

conjunction with anti-avoidance regulations and therefore runs the risk of being generally regarded as a tool to circumvent taxation.

The UN TP Practical Manual, 2011 deals with the basic questions regarding TP, including: hhow to draft TP legislation, how to set up special TP units, how to identify and work with TP databases and pursue simplified strategies for testing the arm's length nature of a related-party transaction.

3.4 CHALLENGES NOT ADDRESSED IN THE ABOVE FRAMEWORKS

3.4.1 Deficiencies in TP Documentation

The UN TP model is meant to address deficiencies in TP in developing countries, many of them modeled on the OECD guidelines. In a survey conducted by the UNCTAD in 1995, noted that 40% of the developing countries showed that existing TP regulations, guidelines, administrative requirements did not address the issue of services. Technology transfers were not addressed in two thirds of the developing countries. Available evidence shows that MNC "weight profit allocations towards countries with aggressive TP policies, so as to minimize tax risk."[243]

For countries like Kenya with basic TP regulations, challenges arise from limited experience and expertise in analyzing complex TP situations. There are a few audit firms that have specialized in this but their number is countable. Lack of administrative experience may allow firms to take advantage of the situation and shift income or be unfairly taxed due to a misapplication of the regulations. Furthermore, the existence of monopolies within a country may affect the tenor of tax regulations so that those monopolies are protected from the competition by MNCs wishing to tap into a captive market share. In some countries "entry is arbitrarily regulated…often from a regulatory authority with vested interests in screening[244]"

3.4.2 Repatriation of Profits

When MNCs invest in developing countries, the agreements mandating the investments may limit the amount of profits that MNCs can repatriate. Very strict agreements have the effect of

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[243] *supra,* note 41, PwC (2011), *Transfer Pricing: Africa Regional Report,* p. 45., p. 1.
[244] Bergsman and Shen (1996), *Foreign Direct Investment in Developing Countries*, p. 346, available at: www.unz.org/Pub/JSocialPoliticalEconomicStudies-1996q3-00343, (last accessed 26th November, 2012).

limiting FDI while others may determine whether MNCs could increase or commence investment and a few have reservations for situations where severe trade imbalances may occur. An analysis of 19 existing regional, bilateral and multilateral FDI instruments by UNCTAD shows that the transfer of funds is only addressed in 9 of those instruments. This is a huge gap through which a lot of revenue is lost.

3.4.3 Double Taxation of Profits

Double taxation of MNCs profits occurs where differences in TP policies of countries exist. The OECD guidelines mandate the use of TNMM while the USA allows the use of CPM. The latter is less rigorous in the range of transactions involved, has no restrictions and only requires documentation that shows that it is "...best method" for the firm. These differences create conflict between the OECD based TP regulations and US regulations.[245]

3.4.4 Customs Valuation

Conflict of interest may arise between valuing a transferred good using an arm's length method and valuing the same goods for purposes of customs duty. Supporters of the ALP cite it as being objective and therefore the need for consistency in its application. This will solve two problems i.e. avoid tax payer confusion and situations where MNCs use one value to minimize tax liability while tax authorities use another to maximize tax revenue. The reality however is that TP valuations usually include costs that are omitted in custom duty valuation. Thus information exchange provisions in tax treaties, tax authorities and custom officials enhances information flow and ensures that differences in declared values are justified. Information exchange is also supported by OECD guidelines.

3.4.5 Cost Sharing

Cost sharing techniques need to be carefully monitored to ensure that they are not shifting the cost of developing intangibles to their affiliates in developing countries. They can be used to allocate research and development and other costs that are disproportionate to the actual benefits enjoyed by these countries. The bottom line is that genuine cost sharing between MNC and affiliates need to be distinguished from those whose aim is tax avoidance.

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[245] UNCTAD (1999), *Transfer Pricing*, UNCTAD Series on Issues in International Investment Agreements, p. 34, available at: http://unctad.org/en/Docs/psiteiitd11v1.en.pdf, (last accessed 26th November, 2012).

3.4.6 Advance Pricing Arrangements (APA)

The promotion of APA may solve some of the problems experienced by developing countries, but MNCs are least interested in participating in APA's that involve developing countries. A survey conducted by UNCTAD showed that 70 to 96% of MNCs did not have plans of pursuing APA with either the home country or host country[246]. The most often cited reason for the reluctance is the amount of information and documentation needed the cost implication which outweighs the benefits and confidentiality concerns[247].

3.4.7 Tax Conventions/Treaties

A tax treaty or convention can be either bilateral or multilateral and can operate a mechanism to co-ordinate taxing rights to prevent double taxation[248]. Double taxation agreements are a form of treaty; they are agreements between governments that seek to avoid their tax payers who have ratified the agreements from the burden of being taxed twice on the same tax base. Member countries can enforce the tax treaties to protect revenue loses through practices such as tax evasion and TP.

To date, Kenya has ratified 8 treaties, that is with Zambia, Norway, Denmark, Sweden, U.K, Germany, Canada and India. The treaties that are signed and are not ratified are with Italy, Tanzania and Uganda. Kenya has also entered into treaty negotiations with France and Thailand. There are conventions under discussion by the Task Force on Double Taxation & Investment Agreements under the chair of the Ministry of Finance, namely, with Seychelles, Nigeria, South Africa, Mauritius, Finland, United Arab Emirates and Islamic Republic of Iran.

3.5 CONCLUSION

The OECD and UN Tax Models contain guidelines on determining tax liability between related enterprises. The tax models are similar in their objectives in that their aim is to promote certainty, transparency and uniformity in order to promote fair trade relations. It is argued, though, that the OECD model reflects the interests of the Western countries whereas the UN Model is meant to propagate the interests of developing countries. The membership of OECD Tax Model largely

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[246] Borkowski, S. C. (1999), *Transfer Pricing Documentation and Penalties: How much is Enough?* 6 International Tax Journal, available at: arxiv.org/pdf/0903.3346, (last accessed 26th November, 2012), p. 5.
[247] *supra*, note 245, UNCTAD (1999), *Transfer Pricing* p. 36.
[248] *supra,* note 62, UN (2012), *Practical Transfer Pricing Manual for Developing Countries,* p. 16.

comprises western countries.[249] At present, the UN Group experts are comprised of 25 members: 10 from developed countries and 15 from developing counties and economies in transition.[250] There are numerous similarities and differences between OECD and UN Tax Models that are discussed by various writers such as Lennard[251] and Mc Intyre.[252] That notwithstanding, both models make reference to Article 9 on the ALP that related parties should observe in their transactions. However, Article 9 is not self entrenching. This means that domestic law must be encoded to bring it to life.[253]

The international best practices in TP under the OECD model were meant to bring clarity and consistency in TP practice globally. The decision of the Unilever case ratified the application of the OECD guidelines in the absence of Kenya's own guidelines. This ratification by the court prompted reaction from KRA to promulgate the TP rules 2006. The adoption of the OECD guidelines by default is not necessarily an answer to TP problems as its creation was meant to address TP challenges of its member states' that were mainly developed economically. The solution lay in a true international tax regime to address the information imbalance existing between the developed countries and developing countries. The release of the UN Practice Manual aimed at solving the TP challenges of developing countries. The background to the UN Model was informed by the deficiencies in the TP legislation of developing countries modeled on the OECD that could not adequately address issues of TP manipulation (TPM), double taxation of profits, customs valuation, cost sharing between related entities, income shifting or profit dumping and reluctance to enter advance pricing arrangements. Thus the gist of the UN model is to bring about uniformity and parity in TP rules globally. The two dominant models are united in the promotion of the ALP as the cornerstone of evaluating the transfer price globally.

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[249] Membership list available at: http://www.o.e.c.d.org/pages/3417, (last accessed 20 November 2012).
[250] Membership list available at: http://unpan1.un.org/intradoc/groups/public documents/un/unpan002084.pdf , (last accessed 15 November 2012)
[251] Lennard Michael (2008), *The UN Model Tax Convention as Compared with the OECD Model Tax Convention: Current Points of Difference and Recent Developments*, Presentation at the Asian Development Bank Institute's Regional Tax Forum, Tokyo, available at: www.taxjustice.net/cms/upload/.../Lennard_0902_UN_Vs_OECD.pdf, (last accessed 20th November, 2012).
[252] McIntyre Michael. J. (2010), *Model Tax Treaties: A Comparison of the UN and OECD Models,* available at: http://faculty.law.wayne.edu/tad/Documents/Teaching_Materials/model_treaties.pdf, (last accessed 20th November, 2012).
[253] *supra*, note 62, UN (2012), *Practical Transfer Pricing Manual for Developing Countries*, p. 11.

CHAPTER FOUR: NEXUS BETWEEN OECD & WTO GUIDELINES ON TP

4.1 INTRODUCTION

In the previous chapter, the various TP regimes were discussed with the aim of appreciating some of the lessons that can be borrowed to enhance the Kenya TP legistlation. This chapter will analyze the relationship between the OECD TP guidelines and the WTO custom valuation rules, methods, challenges and their applicability in customs duty valuation. The chapter seeks to demonstrate some of the complexities between the OECD methods that Kenya adopted and the Customs valuation method.

The term 'Customs value' means the value as determined in accordance with the agreement on implementation of Article VII WTO Agreement on Custom Valuation.[254] The Customs and Excise Act[255] and EAC Customs Management Act defines a customs value as "*...the price actually paid for the goods sold adjusted in accordance with provision of the Act.*"[256]

The problem of ascertaining the value of goods and services within related entities has not only been a concern for tax authorities but also for customs authorities and Kenya has not been spared either. The challenges outlined in chapter 2 with regard to TP hold true for customs valuation and compound the problem of ascertaining a customs value.

For customs purposes, the transfer price has a direct impact on the determination of customs value. The lower the transfer price, the lower the customs value and the applicable customs duties. This also applies to the collection of inland taxes, that is, VAT and excise duty when they are calculated on the basis of the customs value of the imported goods.[257]

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[254] It provides thus; "The Contracting Parties recognize the validity of the general principles of valuation set forth in the following paragraphs of this Article, and they undertake to give effect to such principles, in respect of all products subject to duties or other charges or restrictions on importation and exportation based upon or regulated in any manner by value."

[255] EAC (2012), *East African Community Customs Management Act,* Cap 472, Laws of Kenya, available at: http://www.kra.go.ke/notices/pdf2012/EastAfricanCommunityCustomsManagementAct.pdf, (last accessed 26th November, 2012).

[256] Customs and Excise Act, Article 1, Seventh Schedule, and Section 2 of EACCMA, *ibid.*

[257] OECD (2010), *Transfer Pricing and Treaties in a Changing World,* available at: www.oecd.org/dataoecd/42/6/42650929.pdf, (last accessed 21st November, 2012).

The developed countries created the GATT Valuation Code (identical to the present WTO Customs Valuation) that binds members that accepted its terms to the disadvantage of the Least Developing Countries (LDCs). LDCs declined to accept the terms of the Tokyo rounds regarding treatment of transactions between related companies which essentially favored developing countries.[258] Thus the likelihood of the developing countries using the arm's length price or actual value of the transactions was very minimal. This system was reminiscent of OECD TP guidelines that were suited to member states.

Whereas common purposes and similar concepts exist in international TP and custom valuation rules, the situation at national level is quite different[259]. Here the degree of convergence of the rules and coordination of the tax and customs administration efforts vary greatly. For example, tax and custom authorities have no obligation to accept the value calculated by the other legislation requirements. Customs administration have not yet developed special strategies, procedures and expertise to address TP, MNCs have to comply with both obligations under tax authorities and custom legislation and regulations as well as other regulatory requirements such as foreign exchange control and the thus could lead to double taxation[260]

In the allocation of profits from related enterprises, most nations as well as tax administrations use the OECD guidelines for MNC and UN Model Convention. In calculation of customs duty, most national administrations adhere to the WTO Agreement on the implementation of Article 7 of GATT (1994) (WTO CVA). While the OECD, UN and WTO share similar goals, the differences between them led to issues for MNCs that use TP for customs purposes in two main ways. Firstly MNCs have to demonstrate that the intercompany TP is also an acceptable customs

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[258] Seventeen GATT Members (the (then) EEC counting as one) had signed or accepted the Tokyo Round Agreement at the time that it entered into force, January 1, 1981. Seven of the original signatories were developing countries. GATT Consultative Group of Eighteen, *MTN Agreements: Legal Status as of 2 March 1981* , CG.18/W/46/Supp.1 (March 6, 1981). Over time, however, additional developing countries would sign onto the GATT Valuation Code.

[259] Murphy, Michael E and H.E Files (2009), *The Intersection of TP and Customs Valuation*, International Tax Law Review, 149-156, http://www.bakermckenzie.com/files/Uploads/Documents/CV/Int%20TLR%205%20Murphy%20 Files%20article.pdf, (last accessed 21st November, 2012).

[260] Liu Ping and Caroline Silberztein (2007), *TP, Customs Duties and VAT Rules: Can We Bridge the Gap?* 1 World Com. Rev. p. 1, 36, available at: http://www.oecd.org/dataoecd/40/54/39265412.pdf, (last accessed July 21, 2012). The joint OECD/WCO conferences were held in May 2006 and May 2007.

valuation rate. Secondly, MNCs require to properly account for retroactive TP adjustments and other additions to value for customs purposes.

While the importance of TP is increasingly appreciated, the focus has traditionally been on direct taxation and TP still largely remains a subject for tax specialists. In the past decade, however, it has become obvious that the customs duties and, more recently, the Value Added Tax (VAT) dimensions of TP can also take quite a toll on a company's profits and on government revenues, and they are now increasingly attracting the attention of governments and businesses. Valuation of Related Party Transactions for TP, Customs and VAT purposes was the subject of two major conferences jointly organized by the WCO and the Organisation OECD in May 2006 and May 2007.

The legal foundation of customs valuation in Kenya is founded on treaty law namely the WTO CVA, of which Kenya is a signatory, regional legal instruments and regulations under the auspices of the East African Community (EAC) and the COMESA[261] and under the Customs and Excise Act ('CEA') and EACCMA.[262]

4.2 World Customs Organization (WCO)

WCO is the only intergovernmental organization with a unique Customs focus, the WCO with its headquarters in Brussels currently has 169 Members across the globe at all stages of economic development that collectively process approximately 98% of world trade. The WCO is particularly noted for its work in areas covering the security and facilitation of the trade supply chain, the development of global Customs standards, the simplification and harmonization of Customs procedures, trade facilitation, risk management, integrity promotion, valuation, origin, the Harmonized System goods nomenclature, and sustainable Customs capacity building initiatives.[263]

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[261] Common Market for Eastern and Southern Africa

[262] WCO_OECD (2011), *Conference on Transfer Pricing and Customs Valuation*, available at: http://www.wcoomd.org/WCO_OECD%20Conference%20on%20Transfer%20Pricing%20and%20Customs%20Valuation_Brochure%20EN.pdf, (last accessed 21stNovember, 2012).

[263] WCO (2012), *About Us*, available at: http://www.wcoomd.org/home.htm, (last accessed 26th November, 2012).

Being the global centre of Customs expertise, the WCO provides an ideal forum for Customs administrations and their stakeholders to discuss, exchange experiences, and share best practices on a range of international issues. In this study, we will focus on the role of WCO in reforming the Customs valuation rules.

4.3 WTO: ORIGIN AND PRINCIPLES

The WTO was established in 1995 to administer the trade agreement negotiated by its members especially the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS) and the Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement. The predecessor of WTO was GATT which was negotiated in 1947 by 23 countries.[264] By the year 2001, the total membership of WTO was 144.

The main function of the WTO as a forum for international co-operation on trade related policies is the creation of codes of conduct for member states. The GATT/WTO is underpinned by five basic principles[265], non discrimination,[266] reciprocity, enforceable commitments, transparency[267] and safety valves.

4.4 WTO CUSTOMS VALUATION AGREEMENT (WTO CVA)

Since time immemorial, governments have always used the collection of customs duty on imported goods as a source of revenue. Athens for example applied 20% import duty on corn and other goods while the Romans relied on customs duty before Julius Caesar's reign to support the expansion and maintenance of their empire. Disputes could arise then on the desire by the Roman smugglers to avoid paying customs duty.

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[264] The founding parties to GATT were; Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Chile, Cuba, Czechoslovakia, France, India, Lebanon, Luxemburg, Netherlands, New Zealand, Norway, Pakistan, South Rhodesia, Syria, South Africa, United Kingdom and the United States of America. China, Lebanon and Syria later withdrew. The above amounts to 12 industrial and 11 developing countries.

[265] Hoekman, Bernard (2001), *The WTO; Functions and Basic Principles*, p. 42, available at: www.terry.uga.edu/~eornelas/.../WTO-basics.pdf - United State, (last accessed 20th November, 2012).

[266] GATT/WTO (1990), *General Agreement on Tariffs and Trade*, Article 1 and 3, available at: www.wto.org/english/docs_e/legal_e/**gatt**47_e.pdf, (last accessed 26th November, 2012).

[267] *ibid,* Article 10.

Before 1979, governments displayed diversity and inconsistency in terms of customs valuation, using two different approaches i.e. those based on "notional" concept of value and those based on positive concept. WTO customs valuation is a result of the 1986 to 1994 Uruguay Round of negotiations that evoked the difficulties of customs valuation such as;-[268]

i) Valuation of used goods
ii) Questionable invoices
iii) Use/misuse of alternative valuation methods

The main body of the WTO law is composed of the over sixty individual agreements and decisions that are overseen by councils and committees at the WTO headquarters in Geneva. Customs valuation is administered under the Council for Trade in Goods which oversees all goods agreements committees which include: - agriculture market access, technical barriers, sanitary and phytosanitary measures, customs valuation, rules of origin and anti-dumping measures.

Kenya joined the WTO on 1st January 1995 and thus became bound by all the treaties and agreements that constitute the WTO regime including the WTO CVA. The administration of all matters concerning the collection, administration and enforcement of laws relating to revenue including customs valuation of imports is done by KRA.[269]

4.5 WTO CUSTOMS VALUATION METHODS

The WTO CVA agreed on six customs valuation methods to be used by member states in a hierarchical format in the valuation of imports across borders, including; the transactional value, transaction value of identical goods, transaction value of similar goods, deductive value, computed value and fall-back method. Kenya has adopted these methods which came into effect on 1st January 2000 and are currently the basis of customs valuation by the KRA, they are discussed below:

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[268] WTO (2010), *A Handbook on WTO Customs Valuation Agreement*, (WTO/ Cambridge University Press: London), p. 6.

[269] Obuoforibo Belema (2009), *TP and Customs Valuation; Two Worlds to Tax's One*, available at: http://www.ibfd.org/IBFD-Products/Transfer-Pricing-and-Customs-Valuation-Two-worlds-tax-one, (last accessed 26th November, 2012).

4.5.1 Method 1: Transaction value (TV)

Article 1 of the WTO CVA defines "transactional value as the price actually paid or payable for the goods when sold for export to the country of importation (e.g. invoice price)."[270] The "price paid or payable" in relation to the sale of goods for export to Kenya, means "the aggregate of all payments made or to be made, directly or indirectly, by the purchaser to or for the benefit of the vendor."[271] The transaction value should always prevail as the basis of assessment even for sale between related parties if the relationship has not influenced the price and disclosure made.[272] However, in the interest of accuracy it is prudent that certain payments would need to be added to the transaction value such as:-[273]

i) costs incurred by buyer, but not included in the price: commission and brokerage, except buying commission, cost of containers and cost of packing;
ii) goods and services supplied by buyer free or at reduced price: materials, components; tools, dyes, moulds for production of imported goods; consumables, engineering development, art work, design work undertaken elsewhere than in country of importation;
iii) royalties and license fees related to goods being valued when paid as a condition for sale;
iv) the value of proceeds of any resale accruing to seller; and
v) certain countries including India add the following to transaction value costs of transport; insurance; loading, unloading and handling at the port of importation.

However, in certain circumstances transaction value would not be acceptable if there are restrictions to disposal or use of goods by buyer, the sale is subject to some condition for which a value cannot be determined, some part of the subsequent resale by buyer accrues to the seller for which adjustment cannot be made according to Article 8 and related party transaction where price has been influenced by such a relationship.

The problem of evaluating transactions between related parties for the purpose of calculating transfer price was analyzed in chapter two. The problem still persists because related enterprises are more likely to place a fictitious customs valuation through under-invoicing to avoid paying

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[270] *Customs and Excise Act*, Cap 472 of the Laws of Kenya, Section 2, available at: www.kra.go.ke/customs /pdf/CustomsAndExciseAct2001.pdf, (last accessed 26th November, 2011).
[271] *ibid.*
[272] *ibid,* Seventh Schedule Article 1.
[273] *supra,* note 269, WTO (2010), *A Handbook on WTO Customs Valuation Agreement,* Article 8.

the actual duty. Transaction value between related entities are acceptable so long as the importer demonstrates that such value closely approximates to one of the following occurring at the same time:-[274]

i) the transaction value in sales by the same party to unrelated buyers of identical or similar goods sold for export to Kenya;
ii) the customs value of identical or similar goods as determined under the provisions of Article 5; and
iii) the customs value of identical or similar goods as determined under the provisions of Article 6.

According to the WTO CVA, the list of related persons for the purpose of customs valuation include[275]officers/directors of one other's business, legally recognized partners in business, employer and employee, any person owning, controlling or holding (directly or indirectly) 5% or more of the outstanding voting stock or shares or both, one of them controls the other, both are controlled by a third person, together they control a third person. The above controls can be direct or indirect. Further related persons will also extend to members of the same family and sole agent/ distributor/concessionaire are normally deemed not to be related unless they fulfill one of the above criteria.

4.5.2 Method 2: Transaction Value of Identical Goods

When customs value of imported goods cannot be determined under the provisions of Article 1 (transaction value), the customs value shall be the transaction value of identical goods sold by other sellers for export to Kenya at or about the same as the goods being valued.[276]

Value should be determined on the basis of already determined transaction value for identical goods. The transactional value of identical goods is a method of customs valuation that considers

[274] *supra,* note 271, *Customs and Excise Act*, Cap 472 of the Laws of Kenya, Seventh Schedule Article 1.
[275] *supra,* note 269, WTO (2010), *A Handbook on WTO Customs Valuation Agreement,* Article15.
[276] *supra,* note 271, *Customs and Excise Act*, Cap 472 of the Laws of Kenya Seventh Schedule Article 2.

the similarity of goods in all respects including physical characteristics, quality and reputation.[277] Identical goods are goods which are: [278]

i) the same in all respects, including physical characteristics, quality and reputation with the goods being appraised, minor differences in appearance notwithstanding;
ii) produced in the same country as the goods being appraised; and
iii) produced by or on behalf of the person by or on behalf of whom the goods appraised were produced."

4.5.3 Method 3: Transaction Value of Similar Goods

Where the test of value of identical goods fails, value should be determined on the basis of transaction value of similar goods. Similar goods are those which, although not alike in all respects, have like characteristics and like component materials. They perform the same functions and are commercially interchangeable.[279]

There are a number of principles that underpin the use of identical and similar goods valuation methods namely;-

i) The time element- "at or about the same time as the goods being valued"
ii) "Same commercial level" and "Substantially the same quantity level"
iii) Adjustment be made for different commercial/quantity level
iv) If more than one TV available, take the lowest value.
v) The goods are produced in the same country as the goods being valued and preferably by the same person.

4.5.4 Method 4: Deductive Value

This is a customs valuation method to be applied where the test of value of identical or similar goods fails. This value is to be determined on the basis of the unit sales price of goods of same class or kind in the domestic market of the imported goods (or of identical or similar goods) sold

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[277] *supra,* note 271, *Customs and Excise Act*, Cap 472 of the Laws of Kenya, Seventh Schedule, Article 2.
[278] *ibid.*
[279] *ibid,* Article 3, and *supra,* note 269, WTO (2010), *A Handbook on WTO Customs Valuation Agreement,* Article 3.

to unrelated buyers in the greatest aggregate quantity.[280] To arrive at the actual value suitable deductions should be made for elements like commissions, profits, duties and taxes, transport and insurance and other general expenses related to sales in the country of importation.

4.5.5 Method 5: Computed Value

The computed value method of customs valuation is to be applied where the earlier stated methods of valuation fail. This value is determined by taking into account the cost of production plus the usual amount of profit and general expenses incurred in the sale of goods of the same class or kind.[281] "Computed value" in relation to any goods, means the value of such goods determined in accordance with method 5 set out in the Seventh Schedule."[282]

4.5.6 Method 6: Fall-back Method

This is applied as a last resort when the other methods have failed to give acceptable customs value. It provides that the value for duty will be determined using any of the previous methods in a flexible manner subject to specified conditions.

Obviously, many importers will avoid getting this far and try to reach a compromise with Customs. However, if the first three methods do not work, it is advisable to proceed to method 6 before evaluating the method 5. As specified under method 4, the importer has to resist this. It is not possible for one to state at this point which method will be suitable for a particular importer without a thorough and careful evaluation of the surrounding circumstances. Whichever method is applied, one can reap maximum benefit only through careful planning.

4.6 EAC & COMESA CUSTOMS VALUATION REGULATIONS

At the regional level a number of laws and regulations have been designed to regulate customs valuation as a precursor to a customs union between the member countries. Kenya is a member of the COMESA and EAC and like other member states has a separate customs code and implementing provisions. However, as a COMESA member it is bound by the EACCMA which

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[280] *supra,* note 269, WTO (2010), *A Handbook on WTO Customs Valuation Agreement,* Article 5.
[281] *ibid,* Article 6 and *supra,* note 271, *Customs and Excise Act,* Seventh Schedule Article 6.
[282] *supra,* note 271, *Customs and Excise Act,* Section 2.

sets out customs rules and procedures to facilitate the establishment of a customs union (CU). Besides about seventeen member states belong to the WTO and use the WTO CVA as the basis for their customs valuation.[283]

The objective of the EACCMA as stated in the preamble is "an Act of the Community to make provisions for the management and administration of customs and for related purposes." The Act is the premier law for the regulation of customs valuation on imports and exports in East African Community region. The Act is supplemented by the East African Customs Management Regulations, 2010 established pursuant to Section 251 of the EACCMA.

The East African Common External Tariff[284] regulates the classification of goods for purposes of customs valuation. The common external tariff is compiled in line with international law and pursuant to the nomenclature established under the international Convention on the harmonization of commodity description and coding system that is approved by the customs Co-operation Council on June 1983 as amended in January 2007. Also included are General Rules for the Interpretation of the Harmonized System, Abbreviations and Symbols, Sections, chapter and subheading notes. Each heading is identified by four digits, the first two digits indicating the chapter number and the second two, numerical order and the heading appears within the chapter. The common External Tariff contains general interpretation rules for the classification of goods for purposes of customs valuation.

4.7 WTO VALUATION METHODS AND OECD TP METHODS COMPARED

4.7.1 Rules and Regulations

Direct tax authorities tend to follow the ALP and OECD Guidelines which set the international standard for TP. The Customs authorities apply the relevant provisions of the WTO CVA. In Kenya and for TP purposes, the Income Tax Act as read together with the ITA (TP) rules which are in line with the OECD guidelines which are applied. The EACCMA and Customs and Excise Act are applied with regard to Customs valuation.

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[283] *supra,* note, 270, Obuoforibo Belema (2009), *TP and Customs Valuation; Two Worlds to Tax's One,* p. 150.
[284] EAC (2007), *East African Common External Tariff, Version 2007*, www.revenue.go.ke/customs/pdf/EAC%20 Externaltariff2007.pdf, (last accessed 26th November).

4.7.2 Methods

The TP methods applied include: CUP method, RP Method, CP Method, Profit Split method, TNMM and such other method as may be prescribed by the Commissioner from time to time. A tax payer is required to select the most appropriate method in the circumstances and provide a justification. In terms of hierarchical order for applying TP methods, traditional methods (CUP, RPM and CPM) are preferred over transactional profit methods (TNMM and PSM). OECD methods are largely transactional, in order to arrive at an ALP the choice of method depends on the circumstances of the case.[285]

The WTO Customs Valuation Agreement states that all imported articles must be valued in accordance with a hierarchy of methods one of six valuation methodologies namely; transaction value, transaction value of identical or similar merchandise, computed value, derivative value and fall back method. The goal of each of these methods is to determine an arm's length value of each of the imported goods.

4.7.3 Concept

As a basic principle, both sets of rules require that an "arm's length" or "fair" value be set for cross-border transactions between related parties and associated enterprises. That is, the transfer price must not be influenced by the relationship between the parties or it must be set in the same way as if the parties were not related. However, there are significant differences in the application of this broad principle, e.g. in relation to such major factors as policy objectives, operational functioning, timing of valuation, valuation methods, documentation requirements and dispute resolution mechanisms.

In the USA transactions involving related enterprises, the sale price is subjected to additional scrutiny to ensure that the ALP has been adhered to since it is a product of negotiation by two unrelated parties. For unrelated parties, the invoice price represents the "price actually paid or

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[285] *supra*, note 160, Murphy, Michael E and H.E Files (2009), *The Intersection of TP and Customs Valuation*, p. 150.

payable" for the imported merchandise.[286] The USA customs law provides that a transaction value between a related buyer and seller will be acceptable in cases where:[287]

i) an examination of circumstances of sale of the imported merchandise indicate that the relationship between such a buyer and seller did not influence the price actually paid or payable

ii) the transaction value of the imported merchandise closely approximates certain test values[288]

The statute thus sets the criteria for validating related party transactions for customs purposes i.e. the circumstances of sale test and the test values method. The same rules apply for Kenya as provided for under the EACCMA.

4.7.4 Focus

The TP methods are either transactional or profit based and as such the overall profit levels are important but the customs valuation methods, the transaction value, i.e. the price paid or payable for each specific good imported, is the key pricing determinant.

4.7.5 Administrative Practices

Practices in applying certain provisions of these international standards at the national level by customs and tax authorities can vary, to a certain degree, from country to country. Institutionally it is often the case that two administrative bodies value or review the valuation of international transactions between related parties or associated enterprises.

A striking point is that customs and revenue authorities within the same country can often have conflicting interests. On a given import transaction, a customs officer's natural inclination would be to verify whether or not the value declared by the importer was under-estimated, as the customs officer would be interested in collecting more duties, while a revenue authority's natural inclination would be to verify whether or not the import value declared was over-estimated, as

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[286] *supra,* note 160, Murphy, Michael E and H.E Files (2009), *The Intersection of TP and Customs Valuation,* p. 150.

[287] *U.S. Code - Title 19: Customs Duties*, 19 USC 1401, available at: us-code.vlex.com/vid/sec-value-19194211 - United States, Section, 103 (9)(1).

[288] *ibid,* Section 1401a (b)(2)(B). The fact that the parties are related is not a ground for finding the transaction value unacceptable.

the revenue officer would be interested in limiting what would be regarded as an excessive tax deductible amount in his/her jurisdiction. Or to put it in another way, where the "arm's length" or "fair" value is not clear, might the customs specialist within an MNC be tempted to declare an import value on the lowest side of the range, while his/her tax colleague might possibly be interested in higher transfer prices if they can generate greater deductions.

In Kenya, there is only one revenue authority but with different departments. The domestic tax department which deals with TP is separate from the Customs department which deals with Customs valuation matters. The effect of this is to make a cross border trade complicated and costly which is contrary to the objectives of both the international organizations (OECD, UN and EAC) and national governments concerned.

This therefore follows that the tax authority (KRA) has to abide by the ALP and the OECD TP guidelines for MNC and tax administration which set the international best practices for TP. On the other hand, the customs authorities apply the relevant provisions of the WTO Customs Valuation Agreement. On top of that, different countries apply different rules in the application of these international best practices[289].

The basic principle is that both sets of rules require that an arm's length value should be set for all cross border business transactions between related parties/associated enterprises. Thus TP should be influenced by the relationship between the parties. The applications of this principle in both TP and custom valuation are different in relation to policy, operational functioning, and timing of valuation, valuation methods, documentation and dispute resolution.

As a broader enforcement agency, customs authorities analyze each product and import transaction to determine at the time of importation the customs value. This enables the customs authority to collect the right amount of duty for each product that can be subjected to different rates of duties to be calculated on the basis of its value and tariff classification. The customs value of goods for the purpose of levying ad valorem duties of customs on imported goods. In

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[289] *supra,* note 261, Liu Ping and Caroline Silberztein (2007), *TP, Customs Duties and VAT Rules: Can We Bridge the Gap?* p. 36.

spite of the lack of specific provisions regarding valuation of services and intangibles, they are important and relevant for customs valuation purposes if they are connected with the importation of goods.

In the valuation of related party transactions, customs uses transactions value free from the relationships between transactions. In determining whether the price would be an acceptable basis for determining the value, two tests are carried out[290] ;-

i) The "circumstances of sale" test to determine whether the relationship influenced the price. This is more commonly used because it is fairly broad and the provisions very concise
ii) The "test values" a test which is used to determine whether the transaction value closely approximates one of three types of test values.

Where transactions value of imported goods is found not to be acceptable, the customs department will determine the customs value by using a hierarchy of any of the following alternative methods: transaction value of identical or similar goods, deductive value, computed value or fallback method.

TP on the other hand is enforced by revenue authority regulated by the OECD and UN guidelines that espouse the ALP (a proxy for open market conditions). The essence of these conventions is to allocate taxable profit between related enterprises to achieve a fair allocation of tax revenues amongst tax authorities and avoid double taxation. For the purpose of TP, all cross border commercial and financial transactions between related entities (goods, services, intangibles, financial transactions) are within the purview of TP. TP may also involve attributing profits to permanent establishment between various parts of a single legal entity situated in different tax jurisdictions.

To arrive at an ALP, transfer price requires a comparison of the conditions of a taxpayer's controlled transactions with those of comparable uncontrolled transactions. The criteria used in this regard in assessing comparable transactions is the OECD guidelines such as the

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[290] *supra,* note 261, Liu Ping and Caroline Silberztein (2007), *TP, Customs Duties and VAT Rules: Can We Bridge the Gap?* p. 37.

characteristics of products/services, functions performed by each party taking account of the assets used and the risks assumed, contractual terms, economic conditions and business strategies.

4.7.6 Issues Arising

Does this situation make sense from theoretical and practical perspectives? To what extent is it acceptable to have different rules because the agency policy objectives are different? Do different answers to the same question ("what is the arm's length price?") alter the credibility of the assessing authorities? Is there a need for greater convergence of the two sets of rules? If so, what should be the conceptual framework, at national and international levels? These are some of the tough questions that beg for answers. The issues were discussed at the said joint WCO-OECD conferences which did not conclusively address the issues and the significant further work that would be needed.

In addition, these issues can also arise in relation to VAT to a certain extent. First of all, the determination of the acceptable transfer price and subsequent "adjustments" to be made to it under TP and customs value determination can affect the amount of VAT to be levied and charged on cross-border transactions. Furthermore, a recent EC (European Communities) Council Directive 2006/69/EC opens up the possibility for tax authorities to adjust the valuation of certain goods or service transactions in specific circumstances in case the value declared differs from the "open market value"[291]. This has prompted concerns about the additional uncertainties that might be created and complexities that might be added by yet a third set of rules governing the valuation of cross-border related party transactions that business has to comply with. In effect, the Council Directive does not provide any guidance as to the methods to be used to determine the "open market value" and neither the Commission nor the member states concerned have developed guidance on valuation methods so far.

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[291] WCO/OECD (2006), *Conference on Transfer Pricing and Customs Valuation Brussels (Belgium)*, 3-4 may 2006, available at: http://www.oecd.org/tax/transferpricing/36740073.pdf, (last accessed 21st November, 2012), p. 5.

4.7.7 Issues Involved in TP and Customs Valuation

Reducing the impact of duties and taxes on budgets is an important consideration for most companies, given the current financial conditions. In this regard, TP is a major corporate tax issue – by taking advantage of differences in taxation rates between jurisdictions, MNCs can distribute their tax liabilities to reduce their overall tax burden and increase profitability. But because TP also impacts customs valuation (and vice versa), the gap between the two can create many difficulties for companies, as well as for tax and customs authorities. As a consequence, there have been calls for greater convergence and coordination between customs, tax administrations, the business community, as well as between the WCO, WTO and the OECD, in order to enhance and promote a better understanding of issues pertaining to duties and tax. Indeed, the WCO and OECD said recently that they would explore ways to strengthen coordination between customs and tax authorities. However, multinationals are also encouraged to proactively manage both TP and customs so as to reduce obstacles, disruptions and uncertainty.

4.7.8 Evaluation & Documentation of TP and Custom Valuation

The valuation of a transfer price by a taxpayer takes place at the point when the transaction is entered into (i.e. the arm's length setting approach) and upon filing of the tax returns (arms length approach). In the latter case, information is available to revenue authorities at the end of the year upon filing of the tax return and or later upon retrospective audits,[292] such as, three or four years after the transaction.

TP documentation covers the economic context of the industry and taxpayers description of controlled transactions (terms and conditions), an explanation of the choice of the transfer price method, the comparable analysis (including data on uncontrolled transactions used as comparables). Tax authorities have access to information through domestic provisions (general tax audits provisions, specific TP documentation requirements) and bilateral treaties (exchanges of information). The WTO does not detail the inspection list to be used for the determination of the acceptability of the transfer price for customs purposes. Documentation required for customs purposes depends on the declaration and documentation required of the importing country.

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[292] *supra,* note 160, Murphy, Michael E and H.E Files (2009), *The Intersection of TP and Customs Valuation,* p. 150.

4.7.9 The Impact of Adjustments on Declared Custom Values

Tax authorities may adjust TP retrospectively. This has the effect of impacting on the MNCs that use intercompany TP for customs purposes. Although many countries use the OECD TP methods, they do not readily agree that it could serve the purposes for customs valuation.

4.7.10 A Gulf Between TP and Customs Valuation

With more international transactions between related parties – i.e., between a parent company and its affiliates, or between affiliates themselves – in recent years, TP and customs valuation issues have increased proportionally in both number and size. Indeed, tax authorities are increasingly interested in whether the prices that parties charge each other are influenced by their relationship, as it may have an impact on their tax burden. Similarly, customs authorities have an interest in knowing whether the relationship between two related parties has an influence on the price of the imported product, since the rate of customs duty is applied to the customs value. But in Europe, the fact that TP and customs valuation are governed by two different bodies, produces frequent conflicts. "In the EU, the tax treatment of transfer prices is based on EC Directives and member states' national legislation; these measures, in turn, are based on guidelines produced by the OECD. The value of imported goods for customs duty purposes, however, is determined in accordance with EC Regulations which incorporate the provisions of Article VII of the GATT and the WTO Agreement on the interpretation of that Article,[293]" It should be noted that both the guidelines set by the OECD and WTO abide by the arm's-length principle, and both aim at determining a 'fair' price for transactions that take place between related parties. But in spite of those similarities, the two organizations have different motivations, and their approaches are often incompatible.

In an importing country, tax authorities strive to increase taxable income by reducing import price, while customs authorities on the other hand, will try to increase customs value. Indeed, for an import transaction, the higher the price, the higher the customs base, but also the lower the taxable profit of the importer.[294] "Furthermore, the scope of customs valuation encompasses

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[293] Renauld, Pauline (2010), *Customs Valuation and its Interaction with TP*, Financier Worldwide, available at: www.financierworldwide.com/article.php?id=5670-United Kingdom, (last accessed 25th November, 2012).
[294] *ibid.*

transactions with non-associated enterprises which are out of the scope of TP, while the scope of TP encompasses export as well as import transactions and transactions consisting in the provision of services or transfer of intangible property, which may not be of great interest to customs authorities," she adds. In addition, both the tax and duty rules provide for a range of acceptable values, rather than trying to specify a definitive price based on a rigid formula. This flexibility, while needed because TP is not an exact science, creates uncertainties for both taxpayers and revenue authorities. Also, it is thought that there will be few cases wherein the tax and duty rules, correctly applied to the same facts, will yield an identical transfer price and customs value.

Some experts also blame the methods used by customs bodies as being partly responsible for such inconsistencies. "The customs value is simply the value of a good. In many jurisdictions it has to be the value at the moment of importation. However, the WTO Customs Valuation Code does not really define the moment in time to determine the value. Depending on the valuation method applied, the value can be established at different times."[295] However, he adds that with the adoption of the WTO Customs Valuation Code in June 2008, the methods used by customs have been progressively harmonized, but could still be fairer. On the other hand, Ms Silberztein believes that the main problem lies not in equality, but in the lack of coordination:

> "As of today, inconsistencies between TP and customs remain, but we are in an awareness-raising phase for the taxpayers and authorities concerned. While I do not think that customs valuation methods should be amended and aligned to TP methods, I think that a better administrative coordination would be beneficial, in particular to clarify the conditions under which a valuation that is consistent with the TP ALP and methods could be approved by customs, and vice versa," she suggests.

This lack of coordination is often at the source of such difficulties. But companies may also be held responsible for creating certain liabilities. For example, most TP reviews instigated by businesses are mainly driven by direct tax considerations, because rates of customs duty are generally lower than corporate income tax rates, and further, because more than 60 percent of imports into the EC are free of duty. In addition, some companies cannot afford, or believe they do not need a full-time employed customs specialist. But as businesses grow bigger, the risk is that they may create liabilities on the duty side. In turn, this can result in exposures to customs audits, assessments for arrears of duty, and the potential penalties associated with those measures.

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[295] *supra,* note 294, Renauld, Pauline (2010), *Customs Valuation and its Interaction with TP.*

The amount of ad valorem duty is determined by multiplying the rate by the customs value of imported goods. Thus, how customs officials determine the customs value is as important to the importer as the rate of duty specified in the tariff schedule for the goods, as both the basis for customs value and the rate to determine the amount of duty the importer should pay. The rules for valuing imports for purposes of assessing customs duty are defined by the WTO Customs Valuation Agreement (or the Agreement on the Implementation of Article VII of GATT). The gist of Article VII of GATT is that value for customs purposes of imported merchandize should be based on actual value. The purpose of customs valuation is to require countries to adopt a valuation system that is fair, neutral and uniform and to prevent the use of arbitrary or fictitious values[296], widely agreed upon by more than 150 countries.

4.8 CONCLUSION

The relationship between TP and customs valuation is becoming a major issue in international trade. This has been viewed as posing challenges and creating opportunities. For example, importers are expected to demonstrate how their intercompany TP is acceptable under customs valuation. Tax related documentation is becoming less acceptable due to the recognition that TP methods are different across countries.

That notwithstanding, enterprises that prepare TP documentation are expected to comply with the customs valuation methods for the purposes of tax evaluation. For many MNCs, internal controls will need to be maintained. In the case of retroactive TP adjustments of prices, the customs duties paid may also be adjusted by the customs administration. This will be in addition to the other internal controls to ensure that all applicable additions to value such as intercompany royalties, cost sharing payments are accounted for customs purposes. The demands for the evaluation of a transfer price as well as a customs value further complicates the task of KRA and makes it even harder for it to be effective and efficient in the face of challenges envisioned in chapter two.

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[296] Rajkarnikar, P. (2007), *Implementation of the WTO Customs Valuation Agreement in Nepal: An Ex-Ante Impact Assessment*, pp. 195-220, Chapter VI in ESCAP, Trade facilitation beyond the multilateral trade negotiations: Regional practices, customs valuation and other emerging issues – A study by the Asia-Pacific Research and Training Network on Trade, (United Nations, New York). Available online at: http://www.unescap.org/tid/artnet/pub/tipub2466.pdf, (last accessed 20th November, 2012).

There is need for harmonization of both TP and Customs rules to be able to deal with the challenges highlighted herein.

CHAPTER FIVE: CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

This study has highlighted the inadequacy of TP legal framework in Kenya and consequent upon this, it is recommended that the TP regulation should be strengthened to conform to international best practices and Kenya's interests (for revenue purposes). This may be done through alignment with international tax regimes, promotion of APAs, stricter controls on the format and period when documentation should be submitted and the prescription of stiffer penalties for enterprises whose transactions have been adjusted.

5.2 SUGGESTED REFORMS

5.2.1 Legal Reforms

5.2.1.1 Aligning Domestic TP Rules to International Best Practices

Since Kenya's legal framework on TP in the form of Income Tax (TP) Rules does not provide adequately for all aspects of TP[297], it is recommended that domestic legislation be aligned with the OECD, WTO and UN so as to benefit from international best practices. This is because these guidelines were prepared in recognition of cross border transactions within MNCs and thus the need to price them with certainty internationally. This means that an MNC establishing a permanent entity in another country should be sure of how its income and profits will be treated. This can only be achieved if an international standard exists and is known. This also reduces the risk of double taxation.

The conformity of domestic TP rules with the internationally accepted principles set forth in the OECD TP Guidelines promises many advantages which include: provision tools with which to fight artificial shift of profits out of their jurisdiction by MNCs provide them with some certainty of treatment in the country; reduce the risk of economic double taxation; provide a level playing field between countries where both resident and non-resident enterprises reside thus reducing the likelihood of distorting international trade and investment, which is less likely to distort the pattern of international trade and investment; reduces the possibility of one enterprise having an

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[297] *supra*, note 32, Mwangi, Rispah M (2008), *Transfer Pricing: Does Kenya's Law Provide Adequately for This?* p. 35.

advantage over the other and to provide a level playing field between MNCs and independent enterprises doing business within a country. This will have the overall effect of lowering the transaction cost of TP between both parties and bring about certainty in that is currently lacking.

5.2.1.2 Advance Pricing Agreements (APAs)

APA's might help to alleviate some TP problems for developing countries and Kenya in particular. However, MNC's typically appear uninterested in participating in APA programmes. One survey[298]found that, depending on the home country, the percentage of MNC's with no plans to pursue APA's with either their home or host country tax authorities ranged from 71 percent to 96 percent. Canadian MNC's cited the volume of information and/or documentation required and the cost of APA's exceeding their benefits. German MNC's ranked volume of information required and the difficulty of concluding multilateral APA's as the most important deterrents. Japanese MNC's were concerned with volume of information and confidentiality concerns, while United Kingdom MNC's cited cost and confidentiality concerns. United States MNC's ranked cost and volume of information required as the chief drawbacks to APA's.

An APA is an arrangement that determines in advance controlled transactions, an appropriate set of criteria (such as method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of TP for transactions over a period of time. Kenya's legal framework on TP does not expressly encourage APAs, but it is submitted that KRA has more to gain from promoting APA than to lose. APAs supplement traditional administrative judicial and treaty mechanisms for resolving TP issues. APAs are more appropriate where traditional methods fail or become difficult to apply as they bring certainty by enhancing predictability, consultation and co-operation (allows for information disclosure) between tax administrations in a non adversarial manner. Further APAs may prevent costly and time consuming examinations and litigation of major TP issues for tax payers and tax administrators. Besides that, bilateral and multilateral APAs reduce or eliminate the possibility of double taxation granted that countries participate in the arrangement.

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[298] *supra,* note 246, Borkowski, S. C. (1999), *Transfer Pricing Documentation and Penalties: How much is Enough?* p. 346.

Among the many advantages Kenya may gain from APAs, is the alignment of domestic TP legislation with internationally acceptable principles so as to avoid the disconnect that currently leads to unnecessary disputes. In the absence of a treaty or an agreement, courts fall back on international principles to interpret domestic TP legislation due to the absence of guidelines on the interpretation of domestic law. The Unilever case[299] is illustrative of existence of substantive law without the requisite guidelines or rules on how they should operate. Justice Visram held in *obiter* that:-[300]

i) *OECD guidelines guide countries while entering into double taxation agreements, which is not the case here.*

ii) *the OECD guidelines cannot be part of the legislation of a country unless where a country has adopted the recommendation in a tax treaty with another country; hence the argument is not relevant in this appeal; and*

iii) *the OECD guidelines are not part of the law of this country.*

Where countries have entered into a treaty or agreement in line with Article 9 of OECD, any dispute will be interpreted in line with international best practices.

5.2.1.3 Tax Information Exchange Agreements (TIEAs)

A TIEA is an agreement between two or more nations, regarding the sharing of financial (and taxpayer) information for the purpose of determining the tax liability of a Kenyan entity or individual.

One of the main challenges that KRA faces in tackling tax evasion and abusive transfer mis pricing practices is the lack of information on overseas entities that have been established by Kenyan entities for the purpose of transferring funds that result in tax evasion.

The type of information that can typically be shared under these agreements include information on the ownership of companies or trusts held by banks, other financial institutions or agents, nominees and trustees among others. TIEAs would also allow for exchange of bank statements

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[299] *supra,* note 9, H.C. Income Tax Appeal No. 753 of 2003, [2005] eKLR 1.
[300] *ibid,* p. 8.

held by overseas financial institutions. However, TIEAs would not typically allow for aimless or arbitrary requests for information.

Secondly, doubts have been expressed about the seriousness of financial off-shore centres (tax havens) that sign TIEAs. In some of these jurisdictions, the TIEAs do not overrule domestic provisions relating to taxpayer confidentiality or there are no domestic provisions enabling the counterparty revenue authority to force law firms or banks to provide the required information. The Africa Tax Administrative Forum ('ATAF') which has been intimating the prospect of regional / pan African tax audits may provide technical resources to the KRA to assist in the practical implementation of TIEAs given the significant technical capacity being built up in ATAF. There have been examples of regional cooperation in the negotiation of TIEAs such as the Nordic corporation (involving Denmark, Finland, Iceland, Norway and Sweden) which have successfully negotiated TIEAs with a number of financial off-shore centres such as the Isle of Mann, Jersey, Guernsey, Cayman Islands, Bermuda, British Virgin Islands, Aruba and the Netherlands Antilles.

5.2.1.4 Search for Comparables/Bench Marking

TP serves two main purposes i.e. to guide taxpayers in their TP and by tax authorities to benchmark on whether an enterprise is complying with the set rules or not. Thus a thorough TP audit function needs to be established with specialized staff for that purpose. Towards this, the training of technical expertise is essential to be able to understand the principles and gain skills to understand the complexity of TP. Staff must also understand domestic law, not only on TP but on intangibles as well, the OECD guidelines and how they relate to domestic legislation. Staff must also understand the taxpayers' business and commercial environment they operate in and more importantly, they must have investigative skills.

It is therefore essential that KRA put in place an audit function dedicated to TP audit. In the UK and Canada, every stage of enquiry is reviewed by senior staff specialized in TP from the time a case is taken up through a negotiated agreement in the process of seeking to make certain adjustments or to proceed to litigation.

5.2.1.5 Streamlining TP Rules

Kenya's TP legal framework does not specify when TP documentation should be prepared thus giving leeway to MNCs to give it lip service. Documentation that is prepared contemporaneously is likely to be more accurate and useful than prepared retrospectively as is the practice in the USA and India. KRA can achieve this by encouraging corporate entities through guidelines to prepare documentations contemporaneously rather than at the time or when the commissioner may require the information.

The OECD TP rules are categorical that record keeping by MNCs is a prerequisite for an effective and efficient TP regime. Rule 9 is clear that an enterprise to which the rules apply maybe required to supply information in terms of books of accounts and documentation relating to TP. However, these are general documentation as the rules do not specify particular documents to be maintained leaving a taxpayer with the discretion as to what documents to maintain and in what form.

The international best practices in the maintenance of documents in other jurisdictions such as India are to give taxpayers a comprehensive list of documents to be maintained. In the UK and Australia [Australian Tax Office (ATO)], tax payers are referred to the OECD TP guidelines as their guide on documentation. It would therefore be advisable that KRA for purposes of compliance and certainty should prescribe the type and format of documentation to be maintained by tax payers. Appropriate action should be taken against MNCs that fail to comply with this requirement.

5.2.1.6 Stricter Penalties when a Transaction is Adjusted

There is need to prescribe special penalties for MNCs whose TP has been adjusted to guard against TP manipulation. The lack of such penalties may encourage other MNCs to continue manipulating the weak TP legal framework to their advantage and deny the country the much needed revenue. The present situation where no special penalties apply in respect of additional tax arising from a TP adjustment is not sustainable. KRA still charges the usual penalty, currently 20% of the principal tax and late payment interest of 2% per month.

Tax payers are under a legal obligation to keep books of accounts[301] failure to which it is considered an offence and a penalty is prescribed.[302] This requirement is, however, not specific to corporate taxpayers. Sections 94(1) and 95 of ITA are not specific to corporate taxpayers and therefore are general provisions.

In some jurisdictions (such as Australia and USA), specific penalties have been prescribed for corporate entities that do not maintain books in a specific form and giving regard to TP circumstances. Australia on its part reduces the penalty if the corporate body has a reasonably arguable case that is evidenced by documentation. In the USA, a penalty is only imposed if an audit reveals a TP adjustment. KRA needs to consider prescribing a penalty that is specific to corporate bodies that are subject to TP which should maintain proper documentation whether or not an audit is anticipated. Some of the documents which the Commissioner may request include documents relating to:-

i) the selection of the TP method and the reasons for the selection;
ii) the application of the method including the calculations made and price adjustment factors considered;
iii) the global organization structure of the enterprise;
iv) the details of the transactions under consideration;
v) the assumptions, strategies and policies applied in selecting the method; and
vi) such other background information as may be necessary regarding the transaction.

5.2.1.7 Harmonizing TP Rules and Customs Valuation Methods

Direct tax authorities tend to follow the ALP and OECD Guidelines which set the international standard for TP. Customs authorities apply the relevant provisions of the WTO CVA. In Kenya and for TP purposes, the Income Tax Act as read together with the ITA (TP) rules which are in line with the OECD guidelines is applied. The EACCMA and Customs and Excise Act are applied with regard to Customs valuation. It is necessary to consider harmonising the methods under the OECD and the WTO methods to avoid controversies. This may pose a risk on value to compute customs and excise duty and also VAT.

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[301] *supra,* note 7, *Income Tax Act,* Section 54.
[302] *ibid,* Section 109(d).

5.2.1.8 Compliance with WTO Valuation Methods and Rules

The WTO CVA agreement is intended to provide a single system that is fair, uniform and neutral for the valuation of imported goods for Customs purposes, conforming to commercial realities and, outlawing the use of arbitrary or fictitious Customs values. The WTO CVA, by its positive definition of value, recognizes that Customs valuation should, as far as possible, be based on the actual price of the goods to be valued. With more than 90% of world trade valued on the basis of the transaction value method and price adjustments based on objective and quantifiable data, the Agreement provides more predictability, stability and transparency for trade, thus facilitating international trade while at the same time ensuring compliance with national laws and regulations.

5.2.1.9 Adopting the UN Model

The OECD Guidelines tend to protect the interests of OECD member-countries while the UN seeks to create a TP framework that would better suit the needs of developing countries.
Kenya should consider adopting the UN Practical Manual which provides guidelines on: how to draft TP legislation, how to set up special TP units, how to identify and work with TP databases; and how to pursue simplified strategies for testing the arm's length nature of a related-party transaction. The change of approach is likely to favour Kenya, being a developing country.

5.2.2 Administrative Reforms

5.2.2.1 Training and Capacity Building

Given the significance of TP, the government should facilitate capacity building, for example, by providing funds for awareness programmes, research on TP and access of database for comparables. The Kenyan Government can even consider developing a database of African comparables. Such a database would go a long way in improving TP regulation in Africa. Capacity building also includes conducting seminars and awareness programmes on TP regulation to sensitize and inform stakeholders such as taxpayers, KRA officers, policy makers and adjudicators. More research on TP is also necessary.

For developing countries, it is imperative to concentrate on detection of the various forms of TP malpractices in the TP analysis. Accounting techniques can contribute to wealth deprivation; the

roles of various interested parties like accountants and lawyers who can give advice on both ends, as well as the conflict between society and shareholders on the impact of TP. Policies and systems that are well-researched are likely to succeed in improving regulation and voluntary compliance amongst taxpayers.

5.2.2.2 Harmonization of Policy Units

The policy making function resides with the Ministry of Finance whereas tax administration lies with KRA. There is a need to ensure that investment policies are in harmony with protection of public revenue collection to avoid conflict between policy and administration.

5.2.2.3 Role of Politics

Political issues that surround taxation cannot be ignored. Government regulation of businesses aims at reaching a compromise to ensure businesses thrive without injuring the public interest. In so doing, however, there are interests, including public interests, personal interests and companies' interests that affect investment activities and decisions, and influence taxation. Measures to counter political interference include certainty in legal instruments and stronger enforcement mechanisms. As a region, developing countries can counter interference from economic and political strongholds by way of mass power to push for better tax instruments that make tax avoidance in developing countries less worthwhile.[303]

5.2.2.4 Enhancing the KRA TP Unit

The KRA TP Unit has enhanced capacity and training to enable it deal with the TP challenges. However, the TP unit requires more enhancements to enable it deal with in the increased need for effective administration and increased training. Japan, for example, began with a small TP unit in late 1980s. On realizing the rapidly increasing needs for TP management, it expanded capacity by training on international taxation reaching 100 trainees each year. It reorganized and expanded its national and regional examination division, with a special division for TP.[304]

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[303] *supra,* note 50, ActionAid (2010), *Calling Time: Why Sabmiller Should Stop Dodging Taxes in Africa*, 2010), p. 5.

[304] *supra*, note 62, UN (2012), *Practical Transfer Pricing Manual for Developing Countries.*

The TP Unit is fairly new in Kenya and should be closely monitored using sustainable strategies of expansion; developing efficient risk profiling mechanisms; proper funding and capacity building; integration with other revenue departments, and constant liaison with other revenue authorities for best practice. A unit that enjoys legitimacy within and without KRA is likely to yield better results in regulating TP.

The organizational structure of the Unit should be accessible to the public for ease of reference. Taxpayers and their agents, too, should avail information to KRA on their organizational, management and reporting structure. Transparency promotes effective regulation because it can deter tax avoidance practices like TP.

5.2.2.5 Practice Notes

There is an indispensable need for practice notes to supplement statutes. The practice notes should guide taxpayers on practical aspects of TP like parameters of comparability analysis and market range; aspects tied to the control of TP, such as the content, quality, quantity and times of producing documents, and determination of TP methods to adopt.[305]

The practice notes should be specific as to whether the taxpayer can request for lower TP adjustments and the arm's length price or range to adopt where a method yields more than one price, for example, the median range.[306] The notes should also specify whether analysis will be carried out on multiple year data or single year data, or whether it depends on the circumstances of the transaction.

The notes should also contain audit procedures, dispute resolution mechanisms and guidelines on how to regard specialized situations like intra-group services, business restructurings and intangible rights. Practice notes with illustrations are particularly helpful because illustrations enhance our general understanding of concepts.

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[305] *supra,* note 134, PwC (2011), *Growing Scrutiny: International TP*, p. 56.
[306] *ibid.*

5.2.2.6 Record Keeping

KRA must maintain proper records. This information is important for ease of reference, developing comparable databases, monitoring trade trends and for posterity. Proper and accurate records also serve as proof in dispute resolution.

5.2.2.7 Effectiveness of TP Regulation

KRA should put in place systems to monitor the effectiveness of TP regulation. Possible areas for monitoring include compliance levels; the time taken to resolve disputes; adjustments realized in tax assessment, and outcomes of interviews or contact with businesses.[307] A proper monitoring system at the formative stage of the TP audit unit forms a good foundation for effective administration.

5.3 THE FUTURE OF TP IN AFRICA

As more African countries begin to adopt TP regimes based on the ALS, the TP rules of African countries will naturally harmonize to some extent. In order to continue integrating into the global economy, African nations that have implemented comprehensive TP regimes will likely begin to consider programs that allow for Advance Pricing Agreements ("APAs").

In addition, in order to ease compliance and capacity issues, strategic safe harbors can be employed. Under a safe harbor, a company may be free from adjustment if its profits fall within a preapproved range. An example of a simplifying safe harbor that is consistent with the ALS is the Services Cost Method ("SCM") in the U.S. regulations. The SCM provides that for covered services, taxpayers may elect to treat the arm's length compensation for such services as the total services cost with no mark-up.[308] Balancing compliance costs with protection of the public finance, the SCM was meant to simplify compliance for certain services that otherwise would generate little additional revenue.

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[307] *supra*, note 62, UN (2012), *Practical Transfer Pricing Manual for Developing Countries*, p. 15.

[308] *U.S. Transfer Pricing Laws and Regulations*, 1.482-9(b), available at: www.ustransferpricing.com/laws.html, (24th November, 2012).

Perhaps as a response to the UN's growing influence, the OECD has pledged to simplify TP worldwide, including a possible update to the OECD's existing guidance on safe harbors.[309] African nations for which TP legislation is a long term goal should assess the preconditions identified in the EuropeAid report[310] and work towards bolstering those preconditions to the extent they are lacking.[311] Institutional capacity, including economic, political, and legal preconditions are a necessary first step for developing countries lacking TP rules but interested in developing TP expertise.

After institutional capacity is achieved, developing countries can build a sustainable TP regime. As Africa continues to increase its trade, it will continue to focus to a greater and greater extent on TP issues. Although TP regimes in Africa are expected to be based on the OECD Guidelines and the UN TP Practical Manual, 2011, African governments' desire to protect revenues from natural resources will probably influence future TP legislation. In addition, African nations that have already adopted the ALS will likely move toward legislation that will allow for APAs, tax treaties, and safe harbors as these nations seek to increase domestic tax revenue and make their countries more attractive to MNCs.

5.4 CONCLUSION

The increasing interest in TP by MNCs and tax authorities (KRA in particular) is attributed to the effect of globalization, countries' desire to protect their tax bases, rapid growth in technology, communication and transport. This has made it possible for MNC to place their business interests and activities anywhere in the world and thus shift incomes and profits from one jurisdiction to the next. To the tax authorities, this shifting of income and profit across borders can be abused and manipulated to deny them of taxes due to them. This is capable of causing social upheaval especially where it affects the delivery of social services to the citizens.

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[309] OECD (2011), *Secretary-General Pledges Group To Simplifying TP Provisions,* TP Report 1199, available at: www.pwc.com/gx/en/tax/transfer.../pwc-transfer-pricing-africa.pdf, (last accessed 24th November).

[310] Supra, note 131, EuropeAid/PwC (2011), *TP and Developing Countries*, p. 25.

[311] *ibid,* p. 2. The necessary preconditions are broken down into three broad categories: (i) economic and political preconditions (e.g. economic growth and diversification, open economy and FDI; (ii) legal preconditions (e.g., comprehensive income tax law, tax treaty network, existing TP legislation if applicable); (iii) preconditions related to the tax administration e.g., some level of specialization within the tax administration.

The MNCs on the other hand are interested in the maximization of profits and are ready and willing to use every means available to do so. They view TP as a softer option granted that they control 60% of the total international trade. In shifting their income and profits to low tax countries and tax havens, they are able to manipulate their internal pricing mechanisms on transactions between their affiliates in order to avoid paying full tax. Such pricing is more often not at arm's length which brings it into direct conflict with tax authorities and not to mention the OECD, UN TP rules and WTO customs valuation rules.

TP in Kenya is regulated by the Income Tax (TP) Rules 2010 which are adopted from the OECD TP rules. The evaluation of a transfer price by KRA on transactions in goods and services between related enterprises is dominated by three main challenges namely: valuation, allocation and jurisdiction. In order to value or arrive at a transfer price, KRA must compare the transaction with comparable transactions between unrelated enterprises, but it does not have the requisite capacity to do so. The question of allocation mainly affects how MNCs can allocate profits to their various affiliates that are located across many international borders and in Kenya in particular. Related to allocation of income and profits to various subsidiaries is the authority of KRA to adjust the price of transactions of enterprises resident in Kenya and other countries.

The result is that because the legal framework on TP is weak, MNCs have been able to abuse this loophole and manipulate the pricing of transactions between related entities. This is in spite of the fact that Kenya has domesticated the OECD TP guidelines under the Income Tax (TP) Rules 2010. These rules have not been fully implemented owing to various constraints such as; a weak legal framework, poor documentation practices, lack of comparable databases, poor reception of APA's, lack of technical capacity and lenient penalties for those found flouting TP regulations.

The challenges experienced by KRA in arriving at an arm's length price have a possible solution in the form of adopting international TP best practices. These international best practices form the basis of an international taxation regime that is presently represented by the OECD and UN Model Conventions. International best practices in TP are procedures and rules that have been found to be effective and efficient in eliminating inconsistencies and uncertainties and bringing about uniformity in TP. The developing countries have been able to succeed in reducing such

conflicts by creating the OECD TP Guidelines to regulate TP procedures among the member countries. The UN Model Convention is an attempt to help LDC to improve TP in line with OECD guidelines.

In arriving at a transfer price, the OECD has recommended five methods: comparable uncontrolled price (CUP), cost plus method (CPM), profit split (PSM), transnational net margin method (TNMM) and other methods. These methods are, however, not to be used in a hierarchical manner as there is no requirement that the CUP should be used first. Each of the TP method gains prominence depending on the circumstances such as the economic comparability of the transaction and the comparable market levels.

The UN Model Convention is yet another attempt at introducing international tax guidelines to address the challenges of TP. It is advisable to adopt the UN Practice Manual guidelines as well since these guidelines tend to favor developing countries.

The WTO is a global trading body whose goal is to regulate global trade and reduce barriers to international trade. The WTO valuation rules have been domesticated by the Customs and Excise Act and regionally by the EACCMA and COMESA. These rules and system of arriving at an arm's length price has been adopted by the Kenya Customs department under the administration of KRA.

The features of customs valuation encapsulated under the CEA are stated as the desire for proper documentation requirements, rulings of case law, regulations regarding rules of origin and the supporting guidance of the KRA on all matters concerning customs valuation and rules of origin. The rules of origin are a requirement for regional (EAC and COMESA) countries to ensure uniformity in customs valuation of goods and services transacted between partner states.

Six methods of customs valuation are recognized under the WTO and Customs and Excise Act. They include; the transactional value, the transaction value of identical goods, the transaction value of similar goods, the deductive value, the computed value and the fall-back method. However unlike the OECD TP Guidelines, the WTO valuation methods follow a hierarchy in the

sense that it is only after the transaction value fails in arriving at a customs value that the next method can be resorted to.

Under these rules, valuation of transactions between related entities is also challenging because MNCs are able to abuse these rules through under invoicing of their goods and services. On top of the challenges of arriving at an arm's length price using the OECD TP Guidelines, arriving at a customs value using the WTO is that the two methods increase the transaction cost of arriving at a transfer price and a customs value that is essentially the same. Enterprises are under a legal obligation to prepare TP and customs valuation documentation which further complicates the work of KRA. Customs valuation presents other challenges.

The existence of both TP and customs valuation has presented both opportunities and challenges. For KRA, it is an opportunity to test the effectiveness and efficiency of their systems. MNCs view this as an expensive undertaking impacting negatively on their stated goal of maximization of profits. For example, a retroactive adjustment under TP regime is not a requirement in customs valuation.

APPENDICES

APPENDIX A: CONSTITUTION EXCERPTS

Article 47 of the 2010 Constitution of Kenya

(1) Every person has the right to administrative action that is expeditious, efficient, lawful, reasonable and procedurally fair.

(2) If a right or fundamental freedom of a person has been or is likely to be adversely affected by administrative action, the person has the right to be given written reasons for the action.

(3) Parliament shall enact legislation to give effect to the rights in clause (1) and that legislation shall—

   (a) provide for the review of administrative action by a court or, if appropriate, an independent and impartial tribunal; and

   (b) promote efficient administration.

Article 201 of the 2010 Constitution of Kenya

The following principles shall guide all aspects of public finance in the Republic

(a) there shall be openness and accountability, including public participations in financial matters;

(b) the public finance system shall promote an equitable society, and in particular

   (i) the burden of taxation shall be shared fairly;

   (ii) revenue raised nationally shall be shared equitably among national and county governments; and

   (iii)expenditure shall promote the equitable development of the country, including by making special provision for marginalised groups and areas;

(c) the burdens and benefits of the use of resources and public borrowing shall be shared equitably between present and future generations;

(d) public money shall be used in a prudent and responsible way; and

(e) financial management shall be responsible, and fiscal reporting shall be clear.

APPENDIX B: SECTION 18 OF THE INCOME TAX ACT

Section 18(3) of the Kenya Income Tax Act ("ITA") sets forth Kenya's adherence to the arm's length principle as follows:

(3) 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.

Further guidance was provided in 2006 via the Income Tax (TP) rules. Kenya's rules follow the OECD method, including containing a 'most appropriate method.' Nevertheless, it appears that the KRA has a preference for the CUP method, although the majority of TP policies employ profits-based methods. This disparity is likely to result in a large number of disputes.

a. Documentation

Kenya TP rules require that documentation be maintained, demonstrating:

i) Selection of the most appropriate TP method and the rationale for such selection;
ii) Application of the method, including calculations made and price adjustments;
iii) Assumptions, strategies and policies in selecting the TP method; and
iv) Other background information as may be required by the Commissioner regarding the transaction.

b. Thin capitulation rules

Thin capitalization rules are in place, with the prescribed ratio of debt to equity of 3:1.

c. Kenya Revenue Authority

In 2010/2011, the Kenya Revenue Authority ("KRA") collected KES 606.4 billion. Although no specific information on the contribution of MNCs to total tax revenue and GDP was obtained, MNC's tax revenue to KRA's total tax receipts is about 80%.

Recently, the Government has sought to fund its expenditures through tax revenues. The KRA has been successful at raising revenues, as total tax revenues approximate 22 percent of GDP. Thus, the KRA has become quite aggressive recently in revenue collection.

In 2009, the KRA established a TP unit. As of May 2011, the TP had 17 employees. Currently, this unit is auditing a significant number of MNCs operating in Kenya.

The KRA routinely challenges recharges which often results in proposed adjustments. A general view in Kenya has been that MNC's purposefully structure their local entities to be low-profit making entities. This is achieved through tactics such as stripping distributors and manufacturers of risk and transferring locally created intangibles for little or no consideration.

d. Capacity

The KRA appears to be on the forefront of TP in Africa. To this end, it has:

i) Established a TP unit
ii) Subscribed to Pan European databases (e.g., Amadeus)
iii) Become a member of ATAF
iv) Taken a TP case to court (Unilever Kenya Ltd. v. The Commissioner of Income Tax)

One complaint, recurrent throughout Africa and most of the developing world, is the difficulties of using non-local comparables and the application of country-risk adjustments.

e. The UN model

From informal discussions, it appears that the KRA feels that the UN TP rules will be fairer to developing countries than the OECD Guidelines. There is a general perception that the OECD Guidelines are inappropriate for developing countries and the UN Model may better reflect the needs of developing countries.

f. Penalties

There are no TP-specific penalties in place. However, the Commissioner for Domestic Taxes can conduct an audit and make adjustments to the taxable profit where applicable. Any tax arising from such a TP adjustment is subject to additional penalties under Sections 72D and 94 of the ITA. Section 72D of the ITA states that late payments of tax will be subject to a 20% penalty.

Section 94 of the ITA imposes a 2% interest charge on the amount of unpaid tax greater than a month.

There are also general anti-avoidance rules, although they are rarely used.

g. Tax treaties

Kenya enjoys tax treaties with 8 worldwide countries: Canada, Denmark, Germany, India, Norway, Sweden, the U.K., and Zambia. In addition, Kenya signed a treaty with Italy, but it has not yet been ratified. Kenya also has signed a treaty with the East Africa Partner States, i.e., Uganda, Tanzania, Rwanda, and Burundi, yet this treaty has also not been ratified.

h. Miscellaneous

Firms should consider whether a branch or subsidiary is more appropriate given the specific circumstances. Remittance of profits by a branch to its parent company is not subject to withholding tax, yet dividend payments by subsidiaries to parents are subject to withholding tax.

i. Practical knowledge

i) Differences in Successful and Unsuccessful Entrances into Kenya

MNCs that have success often seek strong local partnerships. This appears to be a critical characteristic of successful entrances, as mere outspending local incumbents has not been sufficient to capture the local consumer trends/patterns.

ii) East African Integration

Under the East African Community ("EAC"), Kenya, Burundi, Rwanda, Tanzania, and Uganda have officially formed a free trade area and a customs union. Sometime in 2012, businesses and persons will be allowed free migration between the EAC. By 2015, the EAC plans to unveil a common currency, the East African Shilling.

APPENDIX C: KENYA TP GUIDELINES

LN No. 67 The Income Tax (TP) Rules 2006

15 June 2007 In the Exercise of the powers conferred by Section 18(8) of the Income Tax Act, the Minister for Finance makes the following Rules"-

1. Citation and commencement

These Rules may be cited as the Income Tax (TP) Rules, and shall come into operation on the 1st July, 2006.

2. Interpretation

In these Rules, unless the context otherwise requires:-

"arm's length price" means the price payable in a transaction between independent enterprises;

"comparable transactions" means transactions between which there are no material differences, or in which reasonably accurate adjustments can be made to eliminate material differences;

"controlled transaction' means a transaction which is monitored to ensure payment of an arm's length price for goods or services;

"related enterprises" means one or more enterprises whereby:-

(a) one of the enterprises participates directly or indirectly in the management, control or capital of the other: or

(b) a third person participates directly or indirectly in the management, control or capital of both.

3. Purpose of Rules

The purpose of these Rules are:-

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

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

4. Person to choose method

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

5. Scope of guidelines

These guidelines shall apply to:-

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

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

6. Transactions subject to Rules

The transactions subject to adjustment of prices under these Rules shall include:-

(a) the sale or purchase of goods;

(b) the sale, purchase or lease of tangible assets;

(c) the transfer, purchase or use of intangible assets;

(d) the provision of services

(e) the lending or borrowing of money; and

(f) any other transactions which may affect the profit or loss of the enterprise involved.

7. Methods

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

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

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

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

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

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

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

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

8. Application methods

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

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

9. Power of Commissioner to request for information

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

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

(a) the selection of the TP method and the reasons for the selection;

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

(c) the global organization structure of the enterprise:

(d) the details of the transaction under consideration;

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

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

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

10. Application of arm's length pricing

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

(a) develop an appropriate TP policy;

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

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

11. Certain provisions of Act to apply

The provisions of the Act relating to fraud, failure to furnish returns and underpayment of tax shall apply with respect to TP.

12. Unpaid tax to be deemed additional tax

Any tax due and unpaid in a TP arrangement shall be deemed to be additional tax for purposes of section 94 and 95 of the Act.

Made on the 15th June 2006

AMOS KIMUNYA,

Minister of Finance

APPENDIX D: OECD TAX MODEL EXTRACTS

Article 9 - Associated Enterprises

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits-which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes Accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other

APPENDIX E: UN TAX MODEL

Article 9 - Associated Enterprises

1. Where:

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason 'of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting, States shall, if necessary, consult each other

3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

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3. STP- Oral Interview October 2012