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An Analysis of Kenya's Transfer Pricing Regime

Transfer pricing is an ongoing issue of interest to tax authorities in most countries and Kenya is no exception. In 2006, the Income Tax (Transfer Pricing) Rules were introduced to provide guidelines for transfer pricing transactions. This article analyses the legal and policy regime and finds that it not as certain and clear as expected. It suggests further reforms to make the regime more certain, effective and efficient.

1. Introduction

Multinational enterprises (MNEs) undertake business operations internationally to gain competitive advantage, make optimum use of locational advantages and economies of scale and other similar factors. Just as many other countries, Kenya is keen on MNEs taking up establishment in the country, as they contribute to economic development through, among other things, facilitating the transfer of capital and investments, technology and managerial expertise; creating employment; and increasing foreign exchange earnings and tax revenue.[1] However, MNEs do not necessarily engender the envisaged benefits. Research has shown that some foreign firms, for instance, introduce inappropriate technologies, cause environmental degradation and generally engender changes that may have adverse effects on a host country's social and economic fabric.[2] Also, host countries are unable to tax effectively international firms because through international tax planning (often using tax havens), tax evasion (using manipulated re-invoicing and other similar means) and abuse of transfer pricing,[3] the firms are able to eliminate or significantly reduce the taxes they pay.

Transfer pricing is an ongoing issue of great relevance to tax systems globally,[4] and Kenya is no exception. The reason is that MNEs use transfer pricing to considerably reduce or eliminate their tax obligations, hence eroding tax revenue in host countries. As a result, host countries are often unable to raise their projected taxes, undermining revenue buoyancy. In response to challenges posed by transfer pricing, Kenya introduced the Income Tax (Transfer Pricing) Rules (the Rules) in 2006, the purpose of which is to provide guidelines that govern transfer pricing law and policy, and to resolve an ambiguity in the substantive provisions of the Income Tax Act (ITA). Section 18(3) of the ITA required related non-resident persons and resident persons to carry on business at arm's length. However, the law did not define what arm's length is, and, when arm's length is established, how the transaction value is to be calculated. This issue was the subject of consideration in the *Unilever* case (Income Tax Appeal No. 753 of 2003),[5] in which the High Court ruled that section 18(3) of the ITA would not be enforced because it was ambiguous.

This article will discuss the law and policy of transfer pricing in Kenya. This is germane in view of the fact that an efficient and effective transfer pricing regime is critical for mobilizing public resources to finance the country's development agenda. In addition, the Rules and discourses on transfer pricing in general are fairly nascent in Kenya and as a result many professionals may not yet fully appreciate them.[6] This article will also identify and discuss aspects of the Kenyan international taxation regime that impact the business of MNEs, and will addresses the legal regime governing transfer pricing. Finally, it will be examined how the ITA seeks to enforce provisions relating to transfer pricing.

2. Overview of Kenya's International Tax Regime

The discussion below focuses on tax measures that are applicable to foreign firms doing business in Kenya. The applicable international tax regime is found in the ITA and Kenyan income tax treaties.Provisions in the ITA relating to international taxation include those on residency, income tax treaties, non-resident withholding tax, transfer pricing and the thin capitalization regime.

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1. Ibrahim F. Shihata, *Legal Treatment of Foreign Investment: The World Bank Guidelines* at 9-12 (Martinus Nijhoff Publishers1993); Robert Pritchard, *The Contemporary Challenges of Economic Development*, in *Economic Development, Foreign Investment and the Law* at 1 (Robert Pritchard ed., Kluwer International 1996).
2. For a synopsis of the negative effects caused by foreign investors in developing countries, see Samuel Asante's remarks quoted in A. Cristiana Baez, *Should Investment in the Third World be Internationally Protected? What Role for the United Nations?*, 79 ASILProc (1985), at 378-394.
3. Richard Bird, *Taxing Tourism in Developing Countries*, 20 World Development (1992), at 1145-1158, at 1148. See also M. Sornarajah, *The International Law on Foreign Investment*, (2nd ed., Cambridge University Press 2004), at 61; and Henri-Bernard Solignac Lecomte, *Taxation for Development in Africa: A Shared Responsibility*, 9 Trade Negotiations Insight 6 (July 2010).
4. 4. *See* PwC, *International Transfer Pricing Book* (PwC 2009), at 195; government of Kenya, Kenyan Government Budget Speech 2010/2011, at 32 (Budget 2009); Michael Waweru, Tax Administration in Kenya: Problems and Prospects, available at www.revenue.go.ke/speeches/cgspeechtax100304.html (accessed 11 May 2010); Kaburu Mugambi, *Keep an Eye on Larger Taxpayer, Waweru Tells African Authorities*, Daily Nation (15 February 2011); and Jevans Nyabiage, *Kenya: Nation Loses Shs 156 Billion in Taxation Tricks By Flower Farms*, Daily Nation (25 October 2010).
5. KE: HC, 17 September 2003, *Unilever Kenya Limited v. The Commissioner of Income Tax.*
6. Even the Kenya Revenue Authority is still building the capacity of its staff to handle transfer pricing issues. See Budget 2009, *Supra n.* 4, at 32.

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2.1. Residence

The key issue for foreign investors is to determine when a taxable presence, referred to as residence, is created in Kenya. Residence gives the Kenya Revenue Authority (the KRA) the right to charge tax on business income earned in Kenya. There are three tests, which are not mutually exclusive, for establishing residence in Kenya, such that a company is deemed to be resident if:[7]

– it is incorporated in Kenya. If so, a company will always be a Kenyan taxpayer even if its place of central management and control is not in Kenya;
– the management and control of the affairs of the company are exercised in Kenya in the particular year under consideration;[8]
– the Minister of Finance declares and gazettes it as such.[9]

There is no Kenyan case dealing with the subject of "management and control" as a determinant of residence. To obtain guidance in interpretation one can refer to cases from the common law and Commonwealth.[10] In the *De Beers* case (1906),[11] the Court held that, for income tax purposes, a company resides where its real business is carried on, and a company's real business is carried on where its central management and control actually abides. Implicitly, once it is shown that the management and control of the affairs of a company are exercised in Kenya, it can be deduced that the company is carrying on business in Kenya, as the exercise of management and control of a company's affairs is the carrying on the company's business.

The territorial concept has always been fundamental to the taxation of profits in Kenya. Generally, only those profits that arise in or are derived from Kenya are liable to tax therein.[12] On this footing, a non-resident company having a permanent establishment in Kenya is required to pay tax only on income derived from Kenya though the permanent establishment.[13] A permanent establishment means a fixed place of business through which a person carries on business, and refers to a building site, or a construction or assembly project, which has existed for six months or more.[14] Also, if a foreign company does not have a fixed place of business in Kenya, it will generally have a permanent establishment in Kenya if there is a person acting for it extensively in the country.[15]

2.2. Double taxation relief

Section 41 of the ITA empowers the Minister of Finance to declare that any arrangement made with the government of a foreign country for the purpose of affording relief from double taxation in relation to income tax and other taxes (i.e. an income tax treaty) will have effect as part of Kenya's domestic law. The relief given may be retrospective to the enactment of the ITA or to the treaty.[16] Typically, the relief is afforded by way of signing tax treaties with foreign countries. Hitherto, Kenya has signed tax treaties with eight countries[17] and has completed or is still negotiating tax treaties with Iran, Kuwait and Mauritius,[18] as well as members of the East African Community and South Africa. The tax treaties are modelled on the OECD Model Tax Convention on Income and on Capital (hereinafter OECD Model) and the United Nations Model Double Taxation Convention between Developed and Developing Countries on Income and Capital (2001) (hereinafter UN Model).

The titles of Kenyan tax treaties show that they have two aims, namely to avoid double taxation and to prevent fiscal evasion. Avoiding double taxation facilitates cross-border trade and investment, an objective succinctly captured in the introduction to the OECD Model:[19]

> [The] harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

In addition to preventing double taxation and fiscal evasion, tax treaties also have the aim of securing equality and reciprocity between contracting states, and proffering an element of legal and fiscal certainty to international investment players.[20] The application of treaties is not limited to commercial and business activities. Rather, they may remove impediments to, among other things, scientific, educational and cultural exchanges.[21]

Section 41(1) of the ITA provides that tax treaties will have force "notwithstanding anything contrary in this Act or any other written law". Clearly, tax treaties override domestic law, and this was affirmed by the House of Lords in *Ostime v. AMP Society* (1959) [22] which considered identical wording in UK tax law. It must be noted that tax treaties can only limit a tax liability that already exists under domestic law. The effect of this is clear with

7. KE: Income Tax Act, sec. 2(1).
8. Id.
9. Id.
10. Reference to foreign decisions is instructive, as these are of persuasive authority only, and are not binding. In the Kenyan case of *C.A. Rashid Moledine v. Home Ginners* (1967) E.A. at 655, the Court said: "It is clear that this court is not bound by any English decision, whether given before or after independence. Nevertheless, this court would pay due regard to the decision of any Commonwealth court where a similar system of law to that appertaining in East Africa exists and will, of course, pay special regard to the decisions of English courts especially where those decisions enunciate the common law or equity or interpret statutes of general application which have been substantially applied in East Africa".
11. UK: HL, 30 July 1906, *De Beers Consolidated Mines Ltd. v. Howe*, at 458.
12. Section 3(1) of the ITA provides that "subject to, and in accordance with, this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya".
13. The rate of tax is 37.5%. *See* paragraph 2(b) of the ITA, Third Schedule,. The ITA does not expressly provide that permanent establishment profits are taxable in Kenya, so the rate of 37.5% is implicit from section 18(5) read together with paragraph 2(b) of the Third Schedule..
14. Sec. 2(1) ITA.
15. Sec. 47 ITA.
16. Sec. 41(2) ITA.
17. Kenya has concluded income tax treaties with Canada, Denmark, Germany, India, Norway, Sweden, the United Kingdom and Zambia.
18. Budget 2009, *supra* n. 4, at 32.
19. OECD Model Tax Convention on Income and on Capital para. 1 (Introduction) (15 July 2005), Models IBFD.
20. United Nations Model Double Taxation Convention between Developed and Developing Countries on Income and Capital (2001) (Introduction).
21. Id.
22. UK: HL, 16 July 1959, *Ostime v. Australian Mutual Provident Society*, Tax Treaty Case Law IBFD.

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regard to exempt income, such that the KRA may not use tax treaties to impose taxes on income that is not already subject to tax under the ITA. This position was underscored by Downes J. in the Australian case of *Roche Products Pty* (2008)[23] where he remarked that:

> …there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body...

2.3. Non-resident withholding taxes

Kenya imposes withholding tax on some forms of payment made to non-residents not having a permanent establishment[24] in Kenya, referred to as non-resident withholding tax. The reason underpinning the imposition of such tax is that it is difficult for states to collect tax from non-residents that have little or no local presence. To circumvent this difficulty, the ITA instructs Kenyan residents to make a deduction from certain payments made to non-residents. In this respect, payments deemed to be income derived from Kenya and subject to a final non-resident withholding tax include management, professional or training fees; royalties; rents; dividends; interest; pensions; and entertainment fees.[25]

Similarly, the same payments, when made to resident persons or non-residents having a permanent establishment in Kenya, are subject to withholding tax, referred to as resident withholding tax. The main difference between non-resident withholding tax and resident withholding tax is that in some instances the resident withholding tax rate may be lower. For instance, the rate of withholding tax on royalties for residents is 5%,[26] while for non-residents it is 20%.[27]

2.4. Thin capitalization

To ascertain the income of a person, interest paid for borrowed money is deductible if the money borrowed has been wholly and exclusive used to earn investment income.[28] However, interest expense is restricted for foreign controlled companies when the ratio of interest bearing loans[29] exceeds three times the borrower's issued and paid-up capital and revenue reserves, which includes accumulated losses.[30] In other words, the ITA stipulates that the debt-to-equity component of a Kenyan company should not normally exceed a 3:1 ratio. If this debt-to-equity ratio is exceeded, the KRA limits the amount of interest that may be deducted to that corresponding to the maximum permitted ratio.

For the KRA to apply this anti-avoidance measure, the Kenyan company must be under the control of a non-resident company and not be a bank licensed under the banking laws.[31] The rule also extends to a non-resident associate of the non-resident company.[32] Control generally refers to circumstances where the Kenyan company conducts its affairs in accordance with the wishes of the foreign company.[33] The powers of the foreign company may be derived from either the holding of shares or the possession of voting power, or from the articles of association or any other document governing relations between the Kenyan company and its foreign counterpart.[34] As regards shares or voting power, a foreign company will be in control if it holds at least 25% of the shares or voting power of the Kenyan company.[35]

3. The Legal Regime of Transfer Pricing in Kenya

Provisions relating to transfer pricing are found in the ITA and Kenyan tax treaties. The legislative source of Kenya's transfer pricing law and policy is section 18(3) of the ITA and the Rules, while for Kenyan tax treaties the source is the associated enterprises article.

3.1. Statutory provisions

Section 18(3) of the ITA provides for the arm's length principle as the basis for pricing transactions between related persons.[36] Section 18(3) provides:

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

The essence of section 18(3) is that, for income tax purposes, the terms and conditions of cross-border transactions between related parties ought to be as the terms and conditions of such transactions between independent parties. The arm's length principle uses the behaviour of independent parties as a guide or benchmark to determine how income and expenses are allocated in international dealings between related parties.[37] The policy underlying section 18(3) is the need to forestall cross-border transactions between related persons that have the undesirable effect of shifting taxable income from Kenya.

Three criteria must be satisfied to create liability under section 18(3). First, there must be business between the

23. AU: AAT, 22 July 2008, *Roche Products Pty Ltd v. Commissioner of Taxation*.
24. Sec. 35(1) ITA.
25. Id.
26. Para. 5(g), Third Schedule, Head B ITA.
27. Para. 3(b), Third Schedule, Head B ITA
28. Sec. 15(3)(a) ITA.
29. Section 16(3) of the ITA defines "all loans" to mean "loans, overdraft, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium".
30. Sec. 15(2)(j) and Sec. 15(4) ITA.
31. Sec. 16(2)(j), proviso ITA.
32. Id.
33. Para. 32(1, Second Schedule ITA.
34. Id.
35. Id.
36. The word "related person" is used synonymously with "associated person". While the statute uses the word "related person", the Income Tax (Transfer Pricing Rules) 2006 use "associated person".
37. Australian Taxation Office, *Introduction to Concepts and Risk Assessment* (Australian Taxation Office, Canberra, 2005), at 3.

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resident person and the non-resident person in respect of which the profit is adjusted. Second, the resident and non-resident person must be related. A person is related to another if either person participates, directly or indirectly, in the management, control or capital of the business of the other; or a third person participates directly or indirectly in the management, control or capital of the business of both.[38] It must be noted that the section does not stipulate the threshold of participation in management, control or capital. Another issue that is not clear from section 18(3) is whether the concept of "related person" includes a branch. There are two perspectives that can be presented in regard to this. The first is that tax treaty provisions and evolving international standards require or anticipate the attribution of income to permanent establishments in accordance with the arm's length principle.[39] Indeed, this evolving jurisprudence is what is encapsulated in paragraph 5(a) of the Rules, which provides that the Rules will apply to transactions between a permanent establishment and its head office or other related branches, in which case the permanent establishment will be treated as a distinct and separate enterprise from its head office and related branches. A problem with this is that the Rules, which are a form of subsidiary legislation, cannot override a substantive statutory provision, section 18(3) of the ITA. The second position is that a person is either a natural person or legal person, and ordinarily a branch is not a person. However, under the provisions of the Interpretation and General Provisions Act, a branch would seem to be a person,[40] and on the strength of this, it is arguable that the concept of "related person" includes a branch. The third condition is that the business between the related parties produces no taxable income or less than might be expected.

Where transfer pricing is identified, section 23, the general anti-avoidance measure in the ITA, authorizes the Commissioner to adjust the profits to those that would have arisen if the parties were dealing with each other independently.

3.2. The scope of section 23 and its historical evolution

Section 23 of the ITA provides:

> where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for a year of income or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction.

Section 23 confers very broad powers to the Commissioner, and the ambit thereof was the subject in *CIT v. Armstrong* (1962).[41] The Court stated that three conditions must be fulfilled in order for the Commissioner's powers not to violate section 23. First, the main purpose, or one of the main purposes, of the transaction must be the avoidance or reduction of the liability to tax. In ferreting out the purpose, the Commissioner must have reasonable grounds of belief that the transaction was effected for the avoidance of tax. Ordinarily, the burden is on the taxpayer to prove that the tax avoidance or reduction was not the main purpose of the transaction.[42] Second, the exercise of the powers must be just and reasonable. What is just and reasonable is not defined, but each transaction must be judged on its own facts. This requirement enables the courts to temper excessive powers exercised by the Commissioner. Third, the Commissioner must issue a direction that profits be adjusted, which often results in an increase in the taxpayer's income. The adjustment is not automatic. Rather, the Commissioner issues to the taxpayer a notice of assessment, stating the amount of income assessed and the amount of tax payable.[43]

CIT v. Armstrong is based on an interpretation of section 23 of the East African Income Tax (Management) Act 1958[44] and, therefore, the question must be asked as to why this is relevant to the ITA, which became operational on 1 January 1974. Income tax was first introduced in Kenya in 1937,[45] but the Income Tax Ordinance 1937 did not provide for a general anti-avoidance provision. Neither did the Income Tax Ordinance 1940 which repealed the Income Tax Ordinance 1937. An anti-avoidance provision appeared for the first time by way of section 23 of the East African Income Tax (Management) Act 1952,[46] and was retained in section 23 of the East African Income Tax (Management) Act 1958.[47] According to the Report of the East African High Commission of Inquiry on Income Tax 1956-57, which gave information on the enactment of the East African Income Tax (Management) Act 1958, the overarching goal of section 23 is to empower the Commissioner, where he has reasonable grounds to believe that the main purpose or one of the main purposes of transaction(s) is the avoidance or reduction of liability to tax, to make adjustments to the tax liability of persons affected, with the object of counteracting the intended avoidance or reduction of tax liability.[48] The East African Income Tax (Management) Acts were in force in Kenya, Tanzania and Uganda, by dint of the countries' membership in the now-defunct East African Community, which broke up in 1977. Most of the provisions in the East African Income Tax (Management) Acts were retained by individual countries when they enacted income tax statutes of their own.

38. Sec. 18(6) ITA.
39. Advisory Panel on Canada's System of International Taxation, *The Administration of Canada's Transfer Pricing Rules*, available at www.apcsit-gcrcfi.ca (accessed 1 April 2010), at 26.
40. Section 3(1) of the Interpretation and General Provisions Act defines a "person" as including a company or association or body of persons, corporate or unincorporate. *See* www.kenyalaw.org/kenyalaw/klr_app/frames.php (accessed 3 March 2011).
41. KE: CA, 6 July 1962. *Commissioner of Income Tax v. C. W. Armstrong.*
42. KE: 1958, *Associated Contractors Ltd v. Commissioner for Income.*
43. Sec. 78 ITA.
44. Act 19, 1958.
45. East African High Commission, Report of the East African High Commission of Inquiry on Income Tax 1956-57 at para. 18 (Nairobi: East African High Commission Printer1957).
46. Act 8, 1952.
47. Act 19, 1958.
48. East African High Commission, *supra* n. 45, at para. 658.

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As the *Unilever* case indicated, section 18(3) by itself is ambiguous, as it does not explain how the arm's length price is to be arrived at. After the ruling in the *Unilever* case, the parliament amended the ITA, by introducing section 18(8), which requires the Minister of Finance to publish rules setting out guidelines that are to be used to determine arm's length values. Subsequently, the Minister published the Rules, which came into effect on 1 January 2006. As the catalyst for the Rules was the *Unilever* case, it is imperative to understand the key pronouncements of that ruling.

3.3. The *Unilever* case and its role in the evolution of Kenya's transfer pricing jurisprudence

This was the first Kenyan case to consider the application of the transfer pricing regime under section 18(3). Unilever Kenya Limited (UKL) and Unilever Uganda Limited (UGL) are subsidiaries of the conglomerate Unilever group of companies. Sometime in 1995, UGL and UKL entered into a contract under which UKL was to manufacture and supply various goods to UGL. The prices that UKL charged UGL were lower than those for identical goods that it charged Kenyan consumers and for exports to countries other than Uganda. The KRA argued that, as the two companies were related, the sale of products at a price lower than that charged to Kenyan consumers and exporters for comparable sales was a transfer price. Consequently, this arrangement resulted in less taxable profits in Kenya than would have been earned if the transactions were carried out with an independent party. As a result, the KRA assessed UKL to additional tax.

However, UKL disagreed with the KRA and filed an appeal at the Local Committee,[49] which ruled against UKL. UKL appealed against the decision of the Committee on a point of law, to wit, that section 18(3) required prices between related parties to be at arm's length, yet did not provide guidance on how to apply this in practice. UKL further contended that, in the absence of such guidelines, it could resort to international best practices, specifically the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), for guidance on how to determine arm's length prices. Indeed, UKL had used the cost-plus method as provided in the OECD Guidelines to calculate the prices it charged UGL and, on this basis, it argued that it had complied with section 18(3).

The High Court agreed with UKL, holding that in the absence of Kenyan guidelines to determine what constitutes an arm's length, the company was justified in resorting to the OECD Guidelines, as these are internationally accepted principles of business and thereby best evidence of international thinking on the subject.[50] Specifically, the Court stated:[51]

> We live in what is now referred to as a "global village". We cannot overlook or sideline what has come out of the wisdom of taxpayers and tax collectors in other countries. And especially because of the absence of any guidelines in Kenya, we must look elsewhere. We must be prepared to innovate and to apply creative solutions based on lessons and best practices available to us. That is indeed how our law will develop and our jurisprudence will be enhanced. And that is also how we shall encourage business to thrive in our country.

The decision offers an important insight into the prominent role that the OECD Guidelines have come to occupy in transfer pricing jurisprudence. During the hearing of the *Unilever* case, the KRA contended that the OECD Guidelines are not part of Kenyan law and, therefore, were not acceptable as guidelines in resolving transfer pricing issues.[52] In other words, the KRA's argument was that the OECD Guidelines are just what they purport to be – guidelines[53] – and, as they had not been incorporated into Kenyan law, lacked legal force. This argument was not accepted by the Court.

Nonetheless, the issue is very arguable and germane to tax jurisprudence in Kenya. The country is not a member of the OECD and was not involved in the drafting of the OECD Guidelines. A question must be asked as to why it was necessary for the Court to rule that Kenya would refer to the OECD Guidelines in determining what constitutes an arm's length price, despite the fact that Kenya is not a member of the OECD and was not involved in the drafting of the OECD Guidelines. It must be noted that there is an alternative view, proffered by foreign case law, that in the absence of any other guidance in determining the arm's length price, the approach of the OECD Model is a useful aid, as they are the best evidence of international thinking on the topic.[54] While resort could be had to foreign jurisprudence, ultimately it is the substance of Kenyan law that must be construed and applied. Undoubtedly, part of the reason for publishing the Rules was to address the view that the OECD Guidelines, absent incorporation, were not part of Kenyan law.

Nonetheless, the finding that section 18(3) was ambiguous for failing to provide guidance as to how to determine arm's length was apposite. Similarly, the Court's words exhorting tax authorities to benchmark the country's tax system against international developments and practices were clearly prescient, for hardly a year later, the Minister of Finance issued and published the Rules, on the whole modelled on the OECD Guidelines.

3.4. Transfer pricing rules

Section 18(8) instructs the Minister of Finance to develop and issue transfer pricing guidelines. Such guidelines have been issued by the Minister in the form of the Rules. The stated purpose of the Rules is:

> to provide guidelines to be applied by related enterprises, in determining the arm's length prices of goods and services in transactions involving them, and, to provide administrative regula-

49. Local Committees serve as the first avenue for appeal against a tax assessment, but for strange reasons do not give justifications for their decisions.
50. AU: FCA *SNF (Australia) Pty Ltd v. Commissioner of Taxation* (2010) FCA 635, para. 47, June 2011, Tax Treaty Case Law IBFD.
51. Income Tax Appeal 753 of 2003, 16.
52. *Unilever Kenya Limited (formerly East African Industries Limited) v. The Commissioner of income Tax*, Income Tax Appeal 753 of 2003, 13.
53. KE: HC, 2003, *SNF Australia,supra* n. 50, para. 58.
54. Id.

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> tions, including the types of records and documentation to be submitted to the Commissioner by a person involved in transfer pricing arrangements.[55]

This is understandable and is supported by the fact that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayers.[56]

The stated purpose of the Rules is to provide guidelines for determining transfer pricing.[57] The term "guidelines" in paragraph 3(1)(a) is a misnomer, as the Rules are a form of subsidiary legislation to the ITA and are therefore prescriptive. Perhaps part of the reason for making the Rules prescriptive is to offer guidance and solutions to transfer pricing issues that are unique to the Kenyan business environment. Partly, also, the Rules were made prescriptive so as to address concerns that the OECD Guidelines were not part of Kenyan law.

There is no reference in the ITA or the Rules to the OECD Guidelines. However, it is clear that the Rules are broadly based on, but do not completely incorporate, the OECD Guidelines. The question may be asked, therefore, as to how the Rules could deal with issues, for example, cost contribution arrangements, that are provided for in the OECD Guidelines but not in the Rules? As held in the *Unilever* case, it is probable that, in the absence of Kenyan guidelines, recourse could be had to the OECD Guidelines. This issue could become clearer if the ITA were amended to require taxpayers to apply the principles in the OECD Guidelines, except where they are incompatible with express provisions of the ITA. Such a legal stipulation would create certainty and assist the KRA and taxpayers in resolving difficult matters by drawing on the experience and practice of other jurisdictions that apply the OECD Guidelines and have resolved similar disputes.

3.5. The arm's length principle

As indicated in the *Unilever* case, the ITA required that transactions be at arm's length, but did not define the concept of arm's length. This ambiguity has been removed through the Rules, which define arm's length consideration as the price payable in a transaction between independent enterprises.[58] Kenya has adopted the international methods for establishing the arm's length price, namely the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit split methods and the transactional net margin method.[59]

Transfer pricing is as much as an art as a science, and there will often be a continuum or range of possible prices/profits.[60] In realization of this, the Rules give enterprises leeway to decide which method, from among the five specified, best suits their transactions.[61] But this discretion is not unfettered. Where the arm's length consideration cannot be determined using any of the methods specified in the Rules, the Commissioner may prescribe another method.[62] In essence, enterprises are prohibited from adopting any other methods apart from those specified in the Rules or prescribed by the Commissioner. This is unnecessarily restrictive and rigid, and implies there is exactitude on what transfer pricing is.

Moreover, there is no guidance on how to select an appropriate transfer pricing methodology. As transfer pricing is not exact science, it may be necessary not to unduly restrict enterprises by allowing them to use any other method not specified in the Rules, provided that adoption of such a method in the particular case under consideration produces an outcome consistent with the arm's length principle.[63] To avoid arbitrariness, such a choice must be accompanied by an explanation as to why it is more appropriate than the methods specified in the Rules. After all, even for the methods specified in the Rules, an enterprise undoubtedly will be required to furnish information to the KRA on the selection of the transfer pricing method and the reasons for the selection and application of the method, including the calculations made and price adjustment factors considered.[64]

As a reform measure, the KRA may consider developing interpretation guidelines and practice notes that provide general guidance and directions to assist taxpayers and KRA officials to deal with the issue of determining the arm's length price. Such interpretation guidelines and practice notes ought not be prescriptive, but enterprises that use them are less likely to be subjected to transfer pricing adjustments.[65] These will assist enterprises to develop and implement internal processes that may be used in resolving any queries from the KRA regarding their international pricing. For comparative purposes, the KRA may borrow a page from the Australian Taxation Office, which has developed four steps to assist businesses in implementing processes for setting and reviewing pricing used in international dealings with related parties.[66]

3.6. Meaning of associated enterprise

The scope of the Rules is limited to:

> (i) transactions between associated enterprises within a multinational company, where one enterprise is located in, and is subject to tax in Kenya, and the other is located outside Kenya; (ii) and transactions between a permanent establishment and its head office or other related branches, in which case the permanent establishment shall be treated as a distinct and separate enterprise from its head office and related branches.[67]

55. Para. 3 ITA, the Rules 2006.
56. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines) (1995), at 1-5.
57. Rule 3(1)(a) provides that the purposes of these Rules are "to provide guidelines to be applied by related enterprises, in determining the arm's length prices of goods and services in transactions involving them".
58. Para. 2 ITA, the Rules 2006.
59. Para. 7 ITA, the Rules 2006.
60. Graeme Cooper et al., *Income Taxation: Commentary and Materials* at 801, (5th ed., Thomson, NSW, 2005).
61. Para. 4 ITA, the Rules 2006.
62. Para. 7(f) ITA, the Rules 2006.
63. Australian Taxation Office, Applying the Arm's Length Principle, at 3.
64. Para. 9(2) ITA, the Rules 2006.
65. Australian Taxation Office, Applying the Arm's Length Principle, at 3.
66. Australian Taxation Office, Income Tax: Documentation and Practical Issues Associated with Setting and Reviewing Transfer Pricing in International Dealings, Taxation Ruling 98/11(Australian Taxation Office1998), chap. 5.
67. Para. 5 ITA, the Rules 2006

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In other words, members of multinational companies are treated as operating as separate entities rather than as a single unified business.

The term "associated enterprises" is not defined. Instead, the Rules define the term "related enterprises" as being "one or more enterprises" whereby one of the enterprises participates directly or indirectly in the management, control or capital of the other, or a third person participates directly or indirectly in the management, control or capital of both.[68] Paragraphs (a) and (b) describe association between enterprises to which transfer pricing adjustments may apply. Also, the definition of "related enterprise" in the Rules is in sync with the definition of "related person" in section 18(6) of the ITA. It would appear that the term "associated enterprise", "related enterprise" and "related person" are synonymous.

Also as indicated above (see 3.1.), section 18(3) makes no reference to a branch, while the Rules do. A problem with this is that the Rules are subsidiary legislation and therefore cannot possibly override a substantive statutory provision. To pre-empt uncertainty and ambiguity, an amendment to refer to a branch in section 18(3) is necessary.

3.7. Documentation

The Rules do not make it mandatory for taxpayers to complete transfer pricing documentation. While information on the performance of public limited companies in Kenya is readily available in the form of published interim and annual financial statements, this is not the case for private companies. Regardless, the published information about public companies may not reveal much about their comparable prices, which can only be gleaned from the management accounting systems of companies. This explains why the KRA may request an enterprise to furnish it with books of accounts and other documents relating to transactions where transfer pricing is applied.[69] The required information will include the selection of the transfer pricing method and the reasons for the selection, and the application of the method, including the calculations made and price adjustment factors considered.[70]

3.8. Transfer Pricing under Kenyan Tax Treaties

The arm's length principle is contained in the associated enterprises articles in each Kenyan tax treaty. A typical example is article 9 of the Kenya–Canada Income Tax Treaty (1983), which requires the comparison of the "conditions that exist in the commercial and financial relations' between independent enterprises, with the conditions that might be expected to operate between independent parties dealing wholly independently with each other". Article 9(2) provides for a corresponding downward adjustment to profits to be made in the other treaty state where an upward adjustment has been made under article 9(1) and vice versa.

68. Para. 2 ITA, the Rules 2006.
69. Para. 9(1) ITA, the Rules 2006.
70. Para. 9(2) ITA, the Rules 2006.

4. Enforcing Transfer Pricing Rules

The ITA does not provide for specific procedures for administering and enforcing transfer pricing. Similarly, there are no special procedural rules for resolving transfer pricing disputes. The corollary is that issues touching on transfer pricing administration, compliance and disputes are handled the same way as other income tax matters. Indeed, the Rules have foreshadowed this by providing that the provisions of the ITA relating to fraud, failure to furnish returns and underpayment of tax will apply with respect to transfer pricing.[71]

4.1. Administration, assessment and ollection

The Commissioner is responsible for control, collection of and accounting for tax.[72] So as to discharge these roles efficiently and effectively, the ITA grants broad powers to the Commissioner. The following two are illustrative. First, where a taxpayer has not furnished a return and the commissioner is of the opinion that such a taxpayer is chargeable to tax, he may estimate the sum in respect of which such person is chargeable to tax and make an assessment accordingly.[73] Second, a taxpayer is enjoined by law to keep books and records that are adequate for computing tax,[74] and if this requirement is not complied with, the Commissioner may impose a penalty on such a person.[75]

As indicated, when transfer pricing is detected, section 23 of the ITA, the general anti-avoidance measure in the ITA, authorizes the Commissioner to make an assessment to adjust the profits to those that would have been agreed if the parties were dealing with each other independently. The Commissioner issues to the taxpayer a notice of assessment, stating the amount of income assessed and the amount of tax payable.[76] The adjusted profits are deemed income and subjected to taxation under the provisions of the ITA. Any tax due and unpaid in a transfer pricing arrangement will be deemed to be additional tax for purposes of sections 94 and 95 of the ITA.[77] Under section 94(1), any tax that remains unpaid after the due date attracts a penalty of 20% and a late payment interest of 2% per month, imposed on the outstanding tax and penalty, for every month that the tax liability is outstanding.[78] Section 95(1) imposes interest at the rate of 2% per month when the difference between the amount of tax assessed on the total income of a person and the amount of the estimate of the tax chargeable contained in a pro-

71. Para. 11 ITA, the Rules 2006.
72. Sec. 122 ITA.
73. Sec. 73 (3) ITA.
74. Sec. 54(A)(1) ITA.
75. Sec. 54(A)(2) ITA.
76. Sec. 78 ITA.
77. Para. 12 ITA, the Rules 2006.
78. Section 94(1) provides that "[i]n addition to the penalty payable under section 72D, a late payment interest of two per cent per month or part thereof shall be charged on the amount, including the penalty remaining unpaid for more than one month after the due date until the full amount is recovered".

    Section 72D provides that "[w]here any amount of tax remains unpaid after the due date a penalty of twenty percent shall immediately become due and payable".

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visional return of income made by that person in respect of that year is greater than 10% of that estimated tax.[79]

4.2. Challenges in enforcing transfer pricing in Kenya

Anecdotal evidence indicates that businesses are increasingly facing transfer pricing queries and audits from the KRA, and this is bound to intensify. Thus, the introduction of the Rules could not have come at a better time, as they provide some measure of certainty and clarity for business enterprises. However, since the Rules were introduced, it appears that no case has been filed in court about the Rules and, therefore, taxpayers do not have the benefit of the courts' insight and thinking which could help in interpreting or explaining the provisions of the Rules. Regardless, on the basis of analysis, a few comments can be made about the possible problems that the Rules will pose in practice.

Transfer pricing is a major tax issue for both developing and developed countries.[80] Indeed, the KRA has, and continues to underscore this fact.[81] However, compared with developed countries, the challenges are severe in Kenya, just as in other developing countries. Transfer pricing is complex – a situation exacerbated by the paucity of capacity and expertise in Kenya.[82] Indeed, the government has acknowledged this and is taking steps to build and enhance the skills and expertise of the KRA staff to handle transfer pricing.[83] In contrast, MNEs have skilled professionals to plan and execute complex transfer pricing transactions that the KRA may find difficult to unravel.

The arm's length principle requires transactions between related parties to be treated for tax purposes by reference to the profits that would have arisen if the same transactions had been carried out by independent parties. Effectively, benchmarking of relevant performance indicators, such as cost base, margins or markups, return on capital or assets, gross and net profits of related parties against those of comparable independent parties is an integral part of determining the arm's length price. In practice, one key difficulty in applying transfer pricing methods is to find open-market transactions between independent enterprises that are comparable to the controlled transactions within a multinational enterprise.[84] The UN Committee of Experts on International Cooperation in Tax Matters has highlighted this as a challenge confronting developing countries:[85]

> Lack of comparable data for calculating costs or resale prices of goods and services is a serious problem in many developing countries. Some developing countries used data extracted from developed country databases, such as from European and United States sources, but others took the view that that could be problematic, because the market conditions, including geographical or locational factors... would be so different. Customs data were generally obtained at a lower cost, but needed sophisticated analysis to assist in auditing taxpayers, and still remained only one part of a solution.

Other comparable difficulties that may be unique to Kenya include a smaller number of independent enterprises operating in their markets that can be looked to for comparisons[86] and intra-group services that are unique to companies and thereby not exposed to market forces as those between independent companies, and the valuation of intangibles.

There is no provision for advance pricing agreements (APAs) in Kenya's transfer pricing regime. APAs allow tax authorities to negotiate and agree with taxpayers on the methodologies to be used in setting transfer prices before a dispute arises. By so doing, both parties can avoid time and costs that may be incurred in litigating transfer pricing disputes.

5. Conclusion

Transfer pricing presents – and will continue to be – an ongoing issue of concern and interest for the KRA. Anecdotal evidence indicates that businesses are increasingly facing transfer pricing queries and audits from the KRA, and this is bound to intensify. Thus, the introduction of the Rules could not have come at a better time, as they provide some measure of certainty and clarity for business enterprises. However, the complexity of transfer pricing, the dearth of transfer pricing expertise and a lack of comparable data for determining arm's length prices are likely to impede efforts to deal with transfer pricing. Moreover, since the Rules were introduced, no case has been filed in court touching on the issue of transfer pricing. Therefore, taxpayers do not have the benefit of the courts' insight and thinking which could help in interpreting or explaining the provisions of the Rules. Regardless, much effort will be expended to make the transfer pricing regime a robust framework so as maximize government revenue collections, increase certainty in its interpretation and minimize controversies between taxpayers and the KRA.

79. Section 95(1) provides: "If, for a year of income, the difference between the amount of tax assessed on the total income of a person and the amount of the estimate of the tax chargeable contained in a provisional return of income made by that person in respect of that year is greater than ten per cent of that estimated tax, interest at the rate of two per cent per month shall be payable on the whole of the difference between the tax so assessed and the tax so estimated".
80. UN Committee of Experts on International Cooperation in Tax Matters, Fifth Session, Geneva, 19-23 October 2009, E/C18/2009/5, at 1.
81. Kabiru Mugambi, *Keep an Eye on Large Taxpayers, Waweru Tells African Authorities*, Daily Nation (15 February 2011), 28.
82. Jevans Nyabiage, *Kenya: Nation Loses Shs 156 Billion in Taxation Tricks By Flower Farms*, Daily Nation (25 October 2010).
83. Government of Kenya, Budget 2009, *supra* n. 4, at 32.
84. Caroline Silberztein, *Transfer Pricing: A Challenge for Developing Countries*, available at www.oecdobserver.org/news/fullstory.php/aid/3131/Transfer_pricing:_A_challenge_for_developing (accessed 16 February 2011).
85. UN Committee of Experts on International Cooperation in Tax Matters, Fifth Session, Geneva, 19-23 October 2009, E/C 18/2009/5, at 3.
86. Id. at 1.

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