TAXATION OF MULTINATIONAL ENTERPRISES: OPPORTUNITIES AND THREATS TO DEVELOPING ECONOMIES

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SUPERVISOR:
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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE DEGREE OF MASTER OF ARTS IN INTERNATIONAL STUDIES

NOVEMBER 2014
DECLARATION

I, J. W. Sangale Nchololoi hereby declare that this research project is my original work and has not been presented for a degree in any other University.

Signed..........................................................  Date..................................................

J. W. Sangale Nchololoi

This project has been submitted for examination with my approval as the University Supervisor.

Signed..........................................................  Date..................................................

Mr. Ikiara, G. K.
DEDICATION

To my family whom I truly value, cherish and adore.
ACKNOWLEDGEMENT

I am most grateful to my supervisor, Mr. G.K. Ikiara without whose guidance, this work wouldn’t have materialized in the manner that it has. I received tremendous input from some staff at the audit at Kenya Revenue Authority, Nairobi, in response to interviews and questionnaires. Since the respondents have requested that I do not write their names, I hereby appreciate them anonymously. I would like to express my gratitude to the faculty and staff of the Institute of Diplomacy and International Studies (IDIS) whose insights have gradually shaped this work in the course of my studies. Last, but not least, I would like to thank my wife Wambui for constant and persistent encouragement throughout this journey, she never gave up on me even when I was really down, and to my sons Lemayian and Leshan who insisted on assisting me accomplish my homework. God bless you all abundantly.
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ABSTRACT

Tax revenue is a major source of the gross national income in many developing countries. While tax revenues in OECD-countries amount to almost 36 per cent of gross national income in 2007, the share in selected developing regions amounts around 23% in Africa (in 2007) and 17.5% Latin America (in 2004). The low percentage of tax revenue attributed to developing economies is indicative of inefficient tax collection mechanisms in these countries. The current study seeks to analyse the influence of legislative and administrative capacity of tax administrators in developing economies to the tax compliance behaviour of the Multinational Enterprises, MNEs. The study focuses on corporation tax revenue payable from MNE’s. The specific objectives of the study include: To examine the extent to which corporation tax revenue from MNE’s is affected by the legislative framework of the host country in selected developing countries; To examine the extent to which corporation tax revenue from MNE’s is affected by the administrative capacity of the tax administrator of the host country in selected developing countries and to assess the impact of various legitimate and illegitimate means through which tax revenue is lost from developing countries through MNE taxation regime. The present study utilizes the dependency theory of international relations for analysis. The dependency theory is a Marxist analytical theory that postulates that resources flow from a “periphery” of poor and less developed states to a "core" of wealthy states, enriching the latter at the expense of the former. It is a central contention of dependency theory that poor states are impoverished and rich ones enriched by the way poor states are integrated into the “world system.” The present study adopts the research design of a survey. Surveys are concerned with describing, recording, analyzing and interpreting conditions that either exist or existed. The researcher does not manipulate the variable or arrange for events to happen. Surveys are only concerned with conditions or relationships as they exist, opinions as they are held, processes as they are going on, effects as they are evident and trends as they develop. An empirical study was conducted whereby 20 KRA auditors were asked to give their views on certain issues related to MNE tax compliance in Kenya. According to the study, the MNEs were considered generally to be non-compliant, scoring a mean index of 1.93 in a scale of 1 to 5. Administrative and legislative factors that predispose the MNEs to non-compliance were investigated as well. The study recommends that there is need to investigate the impact of tax planning and corruption on the corporation tax revenues collected by developing countries.
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ABF</td>
<td>Associated British Foods</td>
</tr>
<tr>
<td>BEPS</td>
<td>Base Erosion and Profit Shifting</td>
</tr>
<tr>
<td>CPM</td>
<td>Cost Price Method</td>
</tr>
<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price</td>
</tr>
<tr>
<td>CUT</td>
<td>Comparable Uncontrolled Transaction</td>
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<tr>
<td>DTA</td>
<td>Double Tax Agreement</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GCP</td>
<td>Gross Corporate Product</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GoK</td>
<td>Government of Kenya</td>
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<tr>
<td>ICT</td>
<td>Information Communication Technology</td>
</tr>
<tr>
<td>ITA</td>
<td>Income Tax Act Cap 470 of Laws of Kenya</td>
</tr>
<tr>
<td>ITMS</td>
<td>Integrated Tax Management System</td>
</tr>
<tr>
<td>KIA</td>
<td>Kenya Investment Authority</td>
</tr>
<tr>
<td>KNBS</td>
<td>Kenya National Bureau of Statistics</td>
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<tr>
<td>KRA</td>
<td>Kenya Revenue Authority</td>
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<tr>
<td>KRATI</td>
<td>KRA Training Institute</td>
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<tr>
<td>LTO</td>
<td>Large Taxpayer’s Office</td>
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<td>MNEs</td>
<td>Multinational Enterprises</td>
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<tr>
<td>MTC</td>
<td>Model Tax Convention</td>
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<td>MTO</td>
<td>Medium Taxpayers Office</td>
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<tr>
<td>NSE</td>
<td>Nairobi Securities Exchange</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<tr>
<td>PAYE</td>
<td>Pay As You Earn</td>
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PwC  Price Waterhouse Coopers
RARMP  Revenue Administration Reform and Modernization Programme
RPM  Resale Price Method
SPSS  Statistical Package for Social Sciences
TNMM  Transactional Net Margin Method
TP  Transfer Pricing
UNCTAD  United Nations Conference on Trade and Development
VAT  Value Added Tax
WTO  World Trade Organization
CHAPTER ONE
INTRODUCTION

1.1 Background of the problem

The term Multinational enterprise (MNE’s) refers to a company whose activities involve international cross-border direct investment. According to Dunning & Lundan, 2008, a multinational or transnational enterprise is an enterprise that engages in foreign direct investment (FDI) and owns or controls value addition activities in more than one country. MNEs expand into other countries and regions through subsidiaries companies, mergers, branch offices and joint ventures operations. Multinational enterprises are also referred to as Multinational Corporations (MNC’s) or Transnational Corporation (TNC’S) or International Enterprises.¹

Usually, the structure of MNE’s entails one of the following formats: a headquarter office located in the source country and subsidiaries in other jurisdictions or a headquarter office located in the source country and permanent establishments (PEs) located in other jurisdictions. A subsidiary is a separate legal entity that is incorporated under the laws of the host country and gets the benefit of tax provisions, such as certain deductions or fiscal incentives, that are available only to a domestic incorporated companies and will normally be treated as a resident taxpayer of the country in which it is incorporated. On the other hand, a PE is a non-separate legal entity to its head office and may be liable for head office’s losses and vice versa. A permanent establishment refers to a fixed place of business such as a management office, a branch, or a factory in the other country or it has a dependent agent in the other country that has

the authority to conclude contracts binding the enterprise and the agent habitually exercises that authority.²

In a discussion of foreign investment, it is important to distinguish between Foreign Direct Investment (FDI) and portfolio investment. The Organization for Economic Co-operation and Development (OECD) defines FDI as a cross-border investment by a resident entity in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy.³ Chrystal and Lipsey define FDI as non-resident investment in the form of a take-over or capital investment in a domestic branch, plant, or subsidiary corporation in which the investor has voting control.⁴ On the other hand, portfolio investment is defined as investment in bonds and other debt instruments that do not imply ownership or in minority holdings of shares do not establish legal control.⁵

Growth in economic integration and global trade has led to increase in number and size of MNEs across the world. In addition, MNEs continue to increase their significance as players in global economic and political affairs. Some MNEs like Coca-cola, Pepsi, Toyota, General Electric, and Barclays operate in many countries of the world. The World Trade Organization (WTO) reports that 51 of the 100 largest economies in the world are MNEs and the top 500 multinational corporations account for nearly 70 percent of the worldwide trade. ⁶ In 1991, the Gross Corporate Product (GCP) of General Motors was estimated to be equal to the Gross Domestic

Product (GDP) of Sweden, was about three times the GDP of Philippines and was about six times the GDP of Bangladesh.\(^7\)

The economic might of some MNEs compared to the Gross Domestic Products (GDP’s) of some developing economies is illustrated in figure 1.0 below.

Figure 1.1: Gross Domestic Products and Gross Corporation products of selected MNEs and selected developing economies.

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP/GCP in US $ Billion</th>
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<tbody>
<tr>
<td>BP</td>
<td>387</td>
</tr>
<tr>
<td>Indonesia</td>
<td>847</td>
</tr>
<tr>
<td>Kenya</td>
<td>34</td>
</tr>
<tr>
<td>Nigeria</td>
<td>236</td>
</tr>
<tr>
<td>Nissan Motor</td>
<td>119</td>
</tr>
<tr>
<td>Reliance Industry</td>
<td>76</td>
</tr>
<tr>
<td>Samsung Electronics</td>
<td>149</td>
</tr>
<tr>
<td>South Africa</td>
<td>408</td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>74</td>
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</table>


Notes: 1. GDP for countries.
2. GCP for MNEs.

An impartial discussion of the relations between developing economies must balance between the benefits accruing to such economies as the result of the investment of the MNEs and the threats that such a relationship presents. As for the MNEs, it is straightforward that their main motivation is making profits.

Hill (2011) says that the benefits of foreign direct investment (FDI) to a host country include resource transfer benefits, employment benefits, balance-of-payment effects and technology transfer benefits. Yeni Mulyani (2010) adds that benefits for the host country include the availability of scarce factors of production, building of economic infrastructure, as well as increasing government revenue through income tax collection.

Considering the economic strength of MNEs generally on one hand, and the sovereignty of developing states on the other hand, each of the parties comes to the relationship having a given point of leverage. MNEs bring the capital and that capital is being competed for by many countries in the world. While developing countries are pressured to make their offer to MNEs more enticing than what can be offered by rival states, the countries also want to keep their sovereignty, free from the manipulation or domination of MNEs. The relationship is inevitably fraught with conflict.

Goldstein and Pevehouse (2010) have enumerated some of the conflicts associated to the relationship between host nations and MNEs to include lack of negotiation skills by the host countries, change of the terms of the contract by the government when the MNE has invested in

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capital infrastructure, trade policies of the host nation, especially where the government wishes to protect local industries, increase of corruption in the form of kickbacks and payoffs and loss of tax revenue through both legitimate and illegitimate means.  

A comprehensive study of all the conflicts listed above may be beyond the scope of the current study. The study however seeks to analyse the influence of legislative and administrative capacity of tax administrators in developing economies to the tax compliance behaviour of the MNEs.

1.2 Statement of the problem

Tax revenue is a major source of the gross national income in many developing countries. While tax revenues in OECD-countries amount to almost 36 per cent of gross national income in 2007, the share in selected developing regions amounts around 23% in Africa (in 2007) and 17.5% Latin America (in 2004). The low percentage of tax revenue attributed to developing economies is indicative of inefficient tax collection mechanisms in these countries. The current study seeks to analyse the influence of legislative and administrative capacity of tax administrators in developing economies to the tax compliance behaviour of the MNEs. The study focuses on corporation tax revenue payable from MNE’s.

Lack of tax compliance among the MNE’s is a serious problem facing tax administrators worldwide. The Government Accountability Office (GAO) of the United States of America reports that from 1998 to 2005, a large number of companies in the United States did not pay any

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12 GIZ (2010). *Addressing tax erosion and tax avoidance in developing countries*. Author
income tax. Among the Foreign Controlled Domestic Corporations (FCDC’s), 70% did not pay while among the United States Controlled Corporations (USCC’s), 65% did not meet their tax obligations.\textsuperscript{14} In Kenya, the commissioner General of the Kenya Revenue Authority (KRA) announced that KRA had conducted a tax audit of 50 multinational firms and recovered tax revenues of more than sh.25 billion. Some of the MNEs were forced to rewrite their financial statements to reflect their profitable positions instead of the losses that they had declared initially. Further, the US-based Global Financial Integrity (GFI) has estimated that Kenya lost sh.115 billion in price transfer cases to MNEs in the last 10 years from 2004.\textsuperscript{15}

Loss of MNE corporation tax revenue can be as a result of either legitimate or illegitimate means. Legitimate means through which host nations may lose revenues to MNEs occur as a result of weak legal frameworks that allow for loopholes to be exploited by the investors to minimize tax liabilities. Illegitimate means through which host nations can lose funds to MNEs include illegal transfer pricing activities.\textsuperscript{16} The current study will also seek to analyse the influence of legislative and administrative capacity of tax administrators in developing economies to the tax compliance behaviour of the MNEs.

1.3 Research objectives

1.3.1 General Objectives

The general objective of the current study is to determine the factors that influence corporate tax revenue from MNE’s in developing countries.


1.3.2 Specific Objectives

The specific objectives of the study include:

1. To examine the extent to which corporation tax revenue from MNE’s is affected by the legislative framework of the host country in selected developing countries.
2. To examine the extent to which corporation tax revenue from MNE’s is affected by the administrative capacity of the tax administrator of the host country in selected developing countries.
3. To assess the impact of various legitimate and illegitimate means through which tax revenue is lost from developing countries through MNE taxation regime.

1.4 Research questions

1. To what extent is corporation tax revenue from developing countries affected by the legislative framework of the host country?
2. How much does corporation tax revenue from MNE’s get influenced by the administrative capacity of the tax administrator of the host country?
3. What is the impact of various legitimate and illegitimate means through which tax revenue gets lost from developing countries through MNE taxation regime?

1.5 Justification of the study

The present study will be of benefit to different stakeholders. Governments of developing nations will consider the findings of the proposed study useful to determine whether or not to make adjustments to the various pieces of legislation governing transfer pricing, including the Finance and Income Tax Acts in Kenya, to enhance tax collection from the MNE sector.
Tax administrators in such jurisdictions may make use of the proposed study while devising administrative strategies to enhance tax collection from transfer price transactions. Quite often, such administrators get engaged in court cases based on differences in interpretation of the Income Tax Act between the revenue authority and the MNEs involved. These differences of opinion between the various stakeholders justify an academic appraisal of the current MNE tax regime in developing economies. The proposed study seeks to meet with such a need.

Managers of MNE firms will find the findings of the proposed study useful as an academic point-of-reference as they devise their tax-compliance strategies in Kenya. The study will also provide academic researchers with useful theoretical, practical and methodological contributions in future studies on the subject.

1.6 Literature Review

1.6.1 Introduction

This literature review describes the concepts of transfer price, profit shifting, and the arm’s length principle. It also discusses the merits and the demerits of the OECD guidelines to multinational enterprises and tax administrators, as applied in developing economies.

1.6.2 Concept of transfer pricing

Transfer price is the price charged by individual entities in a multinational corporation for transactions performed between them. Often, this price is not the same as the market price between unrelated or independent parties.

Transfer pricing is a field of analysis that reflects the determination of profits of each portion of an MNE. The profits of each portion of MNE business are most typically structured through intercompany transactions, including intercompany sales, licensing, leasing and the like.\textsuperscript{18} Management of MNE is often interested in maximizing global profits as well as minimizing the overall tax paid by the group. Thus, the management of MNE group examines and reviews tax laws and administrative requirements in various jurisdictions of operation with a view of assessing their potential tax exposure. One way through which MNEs minimize their effective tax exposure is through transfer pricing by shifting profits from normal or high tax jurisdictions to low-tax jurisdiction and in some cases to tax havens.

\textbf{1.6.3 Profit shifting}

A growing body of evidence indicates that MNEs do indeed minimize their tax obligations by shifting profits from high to low tax jurisdictions. According to Heckemeyer and Overesch (2012) transfer pricing and licensing is the dominant channel of profit shifting.\textsuperscript{19}

Therefore, existence of low tax jurisdictions and tax havens has made the situation worse since they have created avenues and incentives for MNEs to shift profits from high tax jurisdictions to low tax jurisdictions and tax havens by use of transfer pricing schemes.

Profit shifting by MNEs leads to reduction of the tax base and ultimately leads to reduction in corporation tax paid by such enterprises in the affected countries. Thus, countries all over the world and their tax authorities are currently putting in place measures to safeguard their tax base.


Globally, transfer pricing and profit shifting has attracted media attention with major issues being headlines in business news in the dailies and internet in both developed and developing economies. For instance, in the case of Apple Inc, the company was able to shift most its profits from United States (US) to low tax jurisdictions like Ireland leading to estimated loss of federal taxes amounting to USD 2.4 billion. Another example in Africa is about the Associated British Foods (ABF) and Zambia Sugar Company where it was reported that ABF a British sugar MNE caused the Zambia Government the loss of tax revenues estimated at USD 17.7 Million through shifting of profits from that country to tax havens\(^\text{20}\) such as Jersey and Mauritius.\(^\text{21}\)

A report done by Global Financial Integrity, indicated that developing countries lose about USD 98 billion to 106 billion every year through mispricing.\(^\text{22}\) In response to the supposedly widespread use of profit shifting techniques by MNEs around the globe, the Organization for Economic Cooperation and Development with support from the G20 and individual governments, has taken the initiative and started a major effort to restrain what they call \textit{base erosion and profit shifting (BEPS)}. The Finance Ministers of G20 in their meeting of 5-6 November 2012 clearly advised that they welcomed the work being done by OECD on Base Erosion and Profit Shifting (BEPS). The G20 leader in their Mexico meeting 18-19 June explicitly declared that there is need to prevent base erosion and profit shifting.

\(^{20}\) Investopedia defines tax haven as a country that offers foreign individuals and businesses little or no tax liability in a politically and economically stable environment. Individuals and businesses that do not reside a tax haven can take advantage of these countries' tax regimes to avoid paying taxes in their home countries. [http://www.investopedia.com/terms/t/taxhaven.asp](http://www.investopedia.com/terms/t/taxhaven.asp). Accessed on July 2014.


\(^{22}\) Hollingshead, A. (2010). \textit{The Implied Tax Revenue Loss From Trade Mispricing}. Global Financial Integrity.
1.6.4 Arm’s length prices

When two related firms transact, there is a possibility of conspiring to under-declare the profits of one of the firms so that in the overall, the MNE benefits by denying tax revenue to one of the tax jurisdictions. The most common conspiracy among related firms is called profit shifting. This occurs when the enterprise located in normal or high tax jurisdiction will simulate losses or insignificant profits while the subsidiary located in a tax haven declares inflated profits. This happens when related firms do not transact at what is commonly known as the arm’s length price.

A transfer price is a price, adopted for bookkeeping purposes, which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer between those enterprises.\(^2^3\)

Tax auditors are interested in determining whether related firms are transacting at arm’s length prices. The determination of arm’s length prices is the subject of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators.

The arm’s length principle develops from a study commissioned by the League of Nations in 1928 which came to be known as the Carrol report, after Mitchell B. Carroll, the leader of the study team. The report advocated for the establishment of separate accounts to determine the profitability of separate but related firms in different tax jurisdictions.\(^2^4\)

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23 The OECD Transfer Pricing Guidelines, 2007, ‘the Glossary of Statistical Terms’.
Today, the arm’s length principle is provided for in article 7 and 9 of the OECD model Tax Convention. Article 7 of the Convention recognizes the applicability of the arm’s length principle. Article 9 defines related enterprises:

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 …

Further, article 9 discusses the relationship between a parent and subsidiary firm.

In 1979, the OECD issued detailed guidelines on the determination of the arm’s length price. These guidelines are commonly known as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators. These guidelines are recognized not only by OECD members but also by non-members. For example, Kenya recognizes the OECD guidelines through the legal doctrine of *stare decisis* following the Unilever case where the judge declared the OECD guidelines applicable to Kenyan tax legislation. Kenya has since issued guidelines for the determination of the arm’s length price, but the guidelines are said to be a reflection of the OECD guidelines. Further, the Kenyan guidelines are said to lack clarity and betray a lack of understanding of the methods of determining the arm’s length price, among the drafters.

To determine the arm’s length prices between related enterprises, tax administrators are compelled to look for similar transactions conducted by unrelated parties. This necessitates the creation of databases to provide data on comparable transactions between unrelated enterprises.

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25 Article 9 of the Article 9 of the OECD Model Tax Convention
Where such databases are unavailable, tax administrators are expected to make adjustments to cater for the discrepancy between the transaction available in the databases and the transaction between related enterprises under review.\textsuperscript{27}

The most commonly used databases include Amadeus for European Union countries, Compusat for Canada and the USA, and JADE for Japanese companies. Osirus and Worldscope have a worldwide coverage. However, it is significant to note that there is no database available as yet for making comparables regarding companies operating in Africa or in the developing world in general. This complicates the work of tax auditors in such jurisdictions, in the audit of companies that are at times provided for better than the tax administrator.\textsuperscript{28} To add to this challenge, developing economies face a serious lack of personnel, technical and legal capacities for TP audit. In 2011, South Africa was reported to have only 40 TP auditors. Obviously, the rest of Africa fares even worse in this aspect. This means that most of the MNEs operating in Africa do so without any fear of TP audit. Even if it were to be done, they are assured that the auditors are quite incompetent in the field. This leaves the economies vulnerable to exploitation by the MNEs with regard to tax compliance.\textsuperscript{29}

1.6.5 Transfer Pricing Methodologies

The OECD Transfer Pricing Guideline classify the transfer pricing methodologies into two categories: transaction based and profit based. The transaction based methods, are called ‘the

\textsuperscript{27} Mulyani, Y. (2010). *Factors Influencing Transfer Pricing Compliance: An Indonesian Perspective (Doctoral thesis, Australian Business School, Univerisity of New South Wales,Australia).*

\textsuperscript{28} Mulyani, Y. (2010). *Factors Influencing Transfer Pricing Compliance: An Indonesian Perspective (Doctoral thesis, Australian Business School, University of New South Wales,Australia).*

\textsuperscript{29} European Commission.(a) (2011). *Transfer Pricing and Developing Countries. Appendix D: Country Study-Kenya*. European Commission
traditional transaction method’ and the profit-based methods are called ‘the transactional profit method’. The traditional transaction method consists of three methods:

1. The comparable uncontrolled price (CUP) method;

2. The resale price method (RPM); and

3. The cost plus method, (CPM).

The transactional profit method consists of two methods:

1. The profit split method; and

2. The transactional net margin method (TNMM).

The traditional transaction methods are based on the principle that the true taxable profit of associated enterprises is calculated based on their past transactions to produce a price which represent the arm’s length price. The traditional methods are the most direct methods of establishing the arm’s length price between associated enterprises. Thus, they have become the most preferred methods. However, difficulties, in applying these methods may arise when there is no similar or comparable data, in which case the transactional profit methods can be used as a last resort.30

The transactional profit methods are based on the principle that the profits of associated enterprises can indicate whether the transactions between those associated enterprises are at

arm’s length. The OECD Transfer Pricing Guidelines point out that in practice it is very rare to find a company that determines its price based on transactional profit methods.\(^{31}\)

It is also important to note that other methods of determining the arm’s length price exist. Such include: the comparable price method (CPM), comparable uncontrolled transaction (CUT) method and the unspecified method.\(^{32}\)

**1.6.6 Criticism to the concept of arm’s length**

The OECD model Tax Convention and the OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administrators are based on the predilection for residence taxation and not source taxation. Under such laws, interest, dividends and royalties are only taxable at the residence jurisdiction and not at the source jurisdiction. This generally works against the tax interests of the developing world because most of the MNEs trading in the global south have their residence in the global north.\(^{33}\) In view of this, developing economies are advised to base their legal framework on the UN Model Tax Convention that has some clauses that allow for taxation at the source.\(^{34}\)

Another issue related to the weaknesses of the arm’s length approach is that it will be difficult to apply to cross-border electronic commerce since the OECD Transfer Pricing Guidelines favour the use of traditional transaction-based transfer pricing methodologies. For example, electronic

\(^{31}\) Ibid.

\(^{32}\) Ibid.


commerce transactions are harder to detect than non-electronic transactions. The server used in electronic commerce transactions can be moved easily from one place to another.  

Faced with these weaknesses the arm’s length principle is increasingly getting questioned and alternative models suggested. For example, Brazil, for example, eschews the OECD model in favour of its own ‘fixed margin’ transfer pricing rules, which give much less room for manoeuvre. They apply to transactions between Brazilian companies and related companies abroad, and all transactions with companies based in tax havens. Brazil’s unilateral approach is controversial, but fixed margins offer a more easily enforced method for developing countries. Others have argued for a wholesale abandonment of transfer pricing in favour of ‘global formulary apportionment’, a system under which a multinational company’s total profits would be allocated for tax purposes between the countries in which it operates according to a formula. In the US, companies already have to use such an approach to allocate profits between states; the ‘three factor state formula’ takes into account the share of a company’s total property, payroll and sales in each state. 

1.7 Theoretical Framework

The present study utilizes the dependency theory of international relations and the economic deterrence theories of tax compliance for analysis.

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1.7.1 Dependency Theory

Dependency theory is a body of social science theories, both from developed and less developed nations, which are predicated on the notion that resources flow from a “periphery” of poor and less developed states to a “core” of wealthy states, enriching the latter at the expense of the former. It is a central contention of dependency theory that poor states are impoverished and rich ones enriched by the way poor states are integrated into the “world system”. This is based on the Marxist analysis of inequalities within the world system, but contrasts with the view of free market economists who argue that free trade advances poor states along an enriching path to full economic integration. As such, dependency theory features prominently in the debate over how poor countries can best be enriched or developed.\(^{37}\)

Dependency was said to be created with the industrial revolution and the expansion of European empires around the world, due to their superior military power and accumulated wealth. Some argue that before this expansion, the exploitation was internal, with the major economic centers dominating the rest of the country (for example: Southeast England dominating Britain, or the Northeast United States dominating the South and West). The establishment of global trade patterns in the nineteenth century allowed capitalism to spread globally. The wealthy became more isolated from the poor, because they gained disproportionately from imperialistic practices.\(^{38}\)

Dependency and world systems theory generally hold that poverty and backwardness in poor countries -like the third world- are caused by the peripheral position that these nations hold in the

\(^{37}\) Chow, T., J. "Intro to international relations primer on basic international political economy concepts" University of California, Berkeley Department of Political Science. (2005).

international division of labor. Ever since the capitalist world system evolved, there is a stark distinction between the nations of the center and the nations of the periphery. Theorists summarized the quantifiable essence of dependency theories as follows: 1). There is a financial and technological penetration by the developed capitalist centers of the countries of the periphery and semi-periphery. 2). This produces an unbalanced economic structure both within the peripheral societies and between them and the centers. 3). This leads to limitations on self-sustained growth in the periphery. 4) This favours the appearance of specific patterns of class relations. 5) These require modifications in the role of the state to guarantee both the functioning of the economy and the political articulation of a society, which contains, within itself, foci of inarticulateness and structuralism balance.

1.7.2 Economic deterrence Theory of tax compliance

The economic definition of taxpayer compliance views taxpayers as ‘a perfectly moral, risk neutral or risk averse utility maximizing individuals who chose to evade tax whenever the expected gain exceeded the cost.’

Some of the earliest models based on the economic deterrence factors are the models developed by Allingham and Sandmo. They developed models to measure individual tax compliance behaviour by analysing the relationship between tax rates and taxpayer’s cheating behaviour. In general, the models try to establish whether higher tax rates influence tax compliance. The study found that increases in penalty rates and the probability of detection will increase tax compliance.

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Their models were further developed by many other researchers by including various additional factors in their models. Yitzhaki included fines as a component of Allingham and Sandmo’s model.\textsuperscript{41} He concluded that taxpayers’ cheating behaviour will decline when the tax rate is higher but only on the condition that the penalty is comparable to the amount of tax evaded.

Proponents of economic deterrence theory suggested that deterre\-nts could be used interchangeably. When detection rates are low, penalties should be high and vice versa. Where the probability of detection is certain, mild punishment may be as effective a deterrent as a more severe one. Hence, increasing the penalty level will not necessarily achieve a greater deterrent effect if the offender knows that the chance of being caught is very high.\textsuperscript{42}

The tax compliance debate extended into the 1980’s as the US government extended the range of penalties for non-compliance. The penalties however failed to improve the rate of compliance raising questions about the merits of the pure economic deterrence models. It was argued that if the sanctions were perceived as being too severe, the taxpayers may become alienated, leading to general disrespect of the law. In a separate study Slemrod introduced the variable of complexity of the tax structure into the economic model. It was argued that because complexity increased the cost of complying with the law it increased non-compliance since taxpayers had to hire professional tax advisor who are often expensive to majority of the taxpayers.\textsuperscript{43}

In summary, the traditional economic deterrence models draw upon deterrence theory and expected utility theory to predict that a rational taxpayer will evade tax as long as the payoff

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from evading is greater than the expected cost of being caught and punished. However, there is only ambiguous empirical evidence to support the predictions of economic deterrence models as a whole. Researchers summarise the effect of factors that determine the monetary cost of compliance as including the tax rate, detection probability, the level of income and penalty structure, and suggest, for all of them, that existing empirical evidence provides no firm conclusions. Studies have suggested that a combination of penalties and rewards is more effective in increasing compliance than a system that focuses solely on sanctions. As such, other factors such as enforcement, public education and the behavioural aspects of taxpayers are critical and must also be considered.

The theories discussed above are suitable for the analysis of tax compliance by MNEs in developing economies. The dependency theory is considered accurate considering the instances when MNEs engage themselves in illegitimate transfer pricing activities which have potential of draining tax revenue from developing economies. The economic deterrence model of tax compliance is suitable for the analysis of tax compliance of MNEs in developing economies in view of the fact that in maximizing their profits, MNEs seek to minimize their tax liabilities. They arrange their global structures in such a way that tax liability is paid in jurisdictions where rates of corporation tax are lowest.

1.8 Conceptual framework

The conceptual framework explains the relationship between the independent variables and the dependent variables in a study. In the present study, the legislative framework of the host economy and the administrative framework of the host economy are the independent variables.


The dependent variable is tax compliance among the MNEs in the host country. Tax compliance is evident when a firm submits the transfer pricing document as required by the Commissioner General of the tax administrator in the host country, submits tax returns in time declaring truthfully and accurately tax payable, makes payment of taxes payable promptly and fully. In the case of MNEs, tax compliance is also evident if the taxpayer explains all the transactions as required in the tax audit.

Independent variables

- Legislative framework of host country
- Administrative structure of the tax administrator in the host country

Dependent variables

- Corporation tax compliance of MNE’s in the tax jurisdiction.
  - Submit the transfer price document as required by the administrator.
  - Makes accurate declarations in tax returns.
  - Pays taxes fully and promptly.

Fig 1.2: The conceptual framework

1.9 Research Methodology

1.9.1 Introduction

The following issues related to research methodology are discussed in this section: Research design, study population, sampling, sample size, instruments for data collection, methods of data collection, ethical considerations and validity & reliability.

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1.9.2 Research design

The present study adopts the research design of a survey. Surveys are concerned with describing, recording, analyzing and interpreting conditions that either exist or existed. The researcher does not manipulate the variable or arrange for events to happen. Surveys are only concerned with conditions or relationships as they exist, opinions as they are held, processes as they are going on, effects as they are evident and trends as they develop. Surveys are generally concerned with the present, but they may pay attention to past events so as to explain how the present conditions have been influenced by past events. Consequently, surveys are well suited for social and behavioural sciences. From the definition above, the survey design is found suitable for the current study.

1.9.3 Study population

A section of the present study seeks to understand the factors contributing to tax compliance among MNEs in Kenya. Kenya is used as a case study country to represent developing economies. The population targeted for the interviews include the transfer price auditors at the Kenya Revenue Authority. The auditors work in the Large Taxpayers’ Office (LTO) and a section of them work at the Medium Taxpayers Office (MTO). In total, there are 32 auditors, who are involved in the tax audits of MNE’s. This population was chosen because of their familiarity with tax compliance matters of MNE’s based in Kenya. Further, their training exposes them to the legislative and administrative issues that have a bearing on tax compliance of MNE’s in the country.

48 Ibid.
1.9.4 Sampling

The respondents to the present study include 10 transfer price auditors, 5 taken from the Large Taxpayers office (LTO) and 5 taken from the Medium Taxpayers Office. (MTO).

The snowballing method was used to sample the respondents. Snowballing is a non-probability method used when the desired sample characteristic is rare. Respondents are selected on the criteria of their ability to provide certain information that may be relevant to the study.\textsuperscript{49}

1.9.5 Sample size

The sample comprises of 31.25\% of the total population. According to Saunders et al.(2007) a sample size for a descriptive survey can be determined by taking 10\% of the target population.\textsuperscript{50} The selected sample exceeds the 10\% threshold recommended by Saunders et al (2007) and is therefore considered to be representative.

1.9.6 Instruments Used for Data Collection

The researcher used three instruments of data collection. They are questionnaires, interviews and literature survey. The present study utilized pretested questionnaires to collect primary data from transfer pricing auditors at KRA as identified in the sampling process.

Literature survey was used to provide information on MNE taxation and transfer pricing. Literature survey was also used to shed light on the illegitimate means that are utilized by MNEs to transfer tax liability from developing countries where the tax rates are usually high to tax havens where tax rates are usually low.


The instruments used for primary data collection are 5-point Likert questionnaires where a 1 score will indicated ‘strongly disagree’ and a 5 score will indicated ‘strongly agree’. Likert scale questionnaires are used to discriminate between those respondents whose total score on an issue is high from those whose score is low.\(^\text{51}\) Likert type scales constitute a suitable tool for measuring the respondents’ attitudes towards a given topic. The scale therefore allows the interviewer to recognize how responses differ between different people and different stimuli. The scales are therefore suitable for measuring such a continuous variable like tax compliance.

In the proposed study, statements were phrased such that a high score in the questionnaires indicated a conducive legislative environment that facilitates easy payment of taxes. On the other hand, a score of ‘1’ signified a complicated legal structure that hinders the payment of corporation tax in time. As regards the administrative capacity of KRA, a score of 5 indicated a ‘very competent’ perception while a score of ‘1’ indicated a ‘very incompetent’ perception. The questionnaire (Appendix 1) comprises of 30 questions, 15 addressing the competitiveness of Kenya’s legal environment for MNE taxation while 15 address KRA’s capacity for TP audit and enforcement. The questionnaires used for this study were developed by the researcher based on the literature review.

### 1.9.7 Validity and reliability

Validity refers to the ability of the research findings to reflect accurately the presence or absence of the concept that is being investigated in the study. On the other hand, reliability refers to the consistence of the research findings over time and place. The measure of reliability indicates

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whether if the study were to be replicated by an independent researcher applying similar methodology would obtain similar results.\textsuperscript{52}

To enhance the validity of the instruments used to conduct this research, a pilot study involving 6 respondents was conducted. Necessary adjustments were made before the instruments were subjected to the actual survey.

Reliability was enhanced by avoiding the use of research assistants in the study and by explaining the concept being asked to the respondents as they gave their responses.

\textbf{1.9.8 Data analysis}

After collection of the questionnaires, the researcher read through them in order to ascertain their numbers and to see how/\ if all the items were responded to. Secondly, the raw data was sorted out and edited to identify unfilled items, and those that could have been wrongly responded to. Questionnaires were then organized and classified according to the patterns of the responses given by the respondents, and their homogeneity. Questions were then coded for purposes of allocations of the magnitude of the variable being measured.

Descriptive statistics which include frequency distribution, percentages, mean and standard deviation were used to summarize findings and describe the population samples involved.\textsuperscript{53} Data was analyzed using descriptive statistics using statistics package SPSS version 2.0 and presented in tables.


1.9.9 Ethical Considerations

All knowledge-material used for this study was referenced appropriately. Anonymity of the respondents was guaranteed where requested.

1.9.10 Scope and Limitations of the Study

This study concerns itself with the corporation tax compliance by MNEs in developing economies, taking the case study of MNEs operating in Kenya. Consequently, other types of taxes are not investigated.

Usually, studies on tax compliance entail an investigative component. The present study does not.

1.11 Conclusion

The literature review has shed light on matters pertinent to MNE taxation such as transfer price, profit shifting, and the arm’s length principle. It also discusses the merits and the demerits of the OECD guidelines to multinational enterprises and tax administrators, as applied in developing economies. In the next two chapters, the application of these principles for MNE taxation in Kenya will be looked into.
CHAPTER TWO

CONTEXTUALIZING THE TAXATION OF MULTINATIONAL ENTERPRISES IN KENYA

2.1 Introduction

In this chapter, the legislative and administrative framework for MNE taxation in Kenya is discussed.

2.2 KRA’s administrative capacity for TP audit and enforcement

This section provides a general overview of the administrative structure of Kenya Revenue Authority and the specific administrative procedures in relation to transfer pricing.

2.2.1 General Administration Structure of KRA

The Kenya Revenue Authority (KRA) was established by an Act of Parliament, Cap 469 of the laws of Kenya, which became effective on 1st July 1995. The Authority is charged with the responsibility of collecting revenue on behalf of the Government of Kenya. The policy decisions to be implemented by KRA management are made by the Board of Directors, consisting of both public and private sector experts. The Chairman of the Board is appointed by the President of the Republic of Kenya. The Chief Executive of the Authority is the Commissioner General who is appointed by the Minister for Finance.\(^5\)

The main objective of KRA is the Assessment, Collection, Administration and Enforcement of laws relating to revenue. The KRA has five regional offices across Kenya namely Rift Valley Regional office, Western Regional office, Southern Regional office, Northern Regional office

and Central Regional office. The division of the authority into regions is so as to ensure that it offers better single-window services to taxpayers.\textsuperscript{55}

KRA is divided into the following departments which are headed by Commissioners: Customs Services Department, Domestic Services Department-Medium & Small Taxpayers (MST), Domestic Services Departments - Large Taxpayers Office (LTO), Investigations & Enforcement Department, Technical Support Services and Corporate Support Services. The MST department is further divided into Medium Taxpayers’ Office (MTO) and Small Taxpayers’ Office (STO)\textsuperscript{56}

The realization that only about 20\% of taxpayers contributed 80\% of the total Domestic Tax Department’s revenue led to the formation of the LTO as a separate department in 2006.\textsuperscript{57} LTO handles tax matters of taxpayers with turnover of over KShs 750 Million and other special taxpayers such as Banks, Insurance Companies and Government Agencies.

The MTO was formed in 2010 in line with KRA’s Revenue Administration Reforms and Modernization Programme (RARMP) initiative as contained in the Fourth Corporate Plan covering the period 2009/10 to 2011/12\textsuperscript{58}. This was been done with the aim of extending the concept of taxpayer segmentation after its success with LTO, where the large multinationals are served from and their tax matters are handled by KRA experts.\textsuperscript{59}

The MTO commenced its operations on 1\textsuperscript{st} November 2010 and serves taxpayers whose turnovers fall between KShs. 300 Million and KShs. 750 Million.\textsuperscript{60} Most of the MNEs operating

\textsuperscript{55} Ibid.
\textsuperscript{56} Ibid.
\textsuperscript{59} Ibid.
\textsuperscript{60} Ibid.
in Kenya fall under the LTO. However, with creation of MTO a few MNEs are handled in this office.

2.2.2 Structure of KRA’s Large Taxpayers Office

In 2009, KRA created dedicated teams of TP auditors in the Large Taxpayer’s Office (LTO), audit section of the department of domestic revenue.

The transfer pricing auditors are grouped into two groups (hereafter referred to as “Transfer Pricing Units”). Each Transfer Pricing Unit is headed by an Audit Manager who reports to the Head of Audit Section within the LTO. Each Transfer Pricing Unit has eight auditors; hence the total number of auditors in the LTO who are responsible for TP audit is sixteen. Transfer pricing units are then divided into teams of four auditors each. Hence, there are four teams of TP auditors in the LTO. The administrative structure is represented in chart 1 below. In addition to the TP auditors in the LTO, a small team of four auditors was formed in the Medium Taxpayers Office, MTO in the fiscal year 2012/13 to handle transfer pricing matters in the MST Department.

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Under Section 52B of the ITA, all corporate taxpayers in Kenya are required to file their tax returns on or before end of the sixth month following end of their accounting period.\textsuperscript{64} KRA implemented an integrated tax management system referred to as iTax. With effect from March 2014 all taxpayers were required to file their tax returns using the online filing system under iTax platform.\textsuperscript{65} For the period 2008 – February 2014 taxpayer used to file their tax returns manually with a few especially LTO taxpayers using the Integrated Tax Management System (hereinafter referred to as “ITMS”). Majority of the MNEs file their tax return as required under the ITA through online systems established by KRA since 2008.


2.2.3 Administrative procedure for transfer pricing in Kenya

The first step in transfer pricing enquiry is the request for transfer pricing policy document as provided under Rules 9 and 10 of the Income Tax Transfer Pricing Rules. The transfer pricing policy document consists of an explanation of the transfer pricing method used and the justification for the use of the method, the application of the method including the calculation made and the price adjustment factors considered, the global organisation of the enterprise, the details of the transaction under consideration, assumptions, strategies and policies applied in selecting the method and other relevant information regarding the transaction in question.66

The second step entails analysis of the availed transfer pricing policy documents by the transfer pricing auditors. The analysis often leads to further requests for more explanation and supporting documents in relation to the related party transactions (hereinafter referred to as “controlled transactions”) and the comparable transactions used for benchmarking purposes.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration requires that determination of the arm’s length principle be made based on the comparability of the same transaction of unrelated parties under the same circumstance. However, it is difficult to find this degree of sameness of transactions. Consequently, companies refer to databases detailing the transactions between unrelated parties all over the world. Some of the well known databases include: Amadeus for European coverage, Compustat for USA and Canada, and JADE for Japan, Osirus and Worldscope. Companies are required to declare to the commissioner of

income tax in the Transfer Pricing policy document the databases they used in their determination of the arm’s length price. 67

Thirdly, the transfer pricing auditor conducts risk assessment of taxpayer’s dealings with a view of ensuring that the selected transfer pricing case has good tax revenue potential. KRA has adopted risk based case selected procedures 68

The fourth step entails communication to the taxpayer of the intention to conduct a transfer pricing audit. According to Section 56(1)(a) of the ITA, the commissioner is empowered to give a notice in writing to a taxpayer requiring him/her to avail documents for examination with a view of establishing full information regarding his/her income for tax purpose. 69

The fifth step relates to actual conduct of transfer pricing audit by the KRA transfer pricing auditors. Typically a transfer pricing audit takes two to three years and even longer especially where the case ends up in court. During this period, the taxpayer is required to avail various records for examination as well as attending to several meetings to discuss the transfer pricing matters.

Where TP disputes arise between KRA and a tax payer, the Ministry of Finance has constituted a quasi-judicial tribunal and a local committee to decide on the disputes. The tribunal has jurisdiction to deal with matters relating to tax avoidance. The local committee has jurisdiction to over all other income tax disputes. TP disputes are consequently listened to by the local committee. An appeal to the decision of the committee or the tribunal goes to the commercial

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and tax division of the high court. Appeals from the high court are heard at the Court of Appeal.\textsuperscript{70}

2.2.4 Corporation tax structure in Kenya

Corporation tax in Kenya does not have a graduated rate structure. Resident companies are taxable at a rate of 30\% while non-resident companies are taxable at a rate of 37.5 \%.\textsuperscript{71} Companies in the export processing zones are exempted from the corporation tax for the first 10 years after which they pay a tax of 25\%. Newly listed companies at the Nairobi Securities Exchange (NSE) are taxed according to the percentage of capital listed in the bourse. Companies listing between 20-30\% are taxed at 27\% of their income. Companies listing between 30-40\% of their capital are taxed at 25\% while companies listing above 40\% are taxed at 20\%. These rates are applicable for the first 5 years, after which the companies are taxed at 30\%.\textsuperscript{72}

2.2.5 Critical analysis of the capacity of KRA to conduct TP audits and enforcement in Kenya

The composition of the tribunal and the local committee has been criticised for lacking personnel competent in transfer pricing matters. Indeed, the competence of the committee on transfer pricing issues came to focus in the hearing of the Unilever case where the committee had, in agreement with the KRA, dismissed the applicability of the OECD guidelines for deciding the arm’s length price between related firms.\textsuperscript{73} Further, the legal basis of both the local committee and the tribunal is unclear. Consequently, some tax payers opt to go to court in the first instance where such a prospect affords them temporary injunctive relief in case the KRA was about to

\textsuperscript{70} The European Commission, 2011.
\textsuperscript{71} Mutua, 2012.
\textsuperscript{72} Mutua, 2012
\textsuperscript{73} Kenya Law Reports, 2005.
freeze their assets, including the bank accounts.  

There has also been an allegation of canvassing at the local committee handling sensitive TP cases.  

The time taken in deciding cases related to Transfer Pricing in courts may also affect the efficiency of KRA in pursuing such cases. Typically, such a case takes two to three years to decide. The Unilever case, for example, took two years to come to conclusion. The European Commission observes that such a lengthy process may discourage the auditors to pursue TP cases in view of the need to achieve their immediate revenue targets.  

Compared to other tax administrators in Africa, KRA has over the years developed into a relatively competitive institution with a robust graduate recruitment programme and competitively remunerated staff. The revenue authority also runs a programme for continuous training of the staff at the Kenya Revenue Training Institute, KRATI, in Mombasa. However, capacity for TP audit and enforcement is said to be very much wanting. For example, KRA lacks the technical expertise required to effectively assess the complex cross-border transactions characteristic of MNEs. This leaves the tax administrator at the mercy of the tax payers and quite often, the administrator is unable to determine whether the taxpayer has met their full tax liability. To solve the challenge of capacity in TP audit and enforcement, the European Commission suggests that KRA should consider staff secondment from more advanced tax administrators. KRA is said to have benefited from similar expertise at the time when VAT was introduced in Kenya.  

Key to the application of the arm’s length principle is the availability of comparable transactions. At present, Kenyan taxpayers rely on data from European companies for their arm’s length

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74 The European Commission, 2011.  
75 Wahome and Muturi, 2013  
76 The European Commission, 2011.  
77 The European Commission, 2011.
Considering the differences in economic environments in which the companies operate compared to those whose data is availed in the most commonly used databases, there is need to create a database featuring Kenyan and/or African companies only. Such a database does not exist currently, posing a major challenge to TP audit and enforcement in Kenya.

2.3 Legislative Framework for TP audit and enforcement in Kenya

This section examines the legislative setting under which TP audit and enforcement is conducted in Kenya. A critical analysis of the legislative suitability of the regulations will also be done.

2.3.1 The Income Tax Act

In Kenya, the transfer pricing taxation and enforcement is provided for in the Income Tax Act (ITA) Cap 470 of the Laws of Kenya. Section 18(3) of the Act requires the application of arm’s length principle in determination of gains or profits for tax purposes of a resident person who conducts business with a related non-resident person. This section states that “Where a non-resident person carries on business with a related resident person and the course of that business is such that it produces to the resident person either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length”.

2.3.2 The Income Tax (Transfer Pricing) Rules 2006

The Income Tax (Transfer Pricing) rules were legislated by the Minister of Finance in 2006 through legal notice no. 67 of 2006, and came to effect in July of the same year (The Income Tax (Transfer Pricing) Rules 2006). The rules are as a consequence to KRA losing the case between

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78 The European Commission, 2011.
it and personal products manufacturer, Unilever Kenya Limited, UKL. KRA had attempted to make transfer pricing adjustment on transactions between Unilever Kenya and Unilever Uganda on the grounds that the sale value of the products from Kenya to Uganda was underpriced. KRA had solely relied on provisions of section 18(3) of ITA but the High Court Judge Alnashir Visram observed that since the ITA then did not provide guidelines for the administration of transfer pricing, other internationally acceptable guidelines may be accepted for assessing arms’ length price. Following this landmark ruling the transfer pricing rules were introduced in June 2006. These rules are largely based on the OECD Transfer Pricing Guidelines for MNEs and Tax Administrators.

The documents required under The Income Tax (Transfer Pricing) Rule, 2006 include: the selection of the transfer pricing 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 transaction under consideration; the assumptions, strategies, and policies applied in selecting the method; and such other background information as may be necessary regarding the transaction. The above documents are normally collated to form a Transfer Pricing Policy document by the taxpayer. Transfer Pricing Rule number 10 requires that the Transfer Pricing Policy document be availed to the Commissioner upon request. The rules further provide that a taxpayer should avail documentation to evidence their analysis upon request by the Commissioner.

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2.3.3 The OECD Transfer Pricing Guidelines for MNEs and Tax Administrators.

The OECD Transfer Pricing Guidelines for MNEs and Tax Administrators became part of Kenya’s legislation via the doctrine of *stare decisis* (“judicial precedent”), despite the existence of The Income Tax (Transfer Pricing) rules of 2006 discussed above. Although there is no direct mention of the matter in local jurisprudence, it is generally considered that where the Income Tax (Transfer Pricing) rules of 2006 are unclear or do not address an issue raised by a taxpayer, the OECD Transfer Pricing Guidelines for MNEs and Tax Administrators will apply.  

2.3.4. Double Tax Agreements

In practice, taxation of MNEs may be influenced by the Double Taxation Agreements (DTA) network of the jurisdictions in which they operate. In the case of a subsidiary, S of a parent company, P the income of the subsidiary will be taxed in the host country and the home country may also tax that income.  

According to Barrios, Huizinga, Laeren, & Nicodeme, (2009) the home country also brings to charge the dividend income the parent receives from its subsidiary S. This exposes the MNE to double taxation which the authors referred to as the international double taxation of foreign sourced income.

In addition to the dividends being paid by a subsidiary to the parent company, the following other transactions may arise within the members of a MNE operating across different jurisdictions: licensing of intangible assets, purchase of goods or services, sale of goods, provision of services, sale/purchase of capital assets, borrowing or lending of funds and so on. Given that these transactions take place in different jurisdictions in which the MNE operates, they expose the MNE to the risk of double taxation.

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82 The European Commission, 2011
83 Barrios, et.al (2009)
General literature on taxation distinguishes two different types of double taxation: juridical double taxation and economic double taxation. Juridical double taxation refers to a situation where the income of an individual or body corporate is taxed by two or more tax jurisdictions in the same period. This arises as a result of the conflict between two different tax systems, for example, where one jurisdiction is taxing on the basis that the taxpayer is a resident of that jurisdiction while the other jurisdiction is taxing on the basis that the relevant income is sourced within its jurisdiction. This can lead to overlapping tax by two or more tax jurisdictions being imposed on that individual’s or entity’s income. On the other hand, the economic double taxation occurs when the same income is taxed by more than one tax jurisdiction at the hands of different taxpayers in case of associated enterprises. For instance, the income of a parent company arising from sales of goods to a subsidiary in another jurisdiction, it would be taxed in its host country but the sales value of goods purchased by the subsidiary may be subjected to transfer pricing analysis to assess whether arms’ length price was charged. By way of illustration, assuming that the host country of the subsidiary makes a transfer pricing adjustment by reason of being more than the arms’ length price, this implies that the same item of income shall be taxed twice. Therefore, where two or more tax administrations take different positions in determining arm’s length conditions, double taxation may occur.

Taxpayers in countries which have entered into double taxation agreements obtain relief from juridical double taxation as provided under such agreements. Typical double taxation agreement (DTA) provides relief from double taxation either through exemptions or foreign tax credits systems. However, double taxation may still occur due to different views of taxing rights among

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84 European Commission, 2011  
85 OECD, 2010  
86 OECD, 2010
countries. Many countries apply either residence or source principles in order to exercise their right to tax in their jurisdiction. These principles often overlap with each other causing double taxation. Many countries avoid these problems by concluding DTAs with other countries, and including clauses such as ‘residence’ tie breakers and ‘source’ rules in those DTAs.

In order to address the problem of double taxation, the OECD formulated model tax conventions which should be used as a guide to countries when negotiating DTAs. These OECD conventions are referred to as the Model Tax Convention on Income and Capital and shall hereunder be denoted as OECD MTC. For the purpose of addressing the problem of economic double taxation, the OECD MTC has Article 9 which provides that “where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprise, 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” 87 This is in effect the requirement to use arms’ length pricing for determination of taxable profits of associated enterprises.

According to OECD MTC (2010) two enterprises are associated enterprises with respect to each other if (a) one of the enterprise participates directly or indirectly in the management, control or capital of an enterprise of the other; or (b) the same persons participate directly or indirectly in the management, control or capital of both of the enterprises (OECD, 2010). Kenya has entered

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87 OECD, 2010
into DTAs with Zambia, Norway, Denmark, Sweden, UK, Germany, Canada, India, France, Malawi and Mauritius.\(^88\)

### 2.3.5 Critical analysis of the Legislative Framework for TP audit and enforcement in Kenya

There are a number of weaknesses associated with The Income Tax (Transfer Pricing Rules) 2006. First, the rules have been described as “poorly drafted” and “giving rise to too much uncertainty”.\(^89\) While there has not been a case in court so far to test the robustness of the rules, there has been perception that the rules might not withstand the extremely adversarial nature of Kenya’s litigation.\(^90\)

Secondly, although it is apparent that these methods are intended to mirror the methods prescribed by the OECD Guidelines, a more detailed examination of the methods prescribed by the TP rules reveals several disparities which were probably not intended and reflect a poor understanding (by the draftsmen) of the arm’s length standard. This is particularly evident from the manner in which the permitted methods are described in the rules. In addition, the rules should also compel the taxpayer to provide the databases used to determine the arm’s length prices. Thirdly, the Transfer Pricing guidelines fail to provide for a penalty when the taxpayer fails to provide the Transfer Pricing Document when required to do so by the Commissioner.\(^91\)

Despite the wide applicability of the OECD Transfer Pricing Guidelines for MNEs and Tax Administrators, the guidelines have been found wanting in certain circumstances. The sentiment of the civil society in Kenya is that the arm’s length principle as recommended by the OECD is unsuitable for developing countries such as Kenya. They recommend methods that allow for

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\(^{89}\) European Commission (2011).

\(^{90}\) European Commission (2011).

\(^{91}\) Ibid.
allocation of profits between various jurisdictions in which the taxpayer has interests in. The arm’s length principle has also been criticised for being acquiescent to numerous tax avoidance schemes.\textsuperscript{92}

Due to the clearly discernible lack of capacity for TP audit and enforcement in developing countries, the arm’s length principle compels MNEs to pay more attention to the more strict tax jurisdictions of developed countries and deliberately fall short of their tax obligations in developing countries where they can effectively police their transactions.\textsuperscript{93}

If the arm’s length principle may be considered to work against the interests of developing countries, another component of OECD’s guidelines, the Double Tax Agreements (DTAs) would be considered to be worse in this aspect.

Jurisdiction to tax income is most frequently based upon either the principle of residence or the principle of source. Under the principle of residence, all income of persons domiciled or normally resident in a country is subject to that country’s income tax; under the principle of source, all income originating in a country, regardless of to whom such income accrues, is subject to that country's income tax. Possibility of taxpayers being subjected to taxation in two jurisdictions for the same income occurs when income accruing to a foreign person in one jurisdiction is taxed by the first jurisdiction based on the principle of source and taxed again by the second jurisdiction based on the principle of residence. The primary purpose of double taxation agreements is to facilitate the international flow of capital, technology, and services by eliminating double taxation of income through bilateral (occasionally multilateral) treaties between overlapping tax jurisdictions.\textsuperscript{94}

\textsuperscript{92} European Commission (2011).
\textsuperscript{93} Ibid.
\textsuperscript{94} Irish (1974)
Among DTAs currently in force, the general drift of these agreements is that the country of the taxpayer's residence is given the exclusive or primary right to tax income while the source country has little or no right to tax such income. The OECD Draft Convention on Income and Capital, published in 1963 on which most of the current DTAs are based limits the source country to tax rates of 10 percent on interest, 5 per cent on dividends paid by 25 per cent owned subsidiaries, and 15 per cent on other dividends, and exempts patent and copyright royalties from taxation at source. Of course, the effect of this emphasis on residence is to expand the revenues of the residence country and contract the revenues of the source country. This discrepancy works against developing countries which are usually ‘source-countries’ and benefits developed economies which are usually ‘resident-countries’.  

As a consequence to a recent DTA signed between the governments of Kenya and Mauritius, the Tax Justice Network Africa (TJN-A) has threatened to go to court arguing that the DTA works against the interests of Kenyans.

An Advance Pricing Arrangement (APA) refers to an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (i.e. method, comparables and appropriate adjustments thereto) for the determination of the transfer pricing for those transactions over a fixed period of time. APA’s may be unilateral, bilateral or multilateral. A unilateral APA is an arrangement between a tax authority and a taxpayer or taxpayers. A bilateral APA refers to an arrangement made by two competent tax authorities. A multilateral APA refers to arrangement made by more than two competent tax authorities. Provided the taxpayer complies with the

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93 Irish, 1974  
96 Michira, 2014 (b)  
97 OECD, 2010
conditions required by the agreement, the tax authority will consider that the methodology chosen is appropriate to determine the arm’s length price.\textsuperscript{98}

APA arrangements have several advantages to the tax administrator. First, the time taken to negotiate an APA is much shorter compared to the time required for the process of litigation. For example, in the USA, negotiating an APA takes on average one year while the litigation process can last up to four years.\textsuperscript{99} Secondly, APA’s increase the assurance of compliance because it is highly unlikely that a non-compliant taxpayer would apply for an APA. To the taxpayer, an APA provides a sense of certainty about the treatment to expect from the tax administrator for a given period of time.\textsuperscript{100} However, caution needs to be taken so that well advised taxpayers do not take advantage of the APAs to conceal transactions that do not meet the arm’s length principle. Secondly, similar oversight and balance as is extended to audits should also prevail in the negotiation of APAs so as to mitigate the risks of corruption.\textsuperscript{101}

In view of the scarce human resource competent in TP audit in Kenya, the consideration for APAs for Kenya remains a valid option. Currently, there is need to enact the relevant legislative framework for APA negotiation in Kenya.\textsuperscript{102}

\textbf{2.4 Conclusion}

The chapter has focused on administrative and legislative frameworks for the audit and enforcement of transfer pricing in Kenya. In the next chapter, an empirical study is conducted to determine the suitability and robustness of the legislative and administrative frameworks for transfer pricing in Kenya.

\textsuperscript{98} Mulyani, 2010  
\textsuperscript{99} Mulyani, 2010  
\textsuperscript{100} OECD. (2012). \textit{Dealing Effectively with the Challenges of Transfer Pricing.} Retrieved August 2014, from OECD: http://dx.doi.org/10.1787/9789264169463-en  
\textsuperscript{102} Pricewaterhouse Coopers, 2012
CHAPTER THREE

ASSESSING THE SUITABILITY OF THE ADMINISTRATIVE AND LEGISLATIVE FRAMEWORKS FOR TRANSFER PRICE AUDIT IN KENYA

3.1 Introduction

A study was conducted to determine the suitability of the current legislative and administrative frameworks that surround transfer pricing audits and monitoring in Kenya. The study involved auditors taken from the Large Taxpayers office and the Medium Taxpayers office of the Kenya Revenue Authority, KRA. The sample consisted of 20 auditors, 10 taken from each of the offices. The respondents were selected because the task of inquiry requires some specialised knowledge that they apply daily in their work. They are also well versed with the challenges addressed in this study. Questionnaires and unstructured interviews were used to collect the data. The questionnaire used to collect the information is included in appendix 1. There was a 100% return rate of the questionnaires. Data was analyzed using descriptive statistics using statistics package SPSS version 2.0 and the results presented in tables. The interview questions are provided in appendix 2.

The study was conducted between October 21st and 24th 2014. The results are presented in the subsequent sections of this chapter.

3.2 Results

3.2.1 Tax compliance among MNEs in Kenya

In the first section of the study, respondents were asked to give their views regarding the general corporation tax compliance behaviour of the MNEs operating in Kenya. The statements were
presented in a Likert scale where a score of 5 would indicate high compliance behaviour while a score of 1 would indicate very poor compliance. The results are presented in table 3.1 below.

*Table 3.1: Tax Compliance among MNEs in Kenya.*

<table>
<thead>
<tr>
<th>Determining corporation tax compliance among MNEs in Kenya.</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>MNEs in Kenya generally compile transfer prices accurately.</td>
<td>1.75</td>
<td>0.716</td>
</tr>
<tr>
<td>MNEs operating in Kenya provide Transfer pricing documents to the Commissioner General of KRA as and when requested to do so.</td>
<td>2</td>
<td>0.562</td>
</tr>
<tr>
<td>Profit shifting is not common among Kenyan MNEs</td>
<td>1.95</td>
<td>0.759</td>
</tr>
<tr>
<td>MNEs in Kenya generally pay their fair share of corporation tax.</td>
<td>2.25</td>
<td>0.91</td>
</tr>
<tr>
<td>MNEs operating in Kenya do not engage in aggressive tax planning activities.</td>
<td>1.7</td>
<td>0.733</td>
</tr>
<tr>
<td>Average</td>
<td>1.93</td>
<td></td>
</tr>
</tbody>
</table>

As can be seen from the table above, the respondents generally do not consider the MNE sector in Kenya to be tax compliant. On averaging the means of all responses, the mean is 1.93, which would indicate a poor rate of compliance. According to the respondents, the transfer prices
calculated by the taxpayers are largely not at arm’s length. This can be seen from the response on
the statement “MNEs in Kenya generally compile transfer prices accurately.” The level of
compliance in this regard is indicated by a score of 1.75 out of a possible 5 which shows that the
respondents generally do not think that the taxpayers are compliant. The relatively large value of
standard deviation (0.716) however indicates that there is a large degree of disagreement among
the respondents on this issue. The results also show that the taxpayers are considered to engage
in aggressive tax planning activities, do not submit transfer pricing documents in time and do
engage regularly in profit shifting.

3.2.2 Influence of Kenya’s legislative framework on MNE tax compliance

A set of statements were administered in a Likert questionnaire in which the influence of
Kenya’s legislative framework on MNE tax compliance was determined. The results are
presented in table 3.2 below.

Table 3.2: Influence of Kenya’s legislative framework on MNE tax compliance

<table>
<thead>
<tr>
<th>Influence of Kenya’s legislative framework on MNE tax compliance.</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenya’s MNE corporation tax regime is clear and easy to comply with.</td>
<td>2.15</td>
<td>.671</td>
</tr>
<tr>
<td>Transfer pricing compliance in Kenya does not comprise of a significant cost of doing business.</td>
<td>2.15</td>
<td>.671</td>
</tr>
<tr>
<td>Court cases on Transfer pricing in Kenya are decided expediently.</td>
<td>2.60</td>
<td>.754</td>
</tr>
<tr>
<td>Kenyan judicial system has capacity to solve transfer pricing cases competently and fairly.</td>
<td>2.50</td>
<td>.513</td>
</tr>
<tr>
<td>The local committee decides Transfer pricing cases fairly.</td>
<td>2.05</td>
<td>.826</td>
</tr>
<tr>
<td>The local committee and the tribunal are meticulous in investigating and deciding Transfer pricing cases.</td>
<td>1.80</td>
<td>.696</td>
</tr>
<tr>
<td>Statement</td>
<td>Score 1</td>
<td>Score 2</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>---------</td>
<td>---------</td>
</tr>
<tr>
<td>Taxpayers generally perceive Kenya’s taxation regime as supportive for business.</td>
<td>1.80</td>
<td>.696</td>
</tr>
<tr>
<td>Some MNEs establish an operation in Kenya primarily because of the favourable corporation tax regime in the country.</td>
<td>2.20</td>
<td>.834</td>
</tr>
<tr>
<td>Kenya’s corporate tax law, guidelines and tax administration procedures are sufficient and advanced pricing agreements (APA’s) with firms investing in the country would not add a lot of value to our business process.</td>
<td>2.65</td>
<td>.671</td>
</tr>
<tr>
<td>Transfer pricing audits conducted by KRA are efficient enough and they do not affect the flow of business process at all.</td>
<td>3.05</td>
<td>.605</td>
</tr>
<tr>
<td>In spite of the outcome of the Unilever case, MNEs consider the provisions of the Income Tax Section 18 (3) on transfer pricing and the determination of arm’s length prices as reliable framework on which to base our transactions with related parties.</td>
<td>2.10</td>
<td>.308</td>
</tr>
<tr>
<td>Preparing Transfer Pricing policy document as required in the Income Tax (Transfer Pricing) rules of 2006 does not increase MNE’s cost of compliance.</td>
<td>1.95</td>
<td>.510</td>
</tr>
<tr>
<td>Generally, MNEs find Kenya’s Double Tax Agreement (DTA) network as favourable to their business structure.</td>
<td>2.50</td>
<td>.513</td>
</tr>
<tr>
<td>Most MNEs understand that all the requirements asked for by the Commissioner General in the Transfer Pricing policy document are appropriate and necessary for the work of the tax administrator.</td>
<td>2.30</td>
<td>.733</td>
</tr>
<tr>
<td>The methods of determining the arm’s length price as explained in the Income Tax (Transfer Pricing) rules of 2006 and the OECD guidelines are suitable for MNE operations in Kenya.</td>
<td>2.32</td>
<td>.749</td>
</tr>
</tbody>
</table>

The respondents in this survey think that Kenya’s MNE corporation tax regime is not as clear enough and that it is not easy to comply with. This is indicated by the low score of 2.15 out of a possible 5. This view is supported by a study conducted by the European commission in 2011.
which suggested that Kenya’s transfer pricing guidelines are ambiguous and may be liable to challenges in court in the future.\textsuperscript{103}

The respondents are of the view that Transfer Pricing audits comprise a significant cost of doing business in Kenya. This must be understood to be a very honest assessment by the auditors, considering that the tax administrator is the one that is charged with the responsibility of lowering the cost of tax compliance in the country. However, the observation agrees with that of the European commission report which said that Kenya is one of the countries with the highest compliance costs in the world. In 2011, Kenya was ranked 162 out of 183 economies in terms of ease of paying taxes.\textsuperscript{104}

The current study passes a harsh assessment of the courts responsible for determining TP cases. The index of 2.60 with respect to the expedience of deciding transfer pricing cases is indicative of a court system that is either overwhelmed, understaffed or just lethargic in the delivery of its judgments. The European commission observes that it took two years for the verdict in the Unilever case to be delivered in 2006.\textsuperscript{105} The competence of the courts in deciding transfer pricing cases has also been put to question by the respondents. In this respect the courts scored an index of 2.50 out of a possible 5. The finding corroborates that of the European Commission (2011) that decried the lack of TP experts not only in the courts but also at the KRA. To solve this problem, the European commission recommended the secondment of staff from more advanced jurisdictions.\textsuperscript{106}

\textsuperscript{104} ibid.
\textsuperscript{105} ibid.
\textsuperscript{106} ibid.
The local committee is created by the Ministry of Finance with a mandate of solving transfer pricing disputes between the taxpayers and the tax administrator. In the current study, the local committee gets an unfavourable review by the auditors with an index of 2.50 with regard to competence in its work and an index of 1.80 with regard to thoroughness in deciding its cases. This unfavourable review of the local committee corresponds to the views of Judge Alnasir Visram in his judgment in the Unilever case.107

The respondents reported that the taxpayers’ outlook of Kenya’s tax system is unfavourable, posting an index of 1.80 in a 5-point scale. As has been mentioned earlier, this finding is similar to that of the European Commission study of 2011 that found that the cost of compliance in Kenya is generally very high.108

There is a result that may not be conclusive according to the finding of this study. When asked to pass an assessment of the efficiency of the KRA in conducting TP audits, the respondents posted an unusually high score of 3.05. This finding is higher than is reported in the literature. The high score is attributed to the fact that in this case, the auditors are making an assessment of themselves and are therefore likely to give themselves a better review than they would get from an independent party. The European Commission study of 2011 quoted taxpayers lamenting that during TP audits, KRA auditors asked for too many documents; an indication of incompetence on their part.109 Further studies may be recommended in this regard where a different set of respondents are asked to comment on the efficiency of the KRA TP audits.

109 Ibid.
Finally, the respondents were asked to comment on the Income Tax (Transfer Pricing) rules of 2006. The assessment is not favourable at all. The index scored in this regard is 2.32 and corresponds to the criticism of the methods by the European Commission study of 2011.\textsuperscript{110}

3.2.3 KRA’s administrative capacity to audit and monitor MNE tax compliance.

A set of statements were administered in a Likert questionnaire in which the influence of KRA’s administrative capacity to audit and monitor MNE tax compliance was determined. The results are presented in table 3.3 below.

<table>
<thead>
<tr>
<th>KRA’s administrative capacity to audit and monitor MNE tax compliance</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>KRA has enough auditors to conduct MNE tax compliance monitoring.</td>
<td>2.20</td>
<td>.616</td>
</tr>
<tr>
<td>KRA TP auditors are competent in their work.</td>
<td>3.40</td>
<td>.883</td>
</tr>
<tr>
<td>KRA officials responsible for TP compliance are not easily corruptible.</td>
<td>3.10</td>
<td>.788</td>
</tr>
<tr>
<td>KRA has legal capacity to enforce MNE tax compliance</td>
<td>2.20</td>
<td>.616</td>
</tr>
<tr>
<td>An MNE is likely to be visited for a TP audit once every three years.</td>
<td>2.20</td>
<td>.616</td>
</tr>
<tr>
<td>The databases used by the Kenyan tax authorities to determine the arm’s length prices are sufficient and suitable for the Kenyan situation.</td>
<td>2.15</td>
<td>.745</td>
</tr>
<tr>
<td>Kenyan tax authorities have capacity to verify transactions between Kenyan MNEs and related companies in other jurisdictions.</td>
<td>2.05</td>
<td>.686</td>
</tr>
<tr>
<td>The general administrative structure of KRA is not only beneficial to the tax authority but is also considerate of the taxpayers’ needs.</td>
<td>2.75</td>
<td>.851</td>
</tr>
<tr>
<td>Establishing the Large Taxpayers’ Office (LTO) and the Medium Taxpayers’ Office (MTO) has reduced the tax compliance costs for MNEs in Kenya.</td>
<td>3.40</td>
<td>.883</td>
</tr>
</tbody>
</table>

The tribunal and the local committee as constituted by the Ministry of Finance help in resolving tax-related disputes between KRA and MNE taxpayers quickly and amicably.

<table>
<thead>
<tr>
<th>Description</th>
<th>Score</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>The personnel in the tribunal and local committee are competent in transfer pricing and are therefore reliable for settling tax-related disputes.</td>
<td>1.65</td>
<td>0.587</td>
</tr>
<tr>
<td>Kenya is increasingly requiring MNEs in the contractual documents to go for arbitration in the event of TP disputes with the tax administrator. Such a requirement will enhance the capacity of the country in conducting TP dispute resolution faster and more appropriately.</td>
<td>2.75</td>
<td>0.851</td>
</tr>
<tr>
<td>Generally, Kenya’s corporate tax regulations and structure do not adversely affect the rating of the country as an investment destination.</td>
<td>2.05</td>
<td>0.686</td>
</tr>
<tr>
<td>The introduction of the Integrated Tax Management System (ITMS) has made Kenya’s competitiveness as an investment destination to improve because it makes it easier to pay taxes for MNE taxpayers.</td>
<td>3.00</td>
<td>0.882</td>
</tr>
</tbody>
</table>

The respondents said that KRA lacked enough personnel qualified in the conduct of transfer pricing audits. In this regard, a score of 2.20 was posted in response to the statement “KRA has enough auditors to conduct MNE tax compliance monitoring.”

There are two statements in this section in which the respondents were required to give an assessment of themselves. The result therefore may not be reliable and the views of an independent respondent may be sought in future studies. When asked to comment on the statement “KRA TP auditors are competent in their work.” the resulting index of 3.40 is considered to be inaccurately high. Similar results are posted in response to the statement “KRA officials responsible for TP compliance are not easily corruptible” where an index of 3.10 was
posted. This finding ought to be corroborated with the views of an impartial respondent. In the past, some KRA staff has been associated with allegations of impropriety in tax collection.\textsuperscript{111}

The findings of this study show that the frequency of audit of MNEs is less than once in three years. This finding bears out that by the European commission that observed that KRA lacks sufficient personnel in the TP audit section to conduct frequent audits in the MNE sector.\textsuperscript{112} The databases used by the Kenyan authorities for determining comparable transactions were described as inadequate for the purpose. In an interview, the auditors explained that the databases used are of European background and lacked any comparability with an African context. This then means that determination of arm’s length prices is likely to differ significantly between the tax administrator and the taxpayers and may lead to frequent disputes over the same. Further, it can be seen that the tax administrator in some sense is at the mercy of the taxpayers as regarding the use of databases. The taxpayers use the databases that give them best savings on tax revenue.\textsuperscript{113}

This study also finds that KRA lacks legal capacity to pursue TP cases in court. Similarly, Kenyan authorities were found to lack capacity for verifying transactions between Kenyan MNEs and their related enterprises in other jurisdictions. This is indicated by a low response of 2.05 on the ability of Kenyan authorities to verify transactions undertaken by Kenyan MNEs in foreign jurisdictions. This could be the reason why KRA has announced its intention to sign the OECD-Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax matters. Through this convention, Kenya will be able to know the real owners of some

\textsuperscript{111} See for example http://www.businessdailyafrica.com/Corporate-News/KRA-pursues-Kingsway-over-Sh3bn-tax-/539550/1424518/-/2r1kp6z/-/index.html
\textsuperscript{113} Interview with KRA auditors, August 2014.
companies trading in its jurisdiction as well as their related enterprises, their global structure and activities.\textsuperscript{114}

The respondents gave a high rating to the establishment of Large Taxpayers Office (LTO), Medium Taxpayers Office (MTO). According to the respondents in this research, these offices have helped in reducing the cost of compliance for MNEs in Kenya. The introduction of the Integrated Tax Management System (ITMS) was also supported, with the respondents saying that the system had increased the competitiveness of the country as an investment destination. The relatively large standard deviation of 0.882 in this regard shows lack of agreement among the respondents on this issue and may be indicative of an area that may benefit with future research.

In addition to clarifying the findings obtained from the inquiry using questionnaires, the interview shed light some issues regarding MNE taxation in Kenya. First, the respondents said that one of the weaknesses of the Kenyan Income Tax Act is that it does not compel the taxpayer to produce the TP policy document within a specified time frame. The problem with this is that taxpayers usually take unnecessarily too long time before submitting the document, probably buying time to avoid audits being conducted at specific time. Secondly, the Income Tax Act and the TP guidelines do not compel the taxpayer to reveal the database used to calculate comparable prices. This not only makes audit procedures difficult to undertake, is an obvious way through which tax revenue is lost, as the taxpayer utilises the database that is most favourable to them in terms of tax revenue payable.\textsuperscript{115}

\textsuperscript{114} Otieno, J.(November, 8\textsuperscript{th} – 14\textsuperscript{th}, 2014). *Kenya to sign convention that curbs tax fraud.* In The East African, November, 8\textsuperscript{th} – 14\textsuperscript{th} 2014.

\textsuperscript{115} Interview with KRA auditors, August 2014.
4.1 Introduction
Profit shifting is defined as an activity whereby multinationals, by the use of internal transactions are able to shift profits between their affiliates so that their incomes are declared in tax havens or low tax jurisdictions in order to reduce the overall tax-burden of the company.\textsuperscript{116} Quite often, profit shifting involves the manipulation of international tax regimes, and therefore the practice is, strictly speaking not illegal. The overall impact of the activity however is draining tax revenues from developing economies to developed economies and tax havens.\textsuperscript{117} Not all MNEs engage in profit shifting, but the practice is quite common among the MNEs. Indeed, the reason for investing in certain developing jurisdictions may be based on the weakness of their tax law practices so that an MNE considers the ability to shift prices from the said jurisdiction as the main attraction to invest there. In 2014, Barclays was reported to promote its 'Barclays Offshore Corporate' as a means of encouraging MNEs to set shop in tax havens like Mauritius, before springing to the rest of Africa. It would appear that such MNEs as Barclays has been advertising to, invest in Africa with a significant motive of draining tax revenue from the continent to the tax havens.\textsuperscript{118}

In this chapter, various incidences that have been reported of MNEs conducting profit shifting activities from developing economies are analysed briefly. It must be noted that the incidences mentioned here do not imply criminal intent on the MNE involved, but should be a reflection of the imbalance that exists in the international tax regime against developing economies.

\textsuperscript{118} \url{http://www.cleanupbarclays.co.uk/}
4.2 Commissioner of Income Tax vs Karuturi Limited.

Karuturi Global is an Indian-based MNE with operations in India, Ethiopia, Kenya, Dubai and the Netherlands. It is listed in the Dubai Stock Exchange and operates through 18 subsidiaries in the fields of cut-flower farming and export, agriculture, food processing and telecoms. (Icra research services, 2011)\textsuperscript{119} Of the 18 subsidiaries, six operate in Kenya. The six are: Yeshoda Investments Ltd, Rhea holdings Ltd, Surya holdings Ltd, Karuturi Sports Ltd, Karuturi Hospital Ltd, and Sher Karuturi Ltd. (Karuturi, 2013)\textsuperscript{120} It is in the business of cut-flower farming and export that Karuturi Global has established itself as a major international player. Karuturi is the world’s largest exporter of cut-roses, exporting more than 500 million roses to the middle East, Russia, Netherlands, Germany among other markets. (Icra research services 2011)\textsuperscript{121}

Karuturi entered into the Kenyan market in 2007 through a buy-out arrangement, where it acquired the assets of Sher Agencies, a flower exporting firm from Netherlands. (Michira, 2014)\textsuperscript{122} Karuturi uses its subsidiaries to ensure that the Kenyan operation which is responsible for its core business is perpetually making losses. Sher Karuturi is the flower growing subsidiary. It is a tenant to the 400 acres of land that is owned by Rhea holdings and Surya holdings. The flower produce is then sold by another of Karuturi’s subsidiaries based in Dubai, Flowers xpress. 75% of the flowers are produced in Kenya while the rest are produced in India and Ethiopia. (Michira, 2014)\textsuperscript{123}

\textsuperscript{119} Icra Equity Research Services (June 15\textsuperscript{th} 2011). Karuturi Global Limited. Mumbai: Author.
\textsuperscript{120} Karuturi, S.R. (August 12\textsuperscript{th} 2013). Director’s Report for FY 2012 – 2013. Bangalore: Karuturi Global
\textsuperscript{121} Icra Equity Research Services (June 15\textsuperscript{th} 2011). Karuturi Global Limited. Mumbai: Author.
KRA’s contention has been that the operations between the subsidiaries have not been conducted at arm’s length as required of OECD TP guidelines of 1995. KRA has said that the operations of the Karuturi subsidiaries have been adjusted so that the local firm buys expensively from the other subsidiaries while it sells its products at a loss. For example, while Karuturi Global reports that it costs USD 0.15 (Karuturi, 2013)\(^{124}\) (approximately Ksh.13.05) to produce a stem of cut-flowers, Flowers xpress paid sh.4.80 per stem between 2007 and 2010.(Michira, 2014)\(^{125}\) Consequently, Sher Karuturi has been reporting losses and claiming tax credits. In 2010, the firm reported a loss of sh.348 million and claimed tax credits. Similarly, in 2013, the firm declared a loss of sh.208 million and claimed sh.129 million in tax credits.(Michira, 2014)\(^{126}\) Ironically, while 2013 was the worst year of the flower firm in Kenya, it was the best year for Karuturi Global, according to the company’s annual report. The company declared a profit of Ksh. 1.5 billion.(Karuturi, 2013)\(^{127}\)

Upon audit, KRA determined that the flower firm was not making losses as claimed and demanded that the firm pays sh.750 million in taxes for its first three years of operation.(Michira, 2014)\(^{128}\) Karuturi and the tax administrator have since agreed to the payment of sh. 340 million in an out-of-court agreement.(Ngigi, 2014)\(^{129}\)


4.3 How SAB Miller escapes tax in developing countries

SABMiller plc is a South African multinational brewing and Beverage Company headquartered in London, England. It is the world’s second-largest brewer measured by revenues (after the Belgian-Brazilian Anheuser-Busch InBev) and is also a major bottler of Coca-Cola. Its brands include Fosters, Grolsch, Miller Brewing Company, Peroni Nastro Azzurro and Pilsner Urquell. It has operations in 80 countries across Africa, Asia, Australia, Europe, North America and South America and sells around 21 billion litres of lager per year. SABMiller operates in six continents. It is the joint owner of China’s biggest brewer, and India’s second-biggest; it has a staggering 94% of the beer market across six Latin American countries; it is Africa’s biggest brewer, operating in 31 countries on the continent. The SABMiller group is made up of 465 subsidiary companies across 67 countries, along with a number of joint ventures and associates in others. Not all of these companies are involved with the production, marketing and distribution of beer. Some may be holding and financing companies set up to manage the group’s interests in its subsidiaries. Others own the group’s assets, for example its trademarks and other intellectual property. These structures allow the group to manage its complex network of operations efficiently.

In 2007, SABMiller acquired a controlling stake in Accra Breweries Limited (ABL) as ABL faced difficult market conditions. In a detailed report illustrating a classic example of a Multinational Conglomerate going great lengths to minimize its tax obligations to the developing world, Action Aid, UK, has illustrated how SABMiller used various channels to avoid paying corporate taxes in Ghana.

First, ABL paid royalties amounting to UK £1.33 million to the Netherlands based subsidiary SABMiller international BV for using such trademarks as Castle Milk Malt and Stone Lager. Since this payment is considered to be an expense to ABL, it is deducted from the company's income for purposes of calculating income tax. Hence, the company appears to have saved UK £210,000 in corporate income tax, which in Ghana is charged at 25%. Still related to the payment of royalties by African subsidiaries, the South African Breweries Ltd, one of the largest SABMiller subsidiaries, pays UK £18 million each year in royalties to SABMiller International BV in the Netherlands. Through that, it saves UK £5.1 million tax deduction through royalty payments. SABMiller has also transferred the brand rights for African beer Chibuku to SABMiller International BV in the Netherlands from Zambia, ostensibly to facilitate further royalty payments in the future.

It is not difficult to decipher the reason why SABMiller wants its brand rights held for the entire group by SABMiller International BV in the Netherlands. The motivation for the acquisition of brand rights appears to be a Dutch tax rule that allows the cost of acquiring the underlying trademarks to be gradually written off (amortised) against payable income tax. For example, in the year 2009 - 2010, SABMiller International BV made a profit of UK £48.6 million from the royalties paid by the other subsidiaries for the use of the brands, creating an income tax liability of UK £12.4 million. It claimed a tax reduction of UK 12.6 million through the amortization programme and ended up paying no income tax at all.

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135 Ibid.
In another instance, SABMiller charges exorbitant management fees to subsidiaries in Africa and India, all with an aim of reducing taxable income. For this, SABMiller has created a subsidiary based in the Swiss city of Zug, called Bevman Services AG. Bevman Services AG charges management fees to other subsidiaries in respect of a variety of services including financial consulting, personnel strategy, business advisory services, marketing, sales, distribution, marketing and technical services. In the year 2010, the Accra based Accra Brewery Limited, a SABMiller subsidiary paid management fees worth UK £0.93million, which was equivalent to 4.6% of ABL’s turnover.

Just like in the case of royalties paid for use of group brands in foreign jurisdictions by subsidiaries, there is a tax-motivation for setting the management company in Switzerland. First is the secrecy associated with the Swiss tax haven, such that the scrutiny for the company’s affairs by interested independent parties is impossible. Secondly, the tax payable to a Swiss Management company is at 7.8%. No further tax is payable by a Management company. By substituting Ghana’s corporation tax at 25% for the Swiss 7.8% tax for Management Companies, SABMiller makes quite substantial savings on taxes. The same Swiss subsidiary also charges Management Fees at the rate of 3.3 to 3.8% to Indian subsidiaries SABMiller India and SKOL Breweries Ltd.

Procurement is another area utilized by SABMiller to cut tax payable to developing economies. To cater for the procurement needs of the African subsidiaries, SABMiller has opened a procurement subsidiary in Mauritius called Mubex. In the year 2010, Mubex handled 50% of Accra Brewery’s procurement needs. Mubex also handles the procurement needs of the South

137 Ibid.
138 Ibid.
African and the Tanzanian subsidiaries. The motivation of setting up such an office in Mauritius is that Mauritius is a tax haven where the effective payable tax for a “global business” company is 3%, much lower than the corporation tax that would accrue to subsidiaries operating in mainland Africa. Significantly, as soon as the procurement of the African subsidiaries got centralized through Mubex in Mauritius, the profitability of the Tanzanian and Ghanaian subsidiaries dropped abruptly. 139

Finally, SABMiller group in its scheme of tax evasion utilizes the concept of thin capitalization to suppress the profitability of the subsidiaries in high tax jurisdictions and boost the profitability of subsidiaries in tax havens. Thin capitalization is the practice of overleveraging companies with debt from associated sources so as to minimize taxable income. In 2009 – 2010, ABL took a loan of £8.5 million from Mubex. The debt is bigger than any mortgage lender would permit, more than seven times Accra Brewery’s capital. It’s unlikely the brewery could have secured such a loan at an arm’s length price. This means that the company got ‘thinly capitalised’. Accra Brewery continues to claim full tax benefit from the interest costs on the loans. Action Aid estimates that the annual interest costs will amount to £445,000. This effectively wipes out the £76,000 of Accra Brewery’s future tax payments each year. 140

In response to these analyses by Action Aid, SABMiller said that it paid US$4.445 billion in taxes globally in the financial year 2009-10. SABMiller even claims to be responsible for 1.7% of the South African government’s total tax haul and to be Uganda’s fourth-largest tax payer. These claims deserve closer interrogation. On inquiry, one finds that SABMiller is utilizing a concept that has been attributed to the finance consultancy firm PriceWaterhouseCoopers, called

140 Ibid.
the “total tax contribution” where a firm counts every single tax penny associated with its business and claims it for itself.

In this case, SABMiller reports VAT paid by the customers, income taxes paid by the employees as well as taxes payable by the suppliers. In actual sense, it has been found that the effective tax paid by SABMiller in 2009 to 2010 is US$620 million, not US$4.445 billion as claimed.\textsuperscript{141}

CHAPTER FIVE
CONCLUSION, SUMMARY AND RECOMMENDATIONS

5.1 Introduction
In this chapter, a conclusion over the issues that have been discussed in the previous chapter is given. A summary of the entire study and suitable recommendations are also provided.

5.2 Conclusion
The researcher is cognizant of the fact that a work on MNE taxation in developing economies is, necessarily a work in balance. While MNEs are driven by profits, their contribution to the development of the economies of the global south is significant. Indeed, it has been noted that the countries in the global south that have made important development strides have benefited from the technology transfer that is facilitated by MNEs.

One example of this is the impact of the MNE Singer Sewing machines in Taiwan. In the negotiation for the entry of Singer Sewing Machines into Taiwan, the government insisted that the company should source for parts in Taiwan. That provision had the effect of increasing the competitiveness of sewing machines coming out of Taiwan, even those manufactured by Singer's rivals based in Taiwan.\(^{142}\) The contribution of Multinational enterprises to the development of the global south through creation of jobs is widely known through the studies based on liberal economic theories.

The present study takes an alternative look into the affairs of MNEs in developing economies and focuses on the compliance of such enterprises to the corporation tax regimes in such economies. The study is based on the Dependency theory. The theory is justified by the extensive evidence of scheming among the MNEs using their global structure and funds to

\(^{142}\) Unidentified Author. Multinational Corporations in the Global Economy.
minimize their tax contribution in developing economies. This study finds that MNEs do take advantage of the weakness of the legislative and tax administrative frameworks of the global south to minimize their taxable incomes from such jurisdictions.

Such schemes are not necessarily illegal, but as the present study argues, the international legal framework is tilted to the disadvantage of the developing economies. One such imbalance is the requirement of taxation at the residence, not at source, a clause that is the basis of many international taxation frameworks, like the OECD model tax convention and a number of Double Taxation Agreements. The effect of this provision is that tax revenue gets siphoned off developing economies and gets paid in tax havens and low tax jurisdictions. Such an arrangement is beneficial to the MNEs and detrimental to the welfare of the developing economies.

The study also notes that many of the Double Taxation Agreements through which some developing economies continue to lose tax revenue through were negotiated by their colonial masters and today are in the favour of those colonizing nations at the expense of the developing states.

Multinational enterprises, as they enter into negotiation with developing nations unleash great economic power that many developing nations cannot match. This economic might becomes evident in areas such as negotiations where the MNEs are able to place better negotiators than the host states, with the effect that such states end up with agreements that are injurious to the interests of the people of the global south. MNEs are also capable to hire better legal representation than the developing economies, such that many countries cannot sustain good transfer pricing cases in court. The present study has found that even the capacity of the courts
and the tribunals, for example in Kenya has been put to question as far as their competence in transfer pricing matters is concerned.

The possibility of corruption that involves state officers through gifts and kickbacks also contributes to loss of state revenue. However, not much has been studied in this area, considering the secrecy in which these activities are carried out.

The present study has also paid attention to the phenomenon of profit shifting through which MNEs utilize their global organizational structures to minimize their tax liability from certain jurisdictions and declare profits in low tax jurisdictions. This section of the work has been tackled using case studies.

5.3 Summary

According to the narration above, an empirical study was done involving 20 auditors in both the LTO and the MTO offices of KRA. The study intended to determine the influence of the legislative and the administrative frameworks of corporation tax in Kenya on the tax compliance behaviour of MNEs operating in the country. The study established that both the administrative and the legislative frameworks surrounding tax compliance of MNEs in Kenya are insufficient for the proper enforcement of compliance Kenya. Overall, the study found that the shortfall is most significant in terms of number of auditors attached to the two offices responsible for MNE taxation and audit. Further, the technical capacity of the auditors could not be verified in the current study but literature suggests that the country is facing a serious shortfall of personnel competent in transfer pricing audit. One other area that could not be verified is the corruptibility of KRA’s auditors and what controls are available for such corruption in the administrative structure of KRA.
Another area that the study found in the current frameworks in the country is the legal capacity. This is in terms of numbers of personnel of people capable of advising KRA in high profile TP cases. Related to this is the capacity to negotiate good terms from the MNEs so that the country does not lose out on tax revenue. The laws, particularly the income tax transfer pricing guidelines of 2006 are said to be ambiguous and may be amenable to challenges in court in future. The income tax itself has been declared by the court insufficient for MNE tax audit. Although the OECD guidelines are accepted in Kenya, they have been said to be tilted towards favouring developed economies at the expense of the developing world in terms of revenue collection.

The local tribunal and the local committee are out-of-court mechanisms for settling disputes between the tax administrator and the MNEs. However, according to the current study, the committee and the tribunal are perceived to be unreliable for such a task considering that they are not composed of people who are competent in transfer pricing investigation and audit. According to the databases used by KRA to look for comparable prices for transfer pricing between related parties are said to be of European origin and are hardly applicable for the Kenyan context. Further, according to the current study, it was found that KRA has no wherewithal with which to verify the transactions between Kenyan and foreign related enterprises. These shortcomings are sure of affecting tax revenue from the MNE sector.

Despite all these, a few issues were looked at positively. For example, it was said that opening the MTO and the LTO has made the cost of compliance for the MNEs to come down. Further, the integrated tax management system was also said to improve in tax collection.
5.4 Recommendations

The following recommendations are made for the current study: First, there is need to study the impact of tax planning by MNEs on corporate tax collections from developing world. Tax planning refers to means through which firms use loopholes in the taxation law so as to minimize their tax liabilities and to maximize their profitability. Tax planning is said to be very prevalent among the MNEs considering that they can afford the services of tax advisers in different jurisdictions.

Another issue that may be of interest to scholars in this field is to determine the extent to which corruption plays a role in reducing the corporate tax collection among MNEs operating in the developing world. Corruption is a relatively difficult phenomenon to study considering the secrecy that goes into the dealings with such MNEs. Yet, an academic study that utilizes a vast network of resources would be able to decipher the corrupt dealings to various degrees.

There is also need for African scholars and practitioners, probably under the aegis of the African Tax Forum (ATAF) to look into ways through which a database of transactions involving African companies can be created. Such a database would be useful in determining the comparable transactions in such a unique business terrain like Africa.
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APPENDIX 1

QUESTIONNAIRE

(To be filled by KRA Transfer Pricing Auditors.)

Introduction

My name is Sangale Nchololoi a postgraduate student at the University of Nairobi. In partial fulfilment of the requirements of the degree of Master of Arts in International Studies, I am conducting a research on *Taxation of Multinational Enterprises: Opportunities and Threats to Developing Economies*

Your participation in this study by responding to this questionnaire will be highly appreciated. Your responses will be treated with utmost confidentiality and the data collected will only be used for academic purposes only.

Section A: Determining corporation tax compliance by MNEs in Kenya

<table>
<thead>
<tr>
<th>Determining corporate tax compliance among Kenya’s MNEs</th>
<th>Strongly disagree</th>
<th>Disagree</th>
<th>Neutral</th>
<th>Agree</th>
<th>Strongly Agree</th>
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<tbody>
<tr>
<td>MNEs in Kenya generally compile transfer prices accurately.</td>
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<td>MNEs operating in Kenya provide Transfer pricing documents to the Commissioner General of KRA as and when requested to do so.</td>
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<td>Profit shifting is not common among Kenyan MNEs</td>
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<td>MNEs in Kenya generally pay their fair share of corporation tax.</td>
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<td>MNEs operating in Kenya do not engage in aggressive tax planning activities.</td>
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### Section B: Perception towards Kenya’s MNE corporation tax regime

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<tr>
<th>Perception towards Kenya’s MNE taxation regime</th>
<th>Strongly disagree</th>
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<th>Strongly Agree</th>
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<td>Kenya’s MNE corporation tax regime is clear and easy to comply with.</td>
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<td>Transfer pricing compliance in Kenya does not comprise of a significant cost of doing business.</td>
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<td>Court cases on Transfer pricing in Kenya are decided expediently.</td>
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<td>Kenyan judicial system has capacity to solve transfer pricing cases competently and fairly.</td>
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<td>The local committee decides Transfer pricing cases fairly.</td>
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<td>The local committee and the tribunal are meticulous in investigating and deciding Transfer pricing cases.</td>
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<td>Taxpayers generally perceive Kenya’s taxation regime as supportive for business.</td>
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<td>Some MNEs establish an operation in Kenya primarily because of the favourable corporation tax regime in the country.</td>
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<td>Kenya’s corporate tax law, guidelines and tax administration procedures are sufficient and advanced pricing</td>
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agreements (APA’s) with firms investing in the country would not add a lot of value to our business process.

Transfer pricing audits conducted by KRA are efficient enough and they do not affect the flow of business process at all.

In spite of the outcome of the Unilever case, MNEs consider the provisions of the Income Tax Section 18 (3) on transfer pricing and the determination of arm’s length prices as reliable framework on which to base our transactions with related parties.

Preparing Transfer Pricing policy document as required in the Income Tax (Transfer Pricing) rules of 2006 does not increase MNE’s cost of compliance.

Generally, MNEs find Kenya’s Double Tax Agreement (DTA) network as favourable to their business structure.

Most MNEs understand that all the requirements asked for by the Commissioner General in the Transfer Pricing policy document are appropriate and necessary for the work of the tax administrator.

The methods of determining the arm’s length price as explained in the Income Tax (Transfer Pricing) rules of 2006 and the OECD guidelines are suitable for MNE operations in Kenya.
## Section C: KRA’s administrative capacity for monitoring and enforcing MNE tax compliance

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<tr>
<th>KRA’s administrative capacity for monitoring and enforcing MNE tax compliance</th>
<th>Strongly disagree</th>
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<th>Neutral</th>
<th>Agree</th>
<th>Strongly Agree</th>
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<tr>
<td>Kenya’s corporation tax structure including the taxable rates and tax incentives are supportive of the businesses of MNEs.</td>
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<td>KRA has enough auditors to conduct MNE tax compliance monitoring.</td>
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<td>KRA TP auditors are competent in their work.</td>
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<td>KRA officials responsible for TP compliance are not easily corruptible.</td>
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<td>KRA has legal capacity to enforce MNE tax compliance</td>
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<td>An MNE is likely to be visited for a TP audit once every three years.</td>
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<td>The databases used by the Kenyan tax authorities to determine the arm’s length prices are sufficient and suitable for the Kenyan situation.</td>
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<td>Kenyan tax authorities have capacity to verify transactions between Kenyan MNEs and related companies in other jurisdictions.</td>
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The general administrative structure of KRA is not only beneficial to the tax authority but is also considerate of the taxpayers’ needs.

Establishing the Large Taxpayers’ Office (LTO) and the Medium Taxpayers’ Office (MTO) has reduced the tax compliance costs for MNEs in Kenya.

The tribunal and the local committee as constituted by the Ministry of Finance help in resolving tax-related disputes between KRA and MNE taxpayers quickly and amicably.

The personnel in the tribunal and local committee are competent in transfer pricing and are therefore reliable for settling tax-related disputes.

Kenya is increasingly requiring MNEs in the contractual documents to go for arbitration in the event of TP disputes with the tax administrator. Such a requirement will enhance the capacity of the country in conducting TP dispute resolution faster and more appropriately.

Generally, Kenya’s corporate tax regulations and structure do not adversely affect the rating of the country as an investment destination.

The introduction of the Integrated Tax Management System (ITMS) has made Kenya’s competitiveness as an investment destination to improve because it makes it easier to pay taxes for MNE taxpayers.
APPENDIX 2

INTERVIEW QUESTIONS

1. What are the requirements asked for in the Transfer Pricing document that a taxpayer should present to the Commissioner General?

2. How would you rate the general corporation tax compliance by MNEs in Africa?

3. Do you think the current legal framework overseeing the TP audit and enforcement in Kenya is robust enough? If not, what improvements would you suggest need to make it more robust?

4. How prepared is the KRA in handling TP audits and enforcement in Kenya in terms of:
   (a) Technical expertise of the auditors?
   (b) Number of auditors vis-avis the number of MNEs operating in the country?
   (c) Legal capacity to pursue TP cases should they go to court?

5. Do you think the OECD Transfer Pricing guidelines are suitable for developing countries?