The Legal and Institutional Framework of Transfer Pricing in Kenya: A Case Study of the Unilever Case and its Aftermath

A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF A MASTER OF LAWS (LL.M) DEGREE OF THE UNIVERSITY OF NAIROBI

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DECLARATION

I **JASPER MICHENI MBIUKI,** do hereby declare that this is my original work and has not been submitted and is not currently being submitted for a degree in any other University.

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

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DEDICATION

This work has been dedicated to my best friend, mentor, confidant, special advisor and business partner- my mother Mrs. Gladys Kathure Mbiuki whose thirst for academic excellence for our family is unquenchable. May this small achievement be a beacon of light for many of her offspring to see the light at the end of the tunnel and then move beyond this point.

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ABSTRACT

This study analyses the legal and institutional framework of transfer pricing in Kenya using the Unilever Case and its aftermath as a case study. In this regard, the action taken by the government after the decision in the Unilever case is examined to determine whether there are any inadequacies in transfer pricing law. The key argument made is that Kenya is facing a problem in the area of transfer pricing owing to the inadequacies in transfer pricing law and absence of transfer pricing case law with good public features.

In addition, the study critically evaluates the existing institutional framework for the implementation of transfer pricing regulations. The thesis looks at the institutions which were in place before and after the Unilever case and proceeds to find out the adequacy of these institutions to execute the transfer pricing law in place at the respective time.

The key findings made include the fact that the Unilever case approved the application of OECD Guidelines even though Kenya had not ratified or adopted them. This application by the court prompted the KRA to promulgate the Income Tax (Transfer Pricing) Rules, 2006 which set out the rules to provide guidelines on transfer pricing. The rules modelled on OECD guidelines on transfer pricing are shown to have inherent inadequacies.

In conclusion, the study establishes that the current legal and institutional framework for transfer pricing in Kenya is inadequate and in need of reforms. In this regard, recommendations are made for strengthening the legal, policy and institutional framework for transfer pricing in Kenya in line with international best practices.

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United Nations Model Double Taxation Convention between developed and developing countries 1979 (ST/SG/AC.8/L.29)- United Nations (1979).

United Nations Conference on Trade and Development, 'Transfer Pricing' United Nations Publication, UNCTAD/ITE/IIT/11(Vol. I), 1999.

Glossary of Terms and Abbreviations

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

Term/Abbreviation	Description
Arm's length Principle("ALP")	The Arm's Length Principle requires that transfer prices charged between related parties are equivalent to those that would have been charged between independent parties in the same circumstances.
Advanced Pricing Agreement ("APA")	An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time
Comparable Uncontrolled Price ("CUP") Method	A method of pricing based on the price charged between unrelated parties in respect of a comparable transaction in comparable circumstances.
Controlled transaction	A transaction affected by the transfer pricing provisions of the Income Tax Act and the transfer pricing rules made the reunder.
Cost Plus Method	A method of pricing based on the costs incurred plus a percentage of those costs.
FDI	Foreign Direct Investment
Functional analysis	The analysis of a business by reference to the location of functions, risks and intangible

	assets
Guidelines	Transfer Pricing Guidelines
IBFD	International Bureau of Fiscal Documentation
ITA	Income Tax Act
KRA	The Kenya Revenue Authority
MNC	Multinational Corporation
OECD	The Organization for Economic Co-operation and Development.
OECD Guidelines	*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* issued by the Organization for Economic Co-operation and Development.
PAYE	Pay As You Earn
PBIT	Profit Before Interest and Tax
Permanent Establishment("PE")	A taxable business unit. Exact definitions vary in different countries. The Kenyan ITA defines a PE as follows: "a ""permanent establishment" in relation to a person means a fixed place of business in which that person carries on business and for the purposes of this definition, a building site, or a construction or assembly project, which has existed for six months or more shall be deemed to be a fixed place of business."
Profit split method ("PSM")	A transfer pricing method used to evaluate whether the allocation of combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each participant's contribution to that profit or

	loss.
Resale price method	A method of pricing based on the price at which a product is resold less a percentage of the resale price.
TP	Transfer pricing
UKL	Unilever Kenya Limited
UN	United Nations
Unilever Case	Commissioner of Income Taxes v. Unilever Kenya Limited (Income Tax Appeal No. 753 of 2003), [2005] eKLR 1
UUL	Unilever Uganda Limited
WTO	World Trade Organization

CHAPTER ONE: INTRODUCTION

1.1. Background to the Problem

Transfer pricing has emerged in the global economy as one of the most important tax issues for MNC's. Managing transfer pricing risk and maximising efficiency opportunities through pricing planning are both key shareholder and value issues.

Transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for good, services, or use of property (including intangible property). Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions.

Many governments have adopted transfer pricing rules that apply in determining or adjusting income taxes of domestic and multinational taxpayers.The substantive law governing transfer pricing in Kenya is Section 18 (3) of the Income Tax Act (ITA).[1] This section requires business carried on between a non-resident and related Kenyan resident to be conducted at arm's length. Further, the Commissioner of Income Tax is given power to adjust the profits of the Kenya resident from that business to the profits which would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length.

Section 18 (8) of the ITA gives the Minister power to make rules to provide *guidelines* of the arms length value of transactions for purposes of the section and to specify requirements necessary for the better carrying out of the provisions of the section. The Minister published The Income Tax (Transfer Pricing) Rules, (2006) ("The Rules") in 2006. The introduction of transfer pricing guidelines was largely influenced by the decision in *Unilever Kenya limited v. The Commissioner of Income Tax (Unilever Case).*[2] The court in

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[1] Cap. 470 of the Laws of Kenya (ITA)
[2] This decision was in *Unilever Kenya limited v The Commissioner of Income Tax* (Unilever Case), (Income Tax Appeal No. 753 of 2003), [2005] eKLR 1, delivered by Visram J on 5 October 2005, Available at: http://www.kenyalaw.org/klr/index.php?id=191, (last accessed 11th November 2011).

the Unilever Case recognized the applicability of the OECD Transfer Pricing guidelines in the absence of Kenyan guidelines. The court held that in the absence of Kenyan guidelines, OECD guidelines will apply. This raises issues concerning the interpretation of tax laws by implication or by references to international instruments, practices, customs or even other countries guidelines.

While recognising the applicability of the guidelines in Kenya, the Court held that the OECD Guidelines,

> *"..have been evolved in other jurisdictions after considerable debates and taking into account appropriate factors to arrive at results that are equitable to all parties. The ways of doing modern business have changed very substantially in the last 20 years or so and it would be fool-hardy for any court to disregard internationally accepted principles of business as long as these do not conflict with our own laws. To do otherwise would be highly short-sighted."*

In essence, the High Court of Kenya endorsed the use of OECD Guidelines in the absence of detailed guidelines from the KRA. The KRA responded with the introduction of Income Tax (Transfer Pricing) Rules, 2006 (TP Rules).[3] These rules provide guidelines on the application of the arm's length principle. This study interrogates the suitability and applicability of the OECD Guidelines in the Unilever case, analyzes the value of adopting the OECD Guidelines in preparing the Transfer Pricing guidelines in Kenya and analyzes the effectiveness of the transfer pricing legal and institutional regime in Kenya, especially the Income Tax (Transfer Pricing) Rules, 2006.

The Study was motivated by my involvement as a legal counsel in a leading multinational banking institution with operations in Kenya in the preparation of its Transfer Pricing Policy in accordance with provisions of the ITA. It occurred to me that the OECD Transfer Pricing Guidelines harboured far too many loopholes as a framework to facilitate Kenya in achieving its objectives in transfer pricing regulation.

[3] Legal Notice No. 67 of 2006 published under section 18(8) of the Income Tax Act with an effective date of 1 July 2006, available at: http://www.kenyalaw.org/klr/index.php?id=619, (last accessed 24th November 2011).

1.2. Statement of the Problem

After the decision in the Unilever case, the Income Tax (Transfer Pricing) Rules, 2006 were enacted as guidelines in determining the arm's length price of controlled transactions. These rules are largely a replica of the OECD model guidelines.

The inadequacy of the Income Tax (Transfer Pricing) Rules, 2006 forms the research problem for this study. First, there was no attempt to domestic the rules to suit the specific circumstances of the Kenyan economic and taxation environment. Second, the Income Tax (Transfer Pricing) Rules, 2006 are mere guidelines implying that the multinationals have an option to either apply or dis-apply them. This robs them of the character of legal enforceability of rules made under acts of parliament.

The study concludes that the action of KRA in hurriedly and unilaterally enacting the guidelines now seem, with benefit of hindsight, self-defeatist, and has even been described as 'hasty, angry and off tangent.'[4] It created inadequate guidelines, opening a floodgate of manipulation.[5] Rather than solve transfer pricing manipulation in Kenya, the guidelines have created a vacuum in legal and institutional regulation of transfer pricing.

1.3. Significance of the Study

The decision of the court in the Unilever case in applying the OECD guidelines to resolve the dispute highlighted a lacuna existing with respect to the regulation of transfer pricing in Kenya. As a result, it is necessary to carry out a case study of the case as well as its aftermath to establish the adequacy of the Kenyan legal framework for regulation of transfer pricing.

This study appraises the legal and institutional framework on transfer pricing in Kenya and evaluates whether or not it is adequate and effective for its purpose. The findings of the study are expected to form the basis for proposals to strengthen the legal and institutional

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[4] See Price Waterhouse Coopers (2011), *Transfer Pricing*, available at: http://www.pwc.com/ke/en/publications/transfer-pricing.jhtml, (last accessed 20th November 2011).
[5] *Ibid.*

framework for transfer pricing in Kenya to help in the quest to tame rogue 'tax avoiding' MNCs in Kenya.

Although Kenya is a non-member state of OECD, yet, it has adopted the OECD guidelines. This strongly suggests that these guidelines provide the foundation of the approach taken in transfer pricing issues in Kenya. Therefore, an analysis of the manner and extent to which Kenya has adopted the OECD guidelines on transfer pricing will substantially contribute towards, taxpayers understanding the application of current policy and the improvement of the existing regime.

The study also makes recommendations which, if acted upon, will contribute to transforming the existing regime and make it more relevant and acceptable. The extent to which the existing regime effectively serves the interests of the stakeholders is a central criterion in determining relevance. Hence, this study will clarify the law on transfer pricing as well as make recommendations which if taken up will contribute to reforming the existing regime.

.4. Research Approach

1.4.1 Objectives of the study

Main Objective

The main objective of the study is to critically analyze the legal and institutional framework of transfer pricing in Kenya by applying the Unilever Case and its aftermath as a case study.

Specific Objectives

The study has the following specific objectives:

a) To analyze the court's decision in the Unilever case.
b) To critique the action taken by the KRA in the aftermath of the Unilever case in adopting the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2006.

c) To evaluate the adequacy of the current legal and institutional framework for transfer pricing in Kenya.

d) To make proposals for reforms towards adequate legal and institutional framework for transfer pricing in Kenya.

1.4.2 Research Questions

This study will seek to answer the following questions:

- Did the court in the Unilever case err in its decision to apply the OECD guidelines?
- Was the decision of KRA in the aftermath of the Unilever Case decision to institutionalize the OECD guidelines justified?
- Is the current legal and institutional framework on Transfer Pricing in Kenya adequate?

1.4.3 Hypotheses

a) The abuse of transfer pricing has limited the benefits accruing from foreign direct investments in Kenya.

b) Kenya needs to strengthen both its legal and institutional framework for transfer pricing as the current one which is based on the OECD Model guidelines is inadequate.

1.5. Conceptual Framework

International trade is facilitated by information technology, transportation, communication, removal of tariff and non tariff barriers and easy cross border movement of goods and services. Underlying all these are various agreements reached by countries including those entered into under the World Trade Organization (WTO).[6]

In this regard, the concept of Multi-National Corporations (MNCs) becomes very important in international trade. MNCs are the biggest players in the global front, carrying out much

[6] Malik Muhammad Khalid (2006), '*Tax Avoidance by Multinational Enterprises through Transfer Pricing,*' p. 6, available at: http://dgtrdt.gov.pk/Research/TAX%20AVOIDANCE.pdf, (last accessed 24th November 2011).

of international trade.[7] The concept refers to a corporation that has its facilities and other assets in at least one country other than its home country. Such companies have offices and/or factories in different countries and usually have a centralized head office where they co-ordinate global management. Very large multinationals have budgets that exceed those of many small countries.[8]

MNC is also defined as 'an enterprise that engages in foreign direct investment (FDI) and owns or controls value adding activities in more than one country.'[9] They coordinate economic production among a number of different enterprises and internalize this coordination problem within a single firm structure. Similarly, a significant portion of the economic transactions connected with this coordinated activity take place across national borders. These attributes result in complexities in the running of MNCs affairs which in turn present challenges to regulators in respect to transfer pricing issues.

The tax implication of transactions and business carried out beyond borders concern both the MNCs and tax authorities.[10] These concerns arise with respect to transactions carried out between and amongst group companies otherwise known as related entities. The transfer price used may become a tool of shifting profits from one tax jurisdiction to the other depriving the source countries their fair share of income/corporate tax.[11] Consequently countries have heightened surveillance and scrutiny over business conducted by MNCs with the intention of avoiding tax.

This then introduces the concept of Transfer Pricing (TP) in international business. TP refers to the price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company, in order to

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[7] Muchlinski Peter (1999), *'Multinational Enterprises and the Law,'* (Blackwell Oxford, UK and Cambridge, USA,) p.12

[8] See definition at: http://www.investopedia.com/terms/m/multinationalcorporation.asp#axzz1emXf8xot, (last accessed 23rd November, 2011).

[9] John H Dunning (1996), *"Re-evaluating the Benefits of Foreign Direct Investment," in Companies without Borders: Transnational Corporations in the 1990s'*, edited by UNCTAD. (London: International Thomson Business Press), p. 73-101.

[10] Steyn Maxi (2003), *'Foreign Branch Operations in a Globalised Environment: A South African Income Tax Perspective: (Part II)'*, Southern African Business Review, p. 56, available at: http://www.unisa.ac.za/contents/faculties/service_dept/docs/Sabview_Vol-7_2.pdf, (last accessed 24th November 2011).

[11] *ibid*, p. 57

calculate each division's profit and loss separately.[12] The UN defines transfer price as the value attached to transfers of goods, services and technology between related entities such as partner and subsidiary corporations and brother/ sister corporations.[13] The 1995 OECD report defined transfer pricing as, *'the transfer prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.'*[14]

A recent survey indicates that MNCs are facing new tax challenges due to growing number of authorities putting in place transfer pricing (TP) requirements. Further, the survey points to an increased regulation of TP. Managing transfer pricing risks concern multinational corporations especially in relation to TP documentation, adjustments and penalties meted out on multinationals in case of an adjustment.[15] MNCs see TP as the most important tax issue facing them today.[16]

The activities of MNCs have been subjected to scrutiny in order to monitor trans-jurisdictional transactions to curb against any TP manipulation. This is intended to protect a country's share of taxable income.[17] To counter this, MNCs have and or will need to develop transfer pricing policy and make sure they adhere to best practices in documenting TP decisions.[18]

In order to meet budgets deficits, regulatory organs are busy sharpening their focus on compliance, enforcement and legislative approaches. High profits and losses in group

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[12] See Kurham (2000), *'General Concept of Transfer Pricing,'* p. 1, available at: http://www.hmaconsultants.com/pdf/t-price.pdf, (last accessed 24th November, 2011).

[13] See United Nations (1979), *'Model Double Taxation Convention between Developed and Developing Countries,'* (ST/SG/AC.8/L.29), p. 3, available at: http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf, (last accessed 24th November 2011).

[14] OECD Report (1995), *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,'* p. 9, available at: http://www.oecd.org/document/34/0,3746,en_2649_33753_1915490_1_1_1_1,00.html, (last accessed 24th November, 2011).

[15] Ernst & Young (2009), *'Precision under Pressure, Global Transfer Pricing Survey 2007-2008'*, p. 4 and 5, available at: http://www.ey.com/Publication/vwLUAssets/Precisionunderpressure/$File/Precisionunderpressure.pdf, (last accessed 24th November 2011).

[16] *ibid*, p. 5.

[17] *supra*, note 10, p. 57.

[18] Bhar Meeta (2009), *'Growing Transfer Pricing Scrutiny by World's Tax Authorities creates new Challenges for Multinationals'*, Ernst and Young News release, Kaula Lampur 28 October 2009, p. 2, available at: http://www.ey.com/RU/en/Newsroom/News-releases/Press-Release---2009-09-29, (last accessed 24th November, 2011).

companies, high inter-company management fees, dealing with a group company in a tax haven, being located in a low cost country along with other hosts of red flags invites a regulatory audit and investigation.[19] This is only possible by utilizing the concept of economic cooperation.

The concept of economic co-operation means, "a series of actions that attempt to coordinate or join efforts to achieve common objectives in entrepreneurial, industrial, financial or productive policies among several countries on the international sphere.'[20] This entails creating organizations with cross-border jurisdiction to address common challenges on the economic front. At the centre of transfer pricing regulation through economic cooperation is OECD, though there are other organizations including United Nations (UN) and the International Bureau of Fiscal Documentation (IBFD) which have contributed on transfer pricing. These bodies set out methods developed in international practice for determining and evaluating taxpayers transfer prices. In the application of the transfer pricing methods most of these bodies endorse the use of the concept of the arm's length principle.

The arm's length principle states that the amount charged by one related party to another for a given product must be the same as if the parties were not related.[21] With most transfer pricing regulations encouraging arms length transactions among various branches of the MNCs, they aim to prevent profits being systematically deviated to lowest tax jurisdictions. MNCs can use transfer pricing manipulation to shift profits from a high taxing jurisdiction to a jurisdiction with a low corporate tax rate or with tax incentives for certain activities.Most TP regulations seek to define what are to be construed as associate companies of MNCs.

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[19] Raby Nick (2009), *'International Transfer Pricing'*, p.4-5, available at: http://www.pwc.com/gx/en/international-transfer-pricing, (last accessed 24th November 2011).
[20] See Chilean Agency for International Cooperation (AGCI) (1999), *'Economic Co-operation,'* p. 3, available at: http://www.agci.cl/docs/biblioteca/documentos_agci/documento_de_trabajo_cooperacion_economica_ingles.pdf, (last accessed 24th November, 2011).
[21] See definition at: http://www.ustransferpricing.com/arms_length_principle.html, (last accessed 24th November, 2011).

The UN endorses the arm's length principle in its comment that a transfer price is not set by an independent transferor and transferee in arm's length negotiations, but is within the discretion of a single enterprise.

Most international organisations agree that the arm's length principle is the standard for determining transfer prices. To that end, arm's length principle is crucial to the determination of a transfer price. However, the arm's length principle is not without challenges which shall be considered in this study. Similarly, there are other methods that have been developed to tackle transfer pricing, including formula apportionment.[22]

MNCs have both internal and external factors that drive them to engage in transfer pricing. Internally, many foreign affiliates are run as profit centres and as a result the rewards of top management in the affiliates depend on their affiliates profits.[23] This is an internal factor to motivate managers and monitor subsidiary performance.[24] Similarly, MNCs may act under pressure to show profits to shareholders in a particular entity by shifting profits to that particular entity.[25] Externally, MNCs are required to pay corporate taxes on their domestic and foreign source income, necessitating that they set prices for cross border trade flows.[26]

The existence of low tax jurisdictions also known as tax havens motivates MNCs to engage in intra-firm shifting of profits. MNCs have no incentive to shift profits if the tax obligations and structures in the home country are the same as those in host or recipient countries.[27] Existence of tax havens is one of the factors that motivate MNCs engagement in transfer pricing manipulation.

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[22] See Bhat Ganapati (2009), *'Transfer pricing, Tax Havens and Global Governance'*, German Development Institute, p 16, available at: http://www.taxjustice.net/cms/upload/pdf/TJN_09_Bhat_Transfer_Pricing.pdf, (last accessed 24th November 2011).

[23] See Li Dan (2007), *'Internal and External Factors on Firm's Transfer Pricing Decisions: Insights from Organisation Studies,'* Indiana University working paper no 6, p 11, available at: http://iconline.ipleiria.pt/bitstream/10400.8/26/1/working%20paper%206_globadvantage.pdf, (last accessed 10th November 2011).

[24] See Eden Lorraine (2001), *'International Taxation, Transfer Pricing and the Multinational Enterprise'*, In Alan Rugman and Thomas Brewer, *Oxford Handbook of International Business*, (Oxford University Press, London, UK.), p. 598.

[25] *supra,* note 23, p. 8

[26] *ibid,* p. 9.

[27] *ibid,* p. 1.

Open market is another driver of transfer pricing among MNCs. This happens in cases where the affiliates of MNCs are not allowed to purchase inputs in the local market or the inputs are not available in the market.[28] Similarly in cases where their business operation requires specific know-how not available in the market and these have to be transferred from the group. This presents an opportunity for MNCs to manipulate prices with the view of shifting profits.[29]

Specific government economic-policy-related factors going beyond tax-related transfer pricing considerations may also motivate a MNC to manipulate transfer prices in a manner that affects the host or home country adversely. These ranges from concerns about repatriation policies, the extent of the exchange risk, asset capitalization policies, anti-monopoly charges, dumping charges, cost-sharing issues, political and policy stabilities.[30] The assessment of the risk of expropriation, business expectations, interest rates etc. is not necessarily guided by taxes. It may so happen that the political regime is in the process of change or amending its policies towards business. To avoid the uncertainty of the future, MNCs may resort to transfer pricing manipulations.[31]

The loopholes or differences in taxation regimes can also be exploited by MNCs to their advantage. Accounting and disclosure requirements differ from one country to the other. In addition, withholding taxes, capital gains tax, dividend taxes and their adjustments differ from one jurisdiction to another. These enable MNCs to plan the repatriation and intra-firm dealings to ensure that they minimise tax obligations.[32]

It is apparent that taxation of MNCs presents a number of problems to revenue authorities. It is therefore important to consider why transfer pricing concerns regulatory organs. These problems faced by revenue authorities are jurisdiction, allocation and valuation.

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[28] United Nations Conference on Trade and Development (UNCTAD) (1999), 'Transfer *Pricing,*' UNCTAD/ITE/IIT/11(vol I), p 3, available at: www.unctad.org/en/docs/psiteiitd11v1.en.pdf, (last accessed 12th November 2011).
[29] *supra*, note 22, p. 8.
[30] *ibid,* p. 7.
[31] *supra*, note 23, p.12.
[32] *ibid,* p. 11.

Transfer pricing concerns Tax authorities because they see transfer pricing as a soft target with the potential to produce very large increase or decrease in tax revenues. Similarly, there is a view that income earned in a jurisdiction should be taxed within the same jurisdiction. Transfer pricing motivates regulatory organs to come up with measures that jealousy guard their tax base.[33]

Transfer pricing can directly affect the amount of profit reported in a country by a MNC, which in turn affects the tax revenues of that country. Of concern to regulatory organs is transfer price manipulation and not transfer pricing.[34] The governments driven by this motive have put in place measures to address transfer pricing manipulation.

The quadruple concepts of multinational corporations, transfer pricing, economic cooperation and arms length transactions thus inform this study. They underpin the discussion and development of thought in this study.

1.6. Literature review

According to Risper M. Mwangi,[35] the confusion in transfer pricing regulation in Kenya has been brought about by the transfer pricing rules of 2006. The thesis discusses the Kenyan law on arms length principle of transfer pricing and its applicability. It also analyses the cost plus method of achieving arms length principle and its practicability. Similarly the thesis discusses the judgment in Unilever case and its contribution to the arms length principle.

This study is significantly different from the above thesis though sharing some perspectives. The present study considers the provisions in Kenyan law from a MNC perspective in respect to fiscal documentation and other administrative approaches to transfer pricing. This study discusses the Kenyan provision on transfer pricing and its deficiencies in addressing requirements of documentation. Though this study points out other areas of deficiencies, the major concern is on fiscal documentation and

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[33] *supra*, note 23, p. 1.
[34] *supra*, note 24, p. 598.
[35] Risper M. Mwangi, *"Transfer Pricing: Does Kenya's Tax Law Provide Adequately for This?"* University of Nairobi LL.M Thesis, 2008 (Unpublished).

recommendation on other alternative and administrative means of resolving transfer pricing disputes.

This study discusses the arms length principle as provided for under the OECD guidelines and the extent to which this principle is suitable to Kenyan situation. As pointed out in the theoretical framework, a legislative framework to be adopted should take a hybrid of OECD and UN approaches including customizing them to fit situation in Kenya. It is a *sui generis* approach.

Finally, this study analyzes the Unilever case with the view of succinctly explaining the *contra preferentum* rule as it applies to fiscal laws. It discusses the legal force of OECD guidelines and Kenyan transfer pricing guidelines. These are some of the points of divergence between this study and the above study. To this end this study is a significant venture as it points out the manner in which OCED guidelines were adopted in Kenya and the deficiencies that are existing ensuing from the quick 'reaction' from the KRA.

Raby Nick in his book[36] provides an up to date general guidance on transfer pricing. He provides an up to date discussion on documentation requirements and the formulation of transfer pricing policy. The book discusses the arms length principle, the factors that can trigger transfer pricing audits, transfer pricing policy and transfer pricing methodologies. The book discusses in depth maintaining of an up to date transfer pricing policy and documentation. Similarly, it gives also the status of transfer pricing legislation and regulation in many countries where PWC has a presence.

Further, the book outlines the statutory provisions and case law on transfer pricing. It points the areas of inadequacies and the anticipated actions from the government. However, it does not discuss the reasoning behind the decision in Unilever case nor does it discuss the rationale of applying OECD guidelines in Kenya. The book, also, does not address the challenges facing the application of arm's length principle. It focuses on documentation and transfer pricing policy. This study borrows much from this book but also addresses the challenges facing the application of transfer pricing in Kenya. This study

[36] Raby Nick (2009), *'International Transfer Pricing', supra* note 19.

goes further to present a review of Unilever case including the suitability of OECD guidelines to Kenya.

Malik Muhammad Khalid[37] discusses transfer pricing *vis-a-vis* tax avoidance from a multinational enterprises perspective. It considers the tax implications of transfer pricing and the arm's length principle. It also discusses the alternative anti-transfer pricing strategies including transfer pricing adjustments, record keeping, penalty provisions and advance price agreements. The writer argues for the formation of international tax organization (ITO) to manage international taxation and as a dispute resolution centre. The paper proposes adoption of unitary system of taxation.

Unlike the above study, the present study limits itself to considerations of the decision in the Unilever case and the aftermath results with due considerations on the applicability of OECD Guidelines. This study considers applicability of arms length principle and the OECD guidelines to Kenya. These issues were not addressed in the paper above.

Bhat Ganapati[38] evaluates the ways and means available to governments to prevent tax-motivated transfer pricing. Juxtaposed with transfer pricing, tax havens emerge as part of the problem for tax administration. The paper also analyses the magnitude and the impact of tax havens as it is closely linked to transfer pricing. Further, Ganapati discusses the factors that motivate MNCs to engage in transfer pricing. The fourth part analyses the options available for stopping transfer pricing with income shifting as its objective, focusing on the advantages and disadvantages of separate accounting and formula apportionment methods. The fifth part briefly examines the efforts of international tax regimes to plug the loopholes and makes a number of policy recommendations.

This study borrows much from Ganapati's paper and more especially on the problems resulting from transfer pricing and the motivating factors for transfer pricing. However, the study differs from the paper in that, additionally, it addresses the critical issues that were

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[37] Malik Muhammad Khalid (2006), '*Tax Avoidance by Multinational Enterprises through Transfer Pricing,*' LLM paper, Warwick University, *supra* note 6.
[38] Bhat Ganapati (2009), *'Transfer pricing, Tax Havens and Global Governance'*, *supra* note 22.

not considered by the court in defining the applicable law in Kenya and the applicability of the OECD guidelines as they were not addressed in this paper.

Onsando Omari Allan's paper[39] discusses the provisions of S 31 of the South African Income Tax Act[40] which form the basis of transfer pricing legal regulatory regime in South Africa. According to him, the arm's length principle forms the backbone of applying the provisions of the section. In his view, the existing legislation is wide in scope hence difficult to apply on the taxpayer's hand; consequently, in some instances it does not serve its intended purpose.[41]

Further, Omari discusses the South Africa Revenue Service (SARS) practice note No. 7 of 1999 which gives guidance on the determination of taxable income for certain persons from international transactions. According to him, the practice note is largely based on the OECD comprehensive transfer pricing guidelines. These guidelines are found in the OECD Report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1997)[42]

These guidelines have increasingly been adopted by many states. South Africa is a non-member state of OECD Model Tax Convention but has however adopted the transfer pricing guidelines therein. The study examines the OECD transfer pricing guidelines, with a view of analysing the manner and extent to which South Africa has adopted them in its current transfer pricing policy. The unique South African economic situation is taken into account. He argues that the rationale and extent to which such guidelines have been adopted is relevant and critical in determining their efficacy.[43]

The findings of Onsando's study are threefold. Firstly, he finds that the OECD transfer pricing guidelines provide globally accepted standards and methodology by which tax authorities act in common interest to share satisfactorily in the tax which is properly due to them from the taxpayer. Secondly, he shows that South Africa has, to a larger extent,

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[39] Onsando Omari Allan (2007), *"The OECD Transfer Pricing Guidelines: An Analysis of Their Application in the South Africa Legal Regime"*, LL.M Thesis, University of Cape Town, (unpublished).
[40] Act No. 58 of 1962
[41] Supra, note 10, p. 2.
[42] Ibid.

managed to keep abreast with the international developments in transfer pricing and compares favourably with the OECD guidelines. Finally, he shows that the existing legislation has shortcomings with respect to regulation of financial intra-group assistance services especially the characterization of certain intra-group debt for transfer purposes. This suggests deviations from the OECD guidelines. Therefore, he casts doubts on the suitability of the existing law to local circumstances.[44]

The present study borrows from the approach taken by Onsando above save for the fact that the analysis herein is focused in Kenya and is based on case study of the Unilever Case. Similarly, the present study seeks to explore how the adoption of the OECD guidelines has contributed in realizing adequate framework for regulation of transfer pricing in Kenya as well as discussing the limitations that still subsist. It is expected that the present study will make a significant contribution to the discourse on regulation of transfer pricing by showing the significant difference in the regulatory issues in progressive developing country like South Africa in comparison with Kenya.

Miesel and Higinbotham describe the arm's length principle as the price that would be negotiated by independent, unrelated parties in the same circumstances as the sale between the associated entities.[45] They find that the principle is based on a sound economic principle, namely that the competitive market is the best way to allocate resources and reward of risks.[46]

In addition, Miesel and Higinbotham attempt to show that despite the general global acceptance of the arm's length principle as an international transfer pricing standard, that is not without criticism. Firstly, they argue that the arm's length standard does not reflect the economical reality of the MNCs as combined with separate entity approach, it poses a problem since MNCs are often integrated enterprises. It is argued that, this very integration is the reason why suitable economic advantages are gained in areas such as logistics,

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[43] *supra,* note 39 p.37.
[44] *ibid*, p. 83.
[45] Miesel VH and Higinbotham HH (2002), *'International transfer pricing: Practical solutions for inter company pricing'* International Tax Journal, p. 6, available at: http://www.mendeley.com/research/international-transfer-pricing-practical-solutions-for-intercompany-pricing/, (last accessed 24th November, 2011).
[46] *ibid, p. 7*

brand development, risk management and technology. The result they say is that "...*the measures of integration cannot be duplicated in the context of arm's length independent transactions conducted by two non-integrated businesses performing the same or similar functions and selling the same or similar products.*"[47]

Miesel and Higinbotham conclude that, applying the arm's length standard in such cases will involve splitting the MNC into separate parts which brings about ambiguity based on the scale of the economies of integration and the relative profitability of the parties involved.[48]

Further argument made by Miesel and Higinbotham is that the arm's length standard cannot be efficiently applied in some circumstances. An example is where MNEs take part in transactions that independent parties would not undertake, such as where a new associated company is maintained at a loss so as to create market share.[49] These kinds of transactions among MNEs may differ fundamentally from comparable transactions between independent enterprises. Accordingly, the strict application of the arms' length principle would be inappropriate as it will be extremely difficult to find comparable transactions among independent enterprises.[50]

Annet Wanyana Oguttu in her study also expands on the discussion of the criticisms against the arms length principle.[51] In first place, she raises the argument concerning the questionable applicability of the arm's length principle in transactions conducted electronically (e-commerce). She cites the *OECD Report of the Committee on Fiscal Affairs,*[52] which found that e-commerce does not pose new essential problems for transfer pricing, because the same challenges have been prevalent in mail or telephone ordering businesses for many years.[53]

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[47] *supra, note 43* p. 62.
[48] *ibid*, p. 6.
[49] *ibid,* p. 7.
[50] *ibid.*
[51] Annet Wanyana Oguttu (2006), *"Transfer pricing and Tax Avoidance: Is the Arm's Length Principle Still Relevant in the e-Commerce Era",* 18 *SA Merc LJ,* p. 138, available at: http://www.sabinet.co.za//ju_samlj /ju_samlj_v18_n2_a3.html, (last accessed 24th November, 2011).
[52] See OECD (1998), *'OECD and Electronic Commerce: A Discussion Paper on Taxation Issues',* available at: lists.elistx.com/archives/ietftrade/199812/msg00000, (last accessed 24th November, 2011).
[53] *ibid,* p. 145.

However, according to her, the difficulty of applying the arm's length principle arises due to the increasing transactions in an e-commerce and advanced technology environment that has resulted in faster and easier cross-border transactions. For example, there is quicker processing of goods and services, data transmission and increased mobility of goods, services and resources. These factors have made it harder for tax authorities to identify, trace, locate and value transactions on an arm's length.[54]

In her view, due to these difficulties, tax authorities find it problematic to rely on the traditional factors that need to be present in order for a taxpayer to be taxable in a specific jurisdiction. This is because applying the arm's length principle in an e-commerce environment challenges these traditional factors. One such factor is that the arm's length principle is based on the separate transaction approach. Contrary to this, e-commerce makes separate transactions so closely linked that they cannot be assessed sufficiently on a separate basis hence making comparison harder.[55]

Oguttu concludes that, in such circumstances, it becomes difficult to find comparables for determining the value of a single electronic contribution in a highly integrated transaction. This puts pressure on the traditional approach used to deal with non-arm's length transfer pricing. Accordingly, the separate transaction analysis becomes practically unattainable since success will require enormous skilled labour.[56]

However, Oguttu rightly points that although there are practical problems in applying the arm's length principle in certain circumstances, there is a general admission that there has not been any justifiable substitute for the arm's length principle. The arm's length principle is hence accepted to create and ensure the most convenient and stable economic environment for enterprises to operate within.[57]

The present study, based on the criticism of the arms length principle seeks to show the inadequacy of the OECD guidelines adopted in Kenya which are based on it. The

[54] *supra,* note 49, p. 146.
[55] *ibid,* p. 147.
[56] *ibid,* p. 156.

relevance of these criticisms in the Kenyan scenario are explored at length and their implication to the local taxation policy elaborated. The present study will basically seek to contextualize the criticism respecting the arms length to the Kenyan scenario by showing how it applies to make the Kenyan transfer pricing regulatory framework inadequate and ineffective.

Eduardo A Baistrocchi's article focuses on the problem of transfer pricing from an international taxation perspective.[58] It elaborates two major points using game theory as a theoretical framework. First, it argues that both developed and developing countries are facing the same fundamental problem in the transfer pricing arena, namely, the meaning of the arm's length standard (ALS) is increasingly unknowable because of the absence of transfer pricing case law with public good features.[59]

According to Baistrocchi, the ALS goes back to 1928 when developed countries created by consensus the legal fiction of the separate entity approach according to which the different profit units of a given MNC should be deemed independent enterprises. Thus, for example, pursuant to the OECD model, IBM (the parent company based in the US) and each of its subsidiaries (based in a number of other countries) are to be considered to be separate taxpayers for the purposes of national corporate income taxes, rather than one global taxpayer. Developed countries also agreed that the fiction of the separate entity approach should be enforced via the arm's length standard (ALS).[60]

The ALS provides that national tax jurisdiction over income produced by an MNE should be allocated among countries on the basis of how comparable non-associated enterprises would have realized income in comparable circumstances. Thus, if the ALS is not met in a given case, national tax authorities are normally vested with the power to adjust the transfer pricing of associated enterprises to make it consistent with the ALS.[61]

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[57] *supra,* note 49, p. 162.
[58] Eduardo A. Baistrocchi (2006), *"The Transfer Pricing Problem: A Proposal for Simplification",* Bepress Legal Series, Paper 1228; available at: http://law.bepress.com/expresso/eps/1228 (last accessed on 29th October 2011).
[59] *ibid*, abstract.
[60] *ibid*, p. 3.
[61] *ibid*, p. 4.

The problem arises in that the concept of associated enterprises, a structural element of the ALS, is standard-based because its meaning is uncertain *ex ante* are relies on case law for determination. Since the late 1970s, countries have faced severe problems with the enforcement of the ALS because of the emergence of confidential advance pricing agreements (APAs) which have made litigation rare in the context of transfer pricing. As a result, the meaning of the ALS is largely unknowable because of the absence of case law defining it. Therefore, the ALS is unable to provide taxpayers with a clear sense of how they are expected to behave in the legal system in which they operate.[62]

Second, the article proposes a solution to the transfer pricing problem within the ALS framework. The proposal consists of a procedural, rather than a substantive, system in which multilateral advance pricing agreements (APAs) are used to produce a proxy for case law with public good features. The proposal is arguably superior to other options because it can be applied by both developed and developing countries and is consistent with the current structure of international taxation. The proposal has been written to facilitate its addition to Article 9 of the OECD Model Tax Convention on Income and on Capital.[63]

The present study seeks to show how the incorporation of the OECD Transfer Pricing Guidelines by implication incorporates the ALS and the problems of uncertainty associated with it. In turn, this study attempts to apply the solution proposed above to the Kenyan scenario to come up with a framework that makes for easy determination of ALS.

Sunil Arora reviews the law of transfer pricing in India.[64] The article provides a brief overview on the applicability of transfer pricing regulations in India, methods of determining the transfer price and the documentation procedures. Arora notes that increasing participation of multi-national groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same group. Therefore, the need arose to introduce a uniform and internationally accepted mechanism of determining reasonable, fair and equitable

[62] *supra,* note 56 p. 7.
[63] *Ibid*, abstract.

profits and tax in India in the case of such multinational enterprises. This was met by the Finance Act, 2001 which introduced law of transfer pricing in India through sections 92A to 92F of the Indian Income Tax Act, 1961. The amendments guide computation of the transfer price and lays down the framework for detailed documentation procedures.[65]

According to Arora, the scope of applicability of Transfer Pricing Regulations ("TPR") extends to the all enterprises that enter into an 'International Transaction' with an 'Associated Enterprise'. Therefore, generally it applies to all cross border transactions entered into between associated enterprises. It even applies to transactions involving a mere book entry and having no apparent financial impact. The aim is to arrive at the comparable price as available to any unrelated party in open market conditions and is known as the Arm's Length Price ('ALP').[66]

The Indian TP regulations also lay down the basic criterion for determining if a company is an Associated Enterprises (AE). This is provided as the participation in management, control or capital (ownership) of one enterprise by another whether direct or indirect or through one or more intermediaries. The law also clearly defines what amounts to an international transaction as being essentially a cross border transaction between AEs in any sort of property, whether tangible or intangible, or in the provision of services, lending of money etc. At least one of the parties to the transaction must be a non-resident. In addition, the law clearly outlines the methodology of determining ALP and is exhaustive on maintenance of documentation. Issues of the burden proof of tax payers and the tax officer with respect to issues of transfer pricing is also adequately provided for.[67]

It is, therefore, apparent that the Indian TP regime is more comprehensive in comparison with the Kenyan arrangement. Further, although it borrows from the OECD TP framework, the Indian law on transfer pricing is anchored on the substantive law with clear provisions outlining the various issues that may arise in enforcement. Arora's paper is therefore relevant to the present study in that it explores a useful case study, namely, India's legal

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[64]Sunil Arora (2008), *"Law of Transfer Pricing in India"*, available at: http://www.cci.in/upload%5CArticle%5Cfile%5CFileKCKXXZHlaw_transfer_pricing.pdf (last accessed 15th November 2011).
[65] *ibid, p. 6*
[66] *ibid*, p. 8.
[67] *ibid, p. 12*

framework for transfer pricing. The present study utilizes the key point's highlighted in Arora's paper in evaluating whether or not the Kenyan framework for TP measures up to the international standards for regulation of transfer pricing.

Jian Li defines international transfer pricing (ITP) as the process of pricing of goods and services transferred between related companies located in different countries.[68] The research mainly examines the methods used by foreign-owned companies operating locally in New Zealand. Li's report on the ITP methods used and the importance of environmental factors affecting the choice of methods by foreign-owned companies operating in New Zealand.[69]

According to Li, until 1984, New Zealand was something of a command economy. However, since then the New Zealand government has freed prices, wages and interest rates, floated the exchange rate, progressively removed tariffs and subsidies, deregulated the financial system, reduced income tax rates, and encouraged overseas investment in the country. These New Zealand developments are observed as being more radical than those carried out in industrialized countries. Given those dramatic changes in the New Zealand commercial, economic and regulatory environment over the past decades, a study concerned with ITP practices in New Zealand offers an opportunity to better understand connections between the business environment and business practices.[70]

Li's paper provides a background of New Zealand's transfer pricing regulatory framework, which is among the most progressive in the world. In addition, the paper makes key findings which include the fact that the 'full plus fixed profit' is the most popular ITP method used by respondent companies. New Zealand subsidiaries now use market-based transfer prices for international transfers more often than in 1995. In addition, he established that legal considerations were the most important variable considered by the respondent

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[68] Jian Li (2005), *"International Transfer Pricing Practices in New Zealand"* University of Auckland Business Review, p. 59-65, available at: http://www.mendeley.com/research/international-transfer-pricing-practices-in-new-zealand/, (last accessed 24th November 2011).
[69] *ibid,* p. 60.
[70] *ibid*, p.62.

companies. Other important variables included corporate profit of the subsidiary, competitive position of the subsidiary and overall profit to multinational group.[71]

Li's paper also reviews the legal framework for transfer pricing in New Zealand. This is considered a key case study, in this study, in evaluating the TP framework in Kenya. Further, the findings of the empirical research in Li's paper help to point out the important considerations in regulating transfer pricing. Finally, it emerges that the state of the legal framework is a key determinant in guiding the transfer pricing policy of the various multinationals operating in any given jurisdiction, including Kenya.

PricewaterhouseCoopers (PWC) in a recent Handout explores the African transfer pricing landscape.[72] The handout raises and addresses diverse transfer pricing issues relevant to Africa as a whole. It particularly, points that Africa has no uniform tax system and is marked by high effective tax rates and tax uncertainty. Tax system often used to protect income base and investors often seen as not paying fair share of taxes. Tax authorities in Africa have embraced transfer pricing which is now considered as new mechanism to protect local tax base.[73]

The handout notes that Foreign Multi-National Enterprises (FMNEs) operating in Africa are guilty of not paying their fair share of taxes. As a result, many tax authorities in many African countries combat this by levying withholding taxes or using anti-avoidance legislation. However, in the recent days, many African tax authorities have started introducing transfer pricing legislation.[74]

However, MNCs do not yet deem African tax authorities as being able to monitor transfer pricing compliance are still persisting in transfer pricing practices. This is because there is few or no specific legislation or guidance. Further, the tax authorities lack extensive experience as well as extensive treaty network laying down clear dispute

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[71] *supra*, note 66, p. 65

[72] PricewaterhouseCoopers (2008), *"African Transfer Pricing Landscape",* A handout Presented at the Business Partners in Africa Conference held at Cairo in September 2008, available at: https://www.africatax symposium.co.za/downloads/Africa_Transfer_Pricing_latestEmergingMarket.pdf (last accessed 20th October, 2011).

[73] *ibid, p. 3.*

[74] *Ibid, p. 2.*

1.7.1. Scope and Limitations

The primary focus of this study is limited to consideration of the decision in Unilever case and its impact in Kenya. This study explores whether the OECD guidelines are suitable for Kenyan situation and more especially the way forward after the decision in Unilever case. The study is limited to Kenyan legal and institutional framework although reference is made to other jurisdictions for guidance. The study is also limited by lack of experienced and trained professionals on transfer pricing in Kenya.

1.8. Chapter breakdown

The study is broken down into the following chapters:-

Chapter One: Introduction to Transfer Pricing in Kenya

Chapter one introduces and discusses, in general, the concept of transfer pricing and related concepts such as Transfer Pricing Manipulation (TPM). The chapter also highlights, *inter alia*, how transfer pricing impacts on the taxation policy and the economy of Kenya. In addition, the Chapter covers the background of the study, the statement of the problem, significance of the study, the research approach, theoretical framework, literature review, research methodology, scope and limitations.

Chapter Two: The OECD pproach to Transfer Pricing

The arm's length principle as enunciated by the OECD guidelines underlines the focus of this chapter with consideration of provisions under Kenyan law. This chapter discusses the OECD approach to transfer pricing and the application of the arm's length principle in determining transfer prices. The discussion is limited to the arm's length principle, guidance for its application, its weaknesses, the methodology of applying the principle and suggested approaches available for resolving transfer pricing disputes.

This chapter also includes a background to the Unilever case as well as a critique of the case majoring on the attempt by the High Court to apply the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2006 which were not law in Kenya at the time. Further, the chapter analyzes the various key findings of the court regarding transfer pricing in Kenya to show that the High Court did "the unthinkable in interpreting the relevant tax statute" as it did in the case.

Chapter Three: The Legal and Institutional Framework of Transfer Pricing in Kenya

This chapter appraises the legal and institutional framework on transfer pricing in Kenya and evaluate whether or not it is adequate and effective for its purpose. In particular, a critically analyses the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2006 which was enacted wholesale by the KRA to find out if it is suited to the circumstances of the Kenyan taxation environment.

Chapter Four: Conclusion and Recommendations

This Chapter draws conclusions and makes a summary of the key findings made in the study based on the hypotheses in an effort to find out whether the hypotheses set out for the study are confirmed or negated. It also makes suggestions for further studies and dealing with legal challenges relating to transfer pricing highlighted in this study.

CHAPTER TWO: THE OECD APPROACH TO TRANSFER PRICING

2.1 Introduction

Kenya's transfer pricing regulation is underpinned on Arm's Length Principle[76] and the OECD guidelines.[77] The arm's length principle has been enacted into the Kenyan legal framework via Section 18(3) of the ITA and The Transfer Pricing Rules of 2006. This provision requires a multinational to adopt the price that may have arisen had its controlled transaction been governed by normal market forces. The arm's length principle is based on comparing arm's length transactions in the market which have been effected in similar circumstances between comparable parties in uncontrolled situations.

However, it is a challenge as shall be discussed in this chapter to determine transactions which are similar as there may be virtually no similar transaction in practice. Similar circumstances or situations are a challenge to obtain as well.[78]

This chapter argues that arm's length principle as provided by the OECD guidelines and the transfer pricing rules is at best attractive and poor on application. With this weakness of the arm's length principle, this chapter considers the alternative dispute resolution methods for transfer pricing that are available for regulatory authorities and taxpayers. This chapter focuses on the applicability and the drawbacks of the Arm's length principle, how it affects transfer pricing in Kenya and the way forward.

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[76] See Annet Wanyana Oguttu, *"Transfer pricing and Tax Avoidance: Is the Arm's Length Principle Still Relevant in the e-Commerce Era," supra* note 49, p. 139.
[77] *ibid*, p. 140.
[78]The1995 OECD Guidelines advise on the application of the arm's length principle. They insist on a comparability analysis, where the issues compared are the types of property or service involved in the transaction. The functions performed, risks taken and assets employed should be similar when comparisons are made. Contractual terms, economic circumstances and the business strategies of the parties compared need to be understood. This comparability analysis must take into account the actual transaction that has taken place in the market. The use of multiple-year data is allowed for comparison purposes. Other factors, such as intentional setoffs of various transactions and the impact of government policies on the decision taken must also be compared and considered. Various transfer pricing methods are used to apply the arm's length principle.

2.2 The OECD approach

Structure and membership of the OECD

The Organisation for Economic Co-operation and Development (OECD) came into operation on the on the 14th December 1960 when the OECD convention was signed. Originally twenty countries signed the Convention and afterwards, fourteen more countries have become members making a total of 34 member states.[79] The OECD was established in 1961 as an economic counterpart to the North Atlantic Treaty Organization (NATO) with the aim to assure growth and employment in its member states.

The objective of the OECD was to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy. Further, the OECD was to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development and contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations."[80]

The structure of OECD consists of three main elements, namely, the OECD Council, Committees and the OECD Secretariat. The OECD Council is made up of member states, each represented by a delegation led by an ambassador and its role is provide direction and guidance to the work of Organization. The OECD has Committees for each work area of the OECD. The Committees oversee all the work on each theme such as publications, task forces and conferences.[81]

The OECD Secretariat, which is led by the Secretary-General, provides support to the Committees. The OECD has an economic intelligence functions and also operates as a

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[79] For a more detailed history of OECD, see the OECD website at: www.oecd.org, (last accessed 24th November, 2011).
[80] See Article 1 of, '*Convention on the Organisation for Economic Co-operation and Development,*' available at: http://www.oecd.org/document/7/0,3746,en_2649_201185_1915847_1_1_1_1,00.html, (last accessed 23rd November, 2011).
[81] *ibid.*

forum within which countries can discuss and share national experiences, identify best practices and find solutions to common problems. Indeed, the OECD has been maintaining a working relationship with over 70 non-member economies. Essentially, the OECD brings together the governments of countries committed to democracy and the market economy from around the world to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development, contribute to growth in world trade. Further, the Organisation provides a setting where governments compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies.[82]

Over the years, the OECD has become one of the world's largest and most reliable sources of comparable statistics and economic and social data. As well as collecting data, it monitors trends, analyses and forecasts economic developments and researches social changes or evolving patterns in trade, environment, agriculture, technology, taxation and more.[83]

Most of its life, the OECD has focused almost exclusively on its member states. However, in recent years it has started to expand its scope of activity. It now cooperates with another 100 countries in transition (mainly in Central and Eastern Europe) and with countries in Latin America and Asia. The OECD offers advice and makes recommendations to its member states and associated countries to help define their national policies. Indeed, the OECD sees itself in "a prominent role in fostering good governance in the public service and in corporate activity. By deciphering emerging issues and identifying policies that work, it helps policy-makers adopt strategic orientations."[84]

Nevertheless, OECD remains an intergovernmental organization with a limited membership, namely of highly industrialized countries, and with a particular interest, which is economic prosperity of its member states. The decision-making power of OECD lies within the OECD Council, which is made up of one representative per member country plus

[82] OECD (2010), *"Self-portrait of the OECD"*, available at: http://fds.oup.com/www.oup.com/pdf/13/9780199591145_chapter1.pdf (last accessed 14th November, 2011).
[83] *ibid.*
[84] *supra*, note 77.

a representative of the European Union (EU) who are mainly tasked with looking into the interests of their member countries.[85]

As a matter of fact, while most of the Model Conventions, Laws and Guidelines emanating from OECD are suited for its member countries need to be customised to fit the regulatory environment in developing countries. Thus, Kenya ought to have customised the OECD Model Transfer Pricing Guidelines to make them more precise and easily enforceable. For instance, enactment more detailed transfer pricing rules which entail contemporaneous documentation requirement. This ensures more accurate and accurate documentation than that prepared retrospectively as required by the OECD Model Guidelines.

2.2.1 Arm's length principle

It is important to point out at the outset that the existence of MNEs is driven by the need to gain advantages of operating as large scale economies. This need to accrue the advantages of large scale economies forms that background of the requirement that MNEs work in an integrated approach. The reason for pointing this out from the outset is because the arms length principle is largely based on independent parties transacting at arm's length. This may not be possible to be applied to related parties such as MNEs because they are a number of companies integrated as one.

The arms length principle is stated in paragraph 1 of Article 9 of the OECD Model Tax Convention.

> *'[When] 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 enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'*[86]

[85] *supra,* note 80, p. 44.
[86] See Article 9 of the *OECD Model Tax Convention*, available at: http://www.oecd.org/document/37/0,3746,en_2649_33747_1913957_1_1_1_1,00.html, (last accessed 23rd November, 2011).

An arm's-length transaction is one which the result is the same as if independent parties had negotiated a price to buy or sell the product.[87] An Arm's length transaction is a transaction in good faith in the ordinary course of business by parties with independent interests commonly applied in areas of taxation when there are dealings between related corporations, e.g. parent and subsidiary.[88]

Arm's length principle is a known separate entity approach because transactions within an MNC group are separated, each entity being considered an independent entity in the market and its transactions with related entities being treated as if they were unrelated and separate. These transactions are in turn compared to arm's length transactions in the market which have been effected in similar circumstances between comparable parties in uncontrolled situations.

The OECD Guidelines state that the arm's length principle should govern the evaluation of transfer prices among associated enterprises because it is sound in theory since it provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises.[89]

The OECD guidelines set out for its member states the use of arm's length principle which is used to determine transfer prices for tax purposes.[90] This is set out as follows:

> "*where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have 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.*"[91]

The OECD guidelines state that the arm's length principle grants states the right to adjust the profits of associated companies to reflect an arm's length profit and this should be done

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[87] Bhat Ganapati (2009), '*Transfer Pricing, Tax Havens and Global Governance*', supra note 22, p. 11.
[88] See Black, H C, *Black's Law Dictionary* 6th ed (1990), p. 109.
[89] *supra*, note 85, p. 13.
[90] See Article 9 of the OECD Model Tax Convention, *supra*, note 84.
[91] *ibid.*

as if the parties were independent of each other.[92] This provision under OECD guidelines guides related parties and the tax authorities to ensure that the conditions of parties dealing at arm's length are met for transactions between such related parties.

Surveys done suggest that there is general international consensus that the arm's length principle has become the international transfer pricing standard of most countries and of almost all tax treaties.[93] This means that the principle is well applied by the tax authorities and probably the most preferred method of determining transfer prices.

2.2.2 Computation of Arm's length price – OECD'S Approach

Having discussed that the arm's length principle is the internationally accepted mode of determining a transfer prices; we shall proceed to consider the recommended OECD methods of determining the arm's length price.

The methods for determination of arm's length prices under Kenyan laws were adopted from the guidelines provided by the OECD. Arm's length price means a price that would be obtainable had the transaction taken place between independent parties in uncontrolled conditions. The Income Tax Transfer Pricing Rules provide five specific methods prescribed for computing arm's length price. These methods are as follows:[94]

a) Comparable uncontrolled price method.
b) Resale price method.
c) Cost plus method.
d) Profit split method.
e) Transactional net margin method.
f) Any other method as may be determined by the Commissioner.

The application of the arm's-length principle relies on two basic concepts of "independence" and "comparability". In setting out the definition of the arm's-length principle, the OECD Guidelines state: "Application of the arm's-length principle is generally

[92] See OECD (1997), *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'*, chap I par 17, available at http://www.oecd.org/document/34/0,3746,en_2649_33753_1915490_1_1_1_1,00.html, (last accessed 24th November, 2011).

[93] Maxi Steyn (2003) *'Foreign Branch Operations In a Globalised Environment: A South African Income Tax Perspective',* (Part II) *supra* note 10, p. 60.

based on a comparison of the conditions in a controlled transaction with the conditions in transactions between "independent" enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently "comparable."[95]

(a) Comparable uncontrolled price method

Under this method, the first step is to identify the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction.[96] Then such price is to be adjusted on account of differences, which could materially affect the price in the open market,[97] if any, between the transactions being compared or between the enterprises entering into such transaction.[98] Such adjusted price can be called an arm's length price computed under this method.[99]

(b) Resale Price Method

Under this method, the first step is to identify the price at which property purchased or services obtained by the enterprise from an "Associated enterprise" is resold or are provided to an unrelated enterprise.[100] From such resale price, the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from same or similar transaction is to be reduced.[101] The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the said transaction.[102] Then such price is to be adjusted to take into account the functional and other differences, including

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[94] Rule 7 of, *'Income Tax (Transfer Pricing Rules) 2006,' supra* note 3.
[95] See Article 9 of the, *'OECD Model Tax Convention,' supra* note 84.
[96] Muhammad Khalid Malik (2006), '*Tax Avoidance by Multinational Enterprises through Transfer Pricing,'* p. 25, *supra* note 6.
[97] See Chris Adam and Peter Graham (1999), '*Transfer Pricing: A UK Perspective*", (Butterworths, London, Edinburgh & Dublin) p. 11-12.
[98] See OECD *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,'* p.11 -15, *supra* note 90.
[99] See, *Income (Transfer Pricing) Rules, 2006*, the comparable uncontrolled price (CUP) method, in which the transfer price in a controlled transaction is compared with the prices in an uncontrolled transaction and accurate adjustments made to eliminate material price differences;
[100] Tristan Sacha Lord (2008), '*Transfer Pricing in South African Income Tax Law,'* p. 15, a Dissertation for Post Graduate Diploma in Income Tax Law, p. 20, available at: http://hdl.handle.net/2165/320, (last accessed 17th November 2011).
[101] *ibid*, p. 17.
[102] *ibid, p. 19.*

differences in accounting practices, which could materially affect the amount of gross profit margin in the open market, between the transactions being compared or between the enterprises entering into such transactions. Such adjusted price can be called an arm's length price computed under this method.[103]

(c) Cost plus method

Under this method, the first step is to determine the direct and indirect cost of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise. The next step is to determine the normal gross profit mark-up to such costs computed according to the same accounting norms of the enterprise or unrelated enterprise in connection with the same or similar comparable uncontrolled transaction.[104] The said normal gross profit mark-up is to be adjusted on account of functional and other differences if any, which could materially affect such profit mark-up in the open market, between the transactions being compared or between the enterprises entering into such transaction.[105] Such profit mark-up is to be added in the cost calculated as per the first step. The sum so arrived at can be called an arm's length price computed under this method.[106]

(d) Profit split method

Under this method, the first step is to determine the combined net profit of the "Associated enterprise" arising from the international transaction in which the enterprises are engaged. After that the relative contribution made by each of the associated enterprise the combined net profit is evaluated on the basis of the functions performed, assets employed or to be employed, reliable external data and risks assumed by each enterprise The combined net profit is then split amongst the enterprises in proportion of their relative contributions and

[103] See, *The Income (Transfer Pricing) Rules, 2006*, the resale price method, in which the transfer price of the produce is compared with the resale price at which the product is sold to an independent enterprise;
[104] See Brian J. Arnold and Michael J. McIntyre (2002), *'International Tax Primer'*, 2nd Edition, (Kluwer Law International, the Hague/London/New York), p. 62.
[105] Chris Adam and Peter Graham (1999), *'Transfer Pricing: A UK Perspective', supra* note 95, p. 21.
[106] See, *'The Income (Transfer Pricing) Rules, 2006'*, the cost plus method, in which costs are assessed using the costs incurred by the supplier of a product in a controlled transaction, with a mark-up added to make an appropriate profit in light of the functions performed, and the assets used and risks assumed by the supplier;

such apportioned profit shall be taken into account to arrive at the arm's length price in relation to the international transaction.[107]

Under this method, if required, firstly, the combined net profit may be partially allocated to each enterprise on the basis of basic market return for similar types of transaction by independent enterprises and thereafter the residual net profit may be split amongst the enterprises in proportion to their relative contribution and the total of both shall be taken to be the profit arising to the enterprise from the international transaction.[108]

In this method, each side's contribution to combined profit or loss is evaluated.

(e) Transactional net margin method

Under this method, first the net profit margin realized by the enterprise from an international transaction entered into with an "Associated enterprise" is computed in relation to costs incurred or sales effected or assets employed or to be employed or any other relevant base. Then the net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction is computed with regard to the same base.[109] Such net profit margin arising in comparable uncontrolled transactions is to be adjusted on account of differences if any, which could materially affect the net profit margin in the open market, between the transactions being compared or between the enterprises entering into such transaction. Then, the net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is established with the net profit margin computed out of comparable uncontrolled transaction and the net profit margin thus established, shall be taken into account to arrive at the arm's length price.[110]

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[107] See, *'The Income (Transfer Pricing) Rules of 2006'*, the profit split method, in which the profits earned in very closely interrelated controlled transactions are split among the related enterprises depending on the functions performed by each enterprise in relation to the transaction, and compared with a profit split among independent enterprises in a joint venture;
[108] *supra*, note 104.
[109] See, *'The Income (Transfer Pricing) Rules, 2006,'* the transnational net margin method, in which the net profit margin attained by a multinational enterprise in a controlled transaction is compared to the net profit margin that would have been earned in comparable transactions by an independent enterprise.
[110] *ibid.*

(f) Other methods

The Income Tax (Transfer Pricing) Rules of 2006 provides that the Commissioner can prescribe another method of determining arm's length price. He can exercise this power if in his opinion the available methods cannot provide sufficient determination of arms length price.[111] This is the section that can be used by the taxpayers to enter in advance pricing agreements with KRA.

2.3 Factors to be considered for comparability transactions

In defining arm's length principle, the OECD guidelines states that the application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between "independent" enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently "comparable."[112]

In order to apply arm's length principle, there should be present situations and circumstances that are comparable. To meet the requirement of comparability, any differences that may arise between the situations being compared cannot be such that the circumstance being examined in the method is materially affected, and there is no possibility of a reliable adjustment being made. There are many factors that can affect the assessment of comparability, such as the features of goods and services, the importance of functions performed the economic circumstances, and the business strategies.[113]

OECD guidelines provide a number of factors that can be taken into consideration in determining arm's length price.[114] These include: similarity of characteristics of goods and services, functional analysis of the transaction [i.e. functions performed by the entity including assets used/economical activities undertaken (like design, manufacturing,

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[111] See Rule 7(f), *Income Tax (Transfer Pricing) Rules, 2006.*
[112] See OECD *'Transfer Pricing Guidelines'* cited in Paul Balkus et al (2005), *'Using Comparables With Significant Inter-Company Sales,'* (7th Edition), p. 15, available at *http://www.kpmgtaxwatch.com/pub/intl/ TransferPricingGuide,pdf,* (last accessed 3 September, 2011).
[113] *ibid.*, p. 18.
[114] See OECD, *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,'* p. 9-15, *supra* note 90.

assembly, research and development etc) and risk involved (like market risks, risk of loss with investment and property, credit risks, exchange risks and interest rate variability etc)], analysis of contractual terms, analysis of economic circumstances/market comparability like geographic location and size of market, extent of competition, availability of substitute goods and services, level of demand and supply, consumer purchasing power, production cost, date and time of transactions etc and analysis of business strategies like innovation and development of new product, degree of diversification etc.[115]

2.4 Setbacks of the arm's length principle

The arm's length principle and it application has been generally accepted as an international standard for determining transfer price between related entities. Even with this there are criticisms that have been leveled against arm's length principle. There are problems associated with arm's length principle which include the comparability analysis, time lapse, economic realities of arm's length pricing and the concept of open market operation which are discussed below:

2.4.1 Comparability analysis

The application of the arm's-length principle relies on the two basic concepts of "independence" and "comparability". In setting out the definition of the arm's-length principle, the OECD Guidelines state: "Application of the arm's-length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between "independent" enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently "comparable".[116]

Independence is required, as only independent transactions/companies can ensure that arm's-length conditions are met, while the conditions of related-party transactions might be

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[115] *supra*, note 112, p. 16.
[116] See Article 9 of the, *'OECD Model Tax Convention,' supra* note 84.

imposed by one of the parties involved and deviate from market conditions.[117] In some cases, it is impossible to identify transactions/companies that are both independent and highly comparable. This might happen, for instance, in sectors where the supply is highly concentrated, the production highly specialized or where the operators are subject to strict regulations, such as the pharmaceutical or automotive sectors.[118]

To test whether controlled transactions satisfy the arm's length standard, MNCs or parties must use an approved transfer pricing method.[119] All four methods (comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method) prescribed by the OECD and provided for under the Kenya's transfer pricing rules hinge on the comparability analysis. Comparability analysis is dependent on determination of prices under which a third party would charge under similar circumstances. The problem of comparability analysis is that of ascertaining consistent facts which to measure a transaction and also obtaining reliable data for comparison analysis.[120]

There is lack of comparable data on aspects which characterize and support the use of external data for comparisons.[121] Publicly available data that can be used for comparisons are not adequate for comparisons as they do not provide sufficient information on contractual specifics and the relevant transactional context.[122] It is hard to find transactions which are similar in contractual and transaction context. Related party transactions and independent party transactions cannot have the same circumstances and can be said to be un-comparables because they do not have adequate attributes.[123] Consequently, the application of arm's length based on the grounds of comparability is a complex process which may lead to flawed results.

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[117] Paul Balkus, '*Using Comparables with Significant Inter-Company Sales*,' p. 31 available at: www.internationaltaxreview.com, (last accessed 2 September, 2011).

[118] *ibid, p. 33.*

[119] See, rule 7 of the, '*Income Tax (Transfer Pricing Rules), 2006*', setting out the various methods. These have been discussed above in this paper, pp. 35-38.

[120] See Steve Fortier (2009), '*Comparables: Geographic Market and Other Factors*', p. 26 available at: www.internationaltaxreview.com, (last accessed 2 September, 2011).

[121] See Brem Markus and Tucha Thomas (2005), '*On Transfer Pricing: Conceptual Thoughts on the Nature of Multinational Firm*', Indian Institute of Management, p. 5, available at: http://ideas.repec.org/p/iim/iimawp/wp01915.html, (last accessed 22nd November 2011).

[122] *ibid, p. 7.*

[123] *ibid, p.8.*

For a small market like Kenya, the use of comparables is even harder. This is because, comparables that could be used relate to a small set of comparables, small number of parties or companies. One of the unfortunate results of focusing exclusively on local market comparables is the reliance upon very small sets of comparables, sets which may be limited to three companies or four companies, or even less. Such very small sets of comparables present several inherent difficulties.[124]

Information asymmetry is a major issue, and neither tax authorities nor taxpayers can use hindsight to justify a transaction that has already occurred. In small economies like Kenya, data is not available as they are available for advanced economies. This makes the application of comparables even harder. The problem with the application of arm's length principle is complicated by a lapse of time between the date of transfer pricing adjustments and the date of actual transaction.

2.4.2 Time lapse

Transfer pricing adjustments come after the transactions between related entities have already been completed. This poses great risk to MNC's since adjustment may be done and penalties are levied on the tax payer. Transfer pricing adjustments is not contemporaneous with the individual transactions between related parties. This means that there is a time lapse between the date of actual transactions and transfer pricing adjustments. During this period the circumstances under which the transaction was conducted and the circumstances obtaining at the time of transfer pricing adjustments will have changed. It can be worse if the there are significant changes of circumstances.

It is difficult to prove, after a lapse of time, that a transaction that has taken place was in fact effected at arm's length.[125]

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[124] *supra*, note 13, p. 56.
[125] See Bhat Ganapati (2009), '*Transfer Pricing, Tax Havens and Global Governance*', *supra* note 22, p. 15.

2.4.3 Economic reality of applying arm's length

There is a developing jurisprudence that the application of this principle does not reflect the economic realities of MNC's.[126] MNC's are integrated enterprises and it would be affront to economic realities to compare transactions of MNC's/related entities with those of independent parties operating at arm's length. It is argued that, this very integration is the reason why suitable economic advantages are gained in areas such as logistics, brand development, risk management and technology.[127] It is pretty hard to hold an integrated enterprise as if it is a non integrated enterprise. Consequently, the application of arm's length principle in integrated MNC's is like splitting the MNC's into separate entities which act against the economic realities upon which MNCs operate. This is not in line with economic realities[128]. From the previous point of comparability analysis, if an MNC's is an integrated body, then it would be difficult to determine arm's length price as if they were operating as independent entities. This would mean that the application of this principle does not make any economic realities and may lead to wrong results.

2.4.4 Open market operation

The open market operation as envisaged by the arm's length principle is largely theoretical than practical. The open market is assumed to be perfectly competitive in this approach, which means there are many buyers and sellers of the same goods and services produced by the MNC's units, and its upstream or downstream units can buy them in the open market[129]. The main feature of MNCs is the fact of integration. It is the basic motivation and tenet to operate as a multinational enterprise which consists of vertical integration and economies of scale[130].

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[126] See Borkowski (2002), *'Electronic Commerce, Transnational Taxation and Transfer Pricing: Issues and Practices,'* 7 International Tax Journal 1, p. 36, available at: http://www.emeraldinsight.com/journals.htm?articleid=1673332&show=pdf, (last accessed 24th November 2011).

[127] Onsando Omari Allan (2007), '*The OECD Transfer Pricing Guidelines: An analysis of their Application in the South Africa Legal Regime'*, LLM Thesis presented at the University of Cape Town, *supra* note 39, p 13.

[128] *ibid, p. 23.*

[129] Bhat Ganapati (2009), '*Transfer Pricing, Tax Havens and Global Governance,' supra* note 22, p. 14.

2.4.5 Introduction to alternative dispute resolution mechanisms

The arm's length prices are often difficult to establish for many intermediate goods and services arm's length standard has become administratively unworkable in its complexity. As a result, the arm's length standard rarely provides useful guidance regarding economic value[131]. This does not negate the fact that arm's length principle is still widely accepted and applied internationally as discussed above.

It can lead to serious double taxation if the tax authorities in two jurisdictions do not agree on the price to be charged. In fact, two tax jurisdictional authorities are unlikely to agree once one of them has increased the taxable income of the MNC, because the taxpayer will ask for a corresponding reduction in the other jurisdiction, causing a loss of revenue for the first jurisdiction. In such a situation, the dispute between the taxpayer and the tax authority in one country will spill over into the other and become a bilateral dispute. Dispute settlement procedures, for which all bilateral tax treaties provide, are administratively costly and time-consuming. An alternative solution therefore needs to be found to stop the revenue leakage due to transfer pricing.

2.5 Alternative transfer pricing dispute resolution

MNC's are confronted with a myriad of transfer pricing issues which can potentially affect their business. As has been discussed in this paper that arm's length method of transfer pricing has shortcomings that may result in double taxation and consequently loss, there is need to explore other avenues of resolving transfer pricing disputes.[132] Tax payment systems need to be run with certainty,[133] and transfer pricing adjustments that may be undertaken by the regulatory body do not assure MNC's certainty.[134] Certainty is key

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[130] *ibid,* p. 17.
[131] See Avi-Yonah, R.S. and Clausing, K.A. (2007), *'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment,'* Brookings Institution, Washington DC, p. 7, available at: http://www.allbusiness.com/legal/tax-law-corporate-tax/13662290-1.html, (last accessed 23rd November 2011).
[132] See Steve Fortier (2008), *'A meeting of Minds: Resolving Transfer Pricing Controversies,'* KPMG Transfer Pricing Services, p. 52, available at: www.kpmg.de/WasWirTun/9530.htm, (last accessed 24th November, 2011).
[133] *ibid*, p. 53.
[134] See, *ibid*, Taxpayers typically regard certainty as lowering tax exposure, but financial statement considerations are becoming more important.

principle of tax law.[135] Venturing into alternative methods of resolving transfer pricing issues offers the best opportunity to avoid irregular transfer pricing adjustment and losses that can be occasioned by the application of arm's length principle.[136]

APAs can offer certainty, so if certainty itself is a prime objective, APAs should be an integral part of the strategy. A taxpayer may choose to seek a bilateral APA to help speed up resolution of such issues.

2.6 Advance Price Agreements

A tax payer can pre – empt an audit and enter into an Advance Price Agreement (APA) with the tax authority or can wait for a transfer pricing adjustment audit.[137] An APA is defined as; '*an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.'*[138]

An APA is essentially a long-term contract between the tax authority and taxpayers. It can provide certainty, which is of benefit to taxpayers trying to manage or reduce transfer pricing risk on their inter-company transactions, but long-term, fixed agreements can have pitfalls. As long as a taxpayer complies with the terms and conditions of the APA, the tax authorities will not contest applications of the agreed transfer pricing methodology for transactions covered by the APA.[139] Therefore an APA is a formal, negotiated agreement with the tax authority of either the home country (unilateral) or all countries involved in the

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[135] The subjects of every state ought to contribute towards the support of the government in proportion to the revenue which they respectively enjoy under the protection of the state.' In order for this to be achieved, taxpayers need to know with certainty the time, manner and amount to be contributed. This allows taxpayers to predict the tax consequences of transactions in advance, resulting in effective tax planning and budgeting. Certainty can be achieved through the implementation of legal rules.

[136] OECD, It has been the experience of a number of countries that the resolution of transfer pricing disputes by traditional audit or examination techniques has often proved very difficult and also costly for taxpayers and tax authorities both in terms of time and resources.

[137] *supra*, note 39, p. 8.

[138] See OECD, *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,' supra* note 90, p. 124.

[139] See Sean Foley and Francois Vincent (2009), *'Advance Pricing Agreements under Pressure,'* KPMG Transfer Pricing, p. 56, available at: http://www.pwc.com/en_GX/gx/international-transfer-pricing/assets/itp-2011.pdf, (last accessed 24th November 2011).

inter-company transaction (bilateral or multilateral) that identifies the Transfer Pricing Method (TPM) to be used for the identified transactions for some number of future years.

An APA offers significant potential advantages to multinationals by helping to reduce uncertainty, avoid disruptive audits (thereby lowering related audit compliance costs), and mitigate the risk of double taxation. APAs also may eliminate the risk of transfer pricing penalties and the need to prepare annual documentation for the covered transactions. However, the cost in pursuing an APA lies in the necessary disclosure of detailed information to the fiscal authorities. Hence, your transfer pricing activities will likely be closely scrutinized.

Transfer pricing in Kenya is lacking in certainty as the application of arm's length principle as provided under Section 18(3) and the ITA does not always result in the arm's length price.[140] The transfer pricing methods provided are applied way after the fact. To ensure certainty of arriving at arm's length price, some countries have adopted the use of APAs.[141]

2.6.1 Advantages of using APAs

The use of APAs upholds the principle of tax certainty. Certainty is necessary so that taxpayers can know in advance the tax consequences of any given transaction.[142] Besides bringing certainty, APAs can help to avoid the extensive audits, queries and controversies resulting in costly transfer pricing disputes, by arriving at arm's length prices before the conclusion of any transactions.[143]

The use of an APA eliminates the need to conduct a long, drawn out audit. This has resulted in an increase in the number of countries choosing in favour of offering APAs as

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[140] *supra*, note 35, p. 47.
[141] Annet Wanyana Oguttu (2006), '*Resolving Transfer-pricing Disputes: Are "Advance Pricing Agreements" the Way Forward for South Africa*?' 18 SA Merc LJ 392, pp. 392-410, available at: http://heinonlinebackup.com/hol-cgi-bin/get_pdf.cgi?handle=hein.journals/safrmerlj18&section=47, (last accessed 24th November 2011).
[142] *supra*, note 139, p. 401.
[143] *ibid*, p. 402.

tax authorities can then devote more time and utilize scarce resources in other tax administrative areas.[144]

Other advantages of using APAs include the reduction or elimination of double taxation, providing an alternative solution to allocating profits to the correct tax jurisdictions without being taxed twice, and minimizing the volume of record keeping as APAs will allow you to know in advance what substantiating records are required to be kept.[145]

2.7 Conclusion

OECD proposes that use of arm's length principle which has been generally accepted as a standard for determining arm's length price for transactions between related entities. Arm's length principle has been adopted in the Kenyan laws under section 18(3) ITA. However, this principle has several weaknesses that make it inapplicable especially in the context of Kenya, a small economy, because comparability analysis may lead to unjustified or wrong results. The application of this principle may expose taxpayers to risks such as double taxation and resultant losses. Businesses need to operate with some level of certainty so to avoid these risks which may result from transfer pricing adjustments when this principle is applied. In order to avoid such risks regulatory authorities and the MNE's should apply alternative methods to solve transfer pricing disputes. APAs provide certainty, which is of benefit to taxpayers trying to manage or reduce transfer pricing risk on their inter-company transactions. APAs need to be adopted in order to resolve effectively and efficiently the transfer pricing disputes and address abusive transfer pricing.

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[144] Australian Taxation Office (2005), '*International Transfer Pricing: Advance Pricing Arrangements*' p. 3, available at: http://www.transferpricing.com/worldtranferpricing_files/world_files/australia/australia.htm, (last accessed 24th November 2011).
[145] *ibid*, p. 4.

CHAPTER THREE: THE LEGAL AND INSTITUTIONAL FRAMEWORK OF TRANSFER PRICING IN KENYA

3.1 Introduction

Multinational enterprises operating in Kenya do, make a significant contribution to our tax revenues. They may, however, use aggressive tax planning techniques, including through transfer pricing, to shift part of their profits to low tax jurisdictions. When this occurs developing countries forgo revenue that is much needed for the investments in the Physical and social infrastructure that are required to achieve sustained growth. Given the high profile of MNCs in the local economies of many developing countries, such behaviour may undermine the legitimacy of local institutions and discourage voluntary compliance by other taxpayers.

Kenya and many other developing countries face practical difficulties in effectively implementing transfer pricing rules. Many of these difficulties are also common to developed countries, but in practice are likely to be more acute for developing countries. These may include difficulties:[146] a) in drafting clear legislation and guidance; b) in building tax administration expertise and experience in transfer pricing to enable them to carry out effective audits; c) in obtaining the information needed from taxpayers in order to select cases for audit or carry out effective audits; and d) in obtaining public information on arm's length conditions, i.e. the conditions (for example, price or profit margin) in place for independent enterprises conducting comparable transactions under comparable circumstances.

In light to the foregoing, transfer pricing is no longer considered on the basis of taxation only but also as a risk factor. It is a risk factor to MNCs caused by fears of transfer pricing adjustments and documentation requirements. It does not concern only the MNCs but the government as well because the manner in which MNCs transfer prices/value across borders may affect the income reported in a country. The effect on income can be

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[146] For an exposition on some of these problems, see OECD (2010), *'Transfer pricing: A challenge for developing countries,'* OECD Observer No 276-277, available at: http://www.oecdobserver.org/news/fullstory.php/aid/3131.html, (last accessed 24th November, 2011).

significantly higher depending on how the regulatory framework is structured. While transfer pricing does not result in income shifting, MNCs can exploit loopholes in the law to manipulate prices. Similarly, vague law is bad because it poses great danger to both the regulator and the subjects as it leaves business to operate in limbo not knowing what to expect.

This chapter considers the transfer pricing legal and institutional framework in Kenya. It considers the transfer pricing regulation in Kenya before 2006 and after 2006. The main difference between these two periods is that before 1 July 2006 there were no transfer pricing Rules in Kenya. These Rules were introduced in the year 2006. Additionally, this chapter shall discuss the reaction and the manner of adoption of OECD Guidelines by KRA.

This chapter also discusses the *Unilever Case.* The Chapter analyzes the various key findings of the court regarding transfer pricing in Kenya. It will show that the "High Court did 'the unthinkable in interpreting the relevant tax statute" as it did in the case.

The chapter details the reasoning of the court along with a discussion of areas of divergence, the principles of interpretation that were applied in the case and the implication of the decision in light of the principles is discussed. The aim is to show that the court erred in its decision by misapplying the principles of interpretation of fiscal laws to the detriment of the taxation subjects.

3.2 Statutory provisions before July 2006[147]

Kenyan legal provisions on transfer pricing were contained only under Section 18 (3) of Income Tax Act. This is a substantive provision. There were no procedural provisions that were provided for. It provides that:

> *"Where a non-resident person carries on business with a related resident person and the course of that business is so arranged[148] that it produces to the resident person*

[147] Before 2006 in this case means before the transfer pricing guidelines were enacted and that is 1 July 2006. It covers the period before to 1 July 2006.

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."[149]

This is the only section that the tax authority was relying on to do transfer pricing adjustments. Before 2006, the tax authority had not provided guidance on how the arm's length standard was to be achieved. This section gives the powers to the Commissioner to adjust the profits of the Kenya tax resident from that business to the profits which would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length.[150]

Section 18 (3) of the Income Tax Act, being the substantive law dealing with transfer pricing concerns itself with a resident person who is in the following circumstances:-

a) He is a **resident** person carrying on a business in Kenya.
b) He carries on that business **together** with a **non-resident** person.
c) He is **related** to that non-resident.
d) The business is **so *arranged*** in such a manner that it produces to the resident person either **no profits or lesser profits** than would have been expected to accrue to the resident person had there been no such arrangements. It should however be noted that Section 18(3) was amended via the Finance Act, 2010 by deleting the words "so arranged" and substituting them with "such". The upshot of this amendment is that related party transactions do not have to be "so arranged" or schemed for the KRA to carry out TP adjustments. So long as the KRA can be able to show that the transaction is not at arm's length whether by design or not, TP Adjustments can be made.
e) Had the business that is conducted been between **independent** unrelated persons dealing at **arm's length**, the amounts of profits accruing to the resident person

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148 The use of the phrase 'so arranged' denoted a deliberate arrangement done by the parties to report less earnings or profits. This point is discussed further below.

149 See the Income Tax Act, Section 18 (3), *supra* note 1.
150 This is the Section that was used by Commissioner of Income Taxes to adjust the profits in Unilever Case.

would be more than that produced to him but for the reason that he is carrying on business with a related non-resident person.

The Act further provides that 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 or both.[151] This will therefore cover affiliates and related entities in which one company has significant control over the other. However, the minimum level of participation for control has not been stated in this definition. OECD guidelines do not also specify a minimum level of participation for the control.

A body is a resident person[152] for the purpose of the Act if: it is a company incorporated under the laws of Kenya; or the management and control of the affairs of the body was exercised in Kenya in a particular year of income under consideration; or the body has been declared by the Minister by notice in the Gazette to be resident in Kenya for any year of income.[153]

The Minister may, by rules published in the Gazette issue guidelines for the determination of the arm's length value of a transaction for purposes of this section; or specify such requirements as he may consider necessary for the better carrying out of the provisions of this section.[154] This section empowers the Minister to make rules to provide guidelines.

Before the decision in Unilever case, the Minister had not exercised any power to make Rules for the determination of arm's length value of a transaction and for this reason the court opted to apply the OECD Guidelines on transfer pricing.

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[151] Income Tax Act, Section 18 (6), *supra* note 1.
[152] A non resident person is not defined in the Act but it would mean a body of persons not resident as defined in the Act.
[153] Section 2(1) of Income Tax Act, *supra* note 1.
[154] Income Tax Act, Section 18 (8), *supra* note 1.

3.3 The Unilever Case

3.3.1 Background to the Case

The case, *Unilever Kenya Limited v the Commissioner for Income Tax,* occurred prior to the coming into force of the Income Tax (Transfer Pricing) Rules which were enacted on June 16 2006. Indeed, at the time, there were no guidelines to assist multinational companies to comply with Section 18 of the ITA particularly with the method of determination of arm's-length pricing. The only legal provision at the time was section 18 which merely provided the substantive law on transfer pricing in Kenya without outlining the procedural aspects of transfer pricing regulation in Kenya. There was, therefore, a lacuna with respect to the issue of how to address such issues as determining the arm's-length pricing and the required mode of documentation.

Multinational companies (MNCs), in the absence of any such regulations, resorted to the application of the universally recognized Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organization for Economic Cooperation and Development (OECD) which the KRA had been reluctant to accept and enact into subsidiary legislation. The 2005 case therefore raised the issue of what regulations were to be applied in the absence of clear guidelines and regulations in respect of transfer pricing in Kenya. In the case, the High Court of Kenya held that in absence of any guidelines on transfer pricing in Kenya, OECD guidelines were acceptable. Immediately after the case, the Minister of Finance enacted the Income Tax (Transfer Pricing) Rules 2006[155] which are substantially based on the OECD guidelines.

[155] See *supra*, note 3.

3.3.2 Facts of the Unilever Case[156]

The Appellant, Unilever Kenya Limited (UKL) engages in manufacture of various consumer goods. The appellant is part of Unilever group of companies. UKL and Unilever Uganda Limited (UUL) are related companies as defined under Section 18 of the Income Tax Act. On 28 August 1995, UKL and UUL entered into a contract whereby UKL was to manufacture on behalf of UUL and to supply to UUL such products as UUL required with orders issued by UUL. UKL supplied such products during the years 1995 and 1996.

UKL also manufactured and sold goods to the Kenyan domestic market and export market, to customers not related to UKL. UKL charged lower prices to UUL than it charged its domestic buyers and importers not related to UKL.

The respondent, Commissioner of Income Tax, raised assessments against UKL in respect of the years 1995 and 1996 in respect of sales made by UKL to UUL on the basis that UKL sales to UUL were not at "arm's length". They raised this issue by relying on section 18 (3) of the ITA.

3.3.3 Analysis of arguments

Appellant's arguments[157]

The appellant argued that the term transfer pricing describes a process by which related entities set prices at which they transfer goods and services between themselves and therefore it is simply a reference to a price which related entities transfer goods and services to each other.

The appellant took issue with the use of the word discounted prices as it implied that there was a standard price at which UKL issued discounts in favour of UUL. The appellant

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[156] See *Unilever Kenya limited v The Commissioner of Income Tax* (Unilever Case), (Income Tax Appeal No. 753 of 2003), [2005] eKLR, *supra* note 2.

[157] For more detailed arguments, see *Unilever Kenya limited v The Commissioner of Income Tax* (Unilever Case), (Income Tax Appeal No. 753 of 2003), [2005] eKLR, *supra* note 2, p. 2.

argued that in the absence of guidelines from the respondent, the OECD guidelines and methods for determining arm's length price are proper, reasonable and objectively acceptable as a basis for determination of arm's length price as provided under Section 18(3).

Respondent's arguments[158]

The respondent submitted that as a result of the special relationship between the appellant and UUL the transactions between them resulted in less taxable profits to UKL. The respondent argued that the sale of products by UKL to UUL at a lower price than that which is charged to comparable Kenyan buyers and outside Kenya importers represents a transfer price and hence the difference becomes subject of taxation on the basis of sales at arm's length prices.

The respondent did not dispute that it was a transfer price but that transfer prices arises where as a result of special relationship goods and services are transferred between related entities and result in less taxable profits than would have been obtained between two unrelated entities dealing at arm's length. The respondent put forth a further argument to the effect that prices charged by UKL on UUL are just but discounted prices.

As a result, taxes must be recalculated to the extent of normal trading transactions so as to arrive at taxable profit. The respondents argued that the OECD guidelines and the methods used by the appellant are not applicable and should not even be considered as Section 18(3) of the Act does not allow such references. They also argued that OECD guidelines apply only to those countries that have entered into Double Taxation Agreements and tax model guidelines cannot be part of legislation of a country unless they have adopted the recommendations under the tax treaty.

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[158] For more detailed arguments see *ibid*, p. 3-4.

Key transfer pricing issues

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

3.3.4 Holding of the Court[159]

The court did not accept the argument of the respondent that in the view of the clear wording of Section 18(3) of the Act, no guidelines are necessary here in Kenya. Visram J stated as follows:-

> *'That is rather simplistic, and devoid of logic. 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 tax payers and tax collectors in other countries. And especially because of the absence of any such 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.*
>
> *Therefore, I cannot ignore the time-tested experiences and best practices of others, in the argument that section 18(3) of the Act brooks of no ambiguity, and it is unnecessary to look elsewhere. That would be too limiting an approach to take."*[160]

The judge held that Section 18(3) of the Act does not tell the tax payers what KRA will accept as arm's length, or how to prove it to KRA or if they are willing to negotiate pricing arrangements. The court approved the use of cost plus method used by UKL.

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[159] See *Unilever Kenya limited vs. The Commissioner of Income Tax* (Unilever Case), (Income Tax Appeal No. 753 of 2003), [2005] eKLR, *supra* note 2, p. 13-17.
[160] See *ibid*, p. 13.

The court also held that there was no deliberate arrangement between UKL and UUL to report lesser profits as there was no evidence of tax cheating or tax fraud. This decision was made pursuant to the provision of Section 18(3).

The court in this case agreed with the appellant that in the absence of guidelines in Kenya on transfer pricing, OECD guidelines shall be applicable.

3.3.5 Implications of the case outcome

The court held that in the absence of our own guidelines, OECD guidelines will apply in Kenya. The learned Judge argues that not to apply the guidelines will be too limiting an approach to take.

In effect, the court ratified the application of OECD guidelines in the absence of our own guidelines. This decision had far reaching implication as it led to new developments in transfer pricing regulation in Kenya.

3.3.6 Areas of divergence

The court in this case agreed with the appellant that in the absence of guidelines in Kenya on transfer pricing, OECD guidelines shall be applicable. The settlement reached in this case is good but for the reasoning of the court. Had the court properly interpreted the law, it would have reached the same position.

This raises issues concerning the interpretation of tax laws by implication or by references to international instruments, practices, customs or even other countries guidelines. Should the mere absence of guidelines on a subject lead to the blanket importation of guidelines from developed economies whose economic circumstances are largely different from the developing world?

3.3.7 Interpretation of Tax Laws in Kenya

The key issue that arose in the Unilever case regards the applicable rules in interpretation of tax laws. It appears the court deliberately adopted a mode of interpreting tax law that was not grounded in the operative principles of tax law. In particular, the court breached the principle of certainty of taxation law.

According to Attiya Warris,[161] certainty is one of the most crucial canons of taxation as enunciated by Adam Smith. In her view, taxpayers should not be subjects to the arbitrariness and discretion of the tax officials. The court does not seem to have given much attention to this principle because if it did, it would have held against the KRA for not promulgating the transfer pricing guidelines in time. As a matter of fact, if there were regulations in place, the case might not have happened in the first place. It is the absence of regulations stipulating the mode of determining the arm's-length pricing that precipitated the dispute in the case after UKL's choice of mode of pricing that was not acceptable to the KRA.

The Court, therefore, in my view misdirected itself in holding out the KRA to be the beneficiary of the uncertainty of the tax laws with respect to transfer pricing at the expense of UKL. After all, it was the responsibility of the tax body to enact regulations for clarifying and rendering certain the mode of regulating transfer pricing in Kenya. Having failed in enacting such regulations in time, KRA should have borne the disadvantage occasioned by the uncertainty of the law. This is in line with the *contra preferentum rule* which the court seems to have largely ignored in its decision.

In the case of *Keroche Industries Limited vs. Kenya Revenue Authority & 5 Others,*[162] the court dealt extensively on interpretation of taxation law. This case involved an appeal from Keroche Industries Limited to have the court quash a decision by KRA to upgrade one of their products to a different and higher excise tax bracket. KRA upgraded the product and thereby assessed tax retrospectively including penalties as well. The License to manufacture the product which is subject to excise duty was issued by KRA under the tarrif

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[161] See Attiya Waris (2009), *'Taxation without Principles: A Historical Analysis of the Kenyan. Taxation System,'* K.L.R p. 272-304, available at: http://www.kenyalaw.org/Downloads_Other/waris_taxation.pdf, (last accessed 24th November 2011).

[162] Miscellaneous Civil Application 743 of 2006, [2007] eKLR, available at: http://www.kenyalaw.org/CaseSearch/view_preview1.php?link=18232127945631405361262, (last accessed 24th November, 2011).

22.04. The issue arose when KRA increased the tarriff of the product to 22.06, assessed tax and penalties on it retrospectively.

The court ruled as follows;

> '..........*the explanatory notes published by the World Customs Organisation (HS) cannot supersede the clear and unambiguous descriptions found in the first schedule. The literal and grammatical meaning of a statute using linguistic cannons of construction is always preferred where the meaning of the enactment is clear and unambiguous. The Act is to be read without engaging in tortured and strained construction. Taxation should be based on clear words and that clarity was captured under the tariff 22.04 and not tariff 22.06 in the case of applicant's products.*'

The court further said that taxation can only be done on clear words and not by intendment. Linked to this is that penalty must be imposed in clear words. In cases where the words are not clear, inclination of the court should be against the construction or interpretation which imposes a burden, tax or duty on a subject.

The Court in the Unilever Case seems to have gone contrary to the holding of the Court in the Keroche case. It ignored the literal and grammatical meaning of section 18 of ITA and opted for an approach which was based on what was mere intendment of the Act. This was contrary to the holding of the court in Keroche case that in cases where the words are not clear, inclination of the court should be against the construction or interpretation which imposes a burden, tax or duty on a subject. In the Unilever Case, the approach adopted by the High Court had the impact of imposing on Unilever new tax obligations that did not exist prior to the decision. Indeed, the KRA noticing this discrepancy rushed to enact the OECD guidelines.

The court in the Keroche case referred to Brooks Legal Maxim summary on penal and fiscal nature of interpretation as follows:

> *'a remedial statute therefore shall be construed so as to include cases which are within the mischief which the statute was intended to remedy; whilst, on the other*

hand, where the intention of the legislature is doubtful, the inclination of the court will always be against that construction which imposes a burden, tax or duty on the subject. It has been designated as a great rule in the construction of fiscal law, that they are not to be extended by any laboured construction, but that you must adhere to the strict rule of interpretation; and if a person who is subjected to a duty in a particular character or answers that description, the duty no longer attaches upon him and cannot be levied. A penalty moreover must be imposed by clear words. The words of the statute shall be restrained for the benefit of him against whom the penalty is inflicted and the language of the statute must be strictly looked at in order to see whether the person against whom the penalty is sought to be enforced has committed an offence to do with it.'[163]

The upshot of the above quote is that penal and fiscal laws including taxation statutes ought to be interpreted strictly for the benefit of the subject. This is the import of the *contra-preferentum* rule. The principle is not only a sound one, but the only one consistent with free institutions given that the interpretation of statutes should be such as to favour the personal liberty of the subject.

The court further said that the context of tax legislation is necessary to consider the legal analysis with the most precision so that the taxpayer shall not be liable to tax unless this is clearly and unequivocally the object of the statutory provisions. The courts are reluctant to adopt a construction permitting a person's tax liability to be fixed by administrative discretion. The taxman cannot go on frolics and detours of his own to impose tax not specifically permitted.

The same principles relied on by the court were accepted and applied in the case of *Cape Brandy Sydicate vs. Inland Revenue Commissioners,*[164] where Ronlat J restated the principles in these words:

'.....in a taxing Act clear words are necessary in order to tax the subject. Too wide and fanciful a construction is often to be given to that maxim, which does not mean

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[163] See *supra* note 160, p. 33.

[164] [1921] K.B, p. 64, available at: http://statutelaw.blogspot.com/2011/05/4-cape-brandy-syndicate-v-inland.html, (last accessed 24th November 2011).

> *that words are to be unduly restricted against the Crown or that there is to be any discrimination against the Crown in those Acts. It simply means that in a taxing Act one has to look at what is clearly said. There is no reason for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing to be read in, nothing to be implied. One can only look fairly at the language used.'*

Again in the case of *Ramsey Limited vs. Inland Revenue Commissioner,*[165] the same principles were expressed as follows

> *'….A subject is only to be taxed in clear words not upon intendment, or upon "equity" of an Act.' Any taxing statute of parliament has to be construed in accordance with this principle. What are "clear words" are to be ascertained upon normal principles; these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and the scheme of the relevant Act as a whole and its purpose may indeed be regarded…..A subject is entitled to arrange his affairs so as to reduce his liability to tax. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides. It must be considered according to its legal effect.'*

In the case of *Commissioner of Inland Revenue the Duke of Westminister,*[166] Lord Russel covered the points above as follows:

> *'… I confess that in the view with disfavour the doctrine that in taxation cases the subject is to be taxed, if in accordance with the court's view of what it considers the substance of the transaction, the court thinks that the case falls within the contemplation or spirit of the statute. The subject is not taxable by inference or by analogy but only by plain words of a statute applicable to the facts and the circumstances of the case. As Lord Cairns said many years ago in Partington vs. Attorney General "As I understand the principle of fiscal legislation it is this, if the person sought comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown is seeking to recover the tax cannot, bring the subject within the letter of the law,*

[165] [1982] AC, p. 300, available at: http://www.justcite.com/Document/b2utmYGdoSaaa/ramsay-w-t-ltd-v-inland-revenue-commissioners, (last accessed 24th November 2011).

the subject is free however apparently within the spirit of the law the case ought otherwise appears to be....'

In the case of *Scott vs. Russell,*[167] Lord Simonds observed:

'..*that the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax on him.*'

In the case of *Commissioner of Inland Revenue vs. Scottish Central Electricity Power Company*[168] the court said as follows

'*But in a taxing Act, I venture to think that it would be contrary to all principle to seek for an implication against a taxpayer.*'

The court in the case of Keroche, reinstated the enunciation of the principles in the above case and stated that '...*Taxation must be on clear words of a statute or Act not intendment or formulae.*' That in case of any ambiguity in the taxing statute, the ambiguity should be interpreted against the state.

3.3.8 The Problem with the Decision in the Unilever Case

In the Unilever case, the court erred and made its decision *par incuriam*. The decision to apply OECD guidelines in the absence of Kenyan guidelines is against the widely held position of interpretation of fiscal law.

Section 18(3) is the basis upon which KRA made the assessments, adjustment and levied penalties on the applicant. Under Section 18(8) the minister is empowered to make Rules to provide guidelines on the determination of arm's length for a transaction and also to issue requirements that he may consider necessary for the better carrying out of the provisions of Section 18(3). By the time this case was decided, Minister had not made any guidelines pursuant to the above powers. Effectively, there were no guidelines for the benefit of the taxpayer (Unilever).

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[166] [1986] AC 1, p. 24, available at: http://statutelaw.blogspot.com/2011/05/6-inland-revenue-commissioners-v-duke.html, (last accessed 24th November 2011).
[167] Inspector of Taxes TC 394, p. 424.

The respondent argued in the case that the OECD guidelines and the methods used by the appellant are not applicable and should not even be considered as Section 18(3) of the Act does not even allow such references. This is partially true in the sense that in matters of fiscal nature the court is limited only to the clear words of the law but in this case guidelines for the proper application of the above section were lacking. The Minister had not provided Guidelines as required by Section 18(6) of the Act. Where an officer is required to provide Guidelines and he fails to do so, the principles of statutory construction of fiscal require that the particular section be construed against such officer. The discussion of the above principles settles this matter beyond conjecture. The taxman can only take that which is clearly and unambiguously worded in the taxing statute. In the instances where the statute is not clear, the interpretation or construction is against the state. There is need for guidelines for Section 18(3) to be properly effective. It is difficult to comprehend how the taxpayer was supposed to know whether the taxing authority will accept his way of determination of arm's length price when there were no guidelines in place.

The taxpayer is entitled to arrange his affairs so as to reduce his tax liability. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides.[169] In determining the arm's length price in the absence of guidelines from the KRA, the taxpayer is entitled to use any other guidelines or formulae. With the use of such guidelines, the court needs not ratify the use of such guidelines. It should however be that, the lack of such guidelines should be interpreted against the state.

The court in this case pointed out that the wording of Section 18(3) thus '........*so arranged*......' is confusing and ambiguous. The subsection said that the Sub section implies that the business so arranged must be such as to show less income to enable the tax authorities to challenge it. The court held that the section is ambiguous as it connotes that there is deliberate act between the parties to report lesser earnings. Indeed so arranged denotes there has got to be some kind of arrangement; deliberate act of conniving or scheming in order to report lesser earnings/profits. It this case there was no

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[168] (1931) 15 TC 761.
[169] See *Ramsey Limited vs. Inland Revenue Commissioner*, *supra* note 163.

evidence of deliberate tax fraud or tax cheating. Therefore the assessment to tax should have failed.

The court had the opinion that Section 18(3) is ambiguous and amenable to two interpretations. The court obligation is to interpret fiscal laws and give effect to what is stated clearly, no more no less. Section 18(3) denotes that there has to be a deliberate act between the parties to report lesser earnings. In this case there was no evidence of tax fraud or tax cheating. The court should have interpreted any ambiguity against the state. In this case the court should have relied on the ambiguity of Section 18(3) to annul the assessment by the respondent as it would have interpreted this ambiguity against the state.

The court agreed with the appellant's arguments that in the absence of specific guidelines from the KRA on the issue, the OECD guidelines and the methods there under for the calculation of the arm' length prices are; proper, reasonable and objectively acceptable basis or the determination of arm's length prices, as stipulated under section 18(3). In light of the foregoing, KRA had failed to issue guidelines necessitating the application of other guidelines in order to give effect and life to Section 18(3). However, did the court have to strain and labour itself to the extent of applying OECD guidelines not stated in Kenya's income tax laws?

In sum Section 18(3) is ambiguous and specific guidelines were lacking. The court should have construed this against the state and consequently allow the appeal and annul the assessment to tax by the respondents.

Based on the preceding analysis, this study concludes that the court did 'the unthinkable in interpreting the relevant tax statute" as it did in the case disregarding the *contra-proferentum* rule.

3.4 Arm's Length principle under the Kenyan Law

Kenyan transfer pricing regime is based on arm's length principle. Section 18(8) of the ITA provides that the Minister may issue guidelines for the determination of the arm's length value of a transaction. As a result of the Unilever case and exercising his powers under Section 18(8) of the ITA, the Minister issued the Transfer Pricing rules.

The rules provide that the "arm's length price" means the price payable in a transaction between independent enterprises. The rules also provide that the taxpayer may choose a method to employ in determining the arm's length price from among the methods in the rules.

Fundamentally, the arm's length principle is based on the notion that the operation of market forces results in a true return to the economic contribution of participants in a transaction.[170] By seeking to remove the effect of the common ownership, the arm's length principle seeks to reduce a transaction within a multinational to one that reflects the conditions that would have existed had the pricing of the transaction been governed by market forces. In this way, the true return to economic contribution for each member of the multinational is determined.[171]

The problem to be resolved is how a multinational should determine what price would have arisen if its transactions were subject to market forces.

3.5 International Accounting Standard (IAS 24)

For financial years ending on or after 31 December 1999, companies are required to disclose all transactions with related parties under IAS 24.[172] The wide definition of related parties in IAS 24 ensures that financial statements prepared in accordance with IFRS will

[170] The argument of whether market forces give a true return to the economic contribution of the participants in a transaction is debatable and may not be entirely true. This study will not however consider the demerits of arm's length in a detailed angle but will limit itself to pointing out the problems with arms length and seeking to give other administrative solutions to transfer pricing issues.

[171] IRD Tax Information Bulletin, *"Transfer Pricing Guidelines"* Vol 12, No 10, 2000, available at http://www.ird.govt.nz/resources/2/b/2b59ab004bbe5827b784f7bc87554a30/trans-price-guidelines.pdf, (last accessed 6 July, 2011).

[172] The objective of this Standard is to ensure that the financial statements of an entity containing the information necessary to demonstrate the possibility that both the financial position as the result of the exercise may have been affected by the existence of related parties and on outstanding balances and transactions conducted with them.

provide the KRA with information concerning related party transactions and this will likely be the starting point for KRA enquiries into transfer pricing.

This Standard applies to:
(a) Identification of relationships and transactions between related parties;
(b) Identifying outstanding balances between an entity and its related parties;
(c) Identification of circumstances that requires disclosure about (a) and (b) above, and
(d) The determination to disclose information on these headings.

This Standard requires disclosure about related party transactions and outstanding balances with them in the separate financial statements of a dominant participant in a joint venture or an investor, prepared in accordance with IAS 27 Consolidated and Separate Financial Statements.[173]

3.6 Additional tax and penalties

Pursuant to section 79 of the Income Tax Act, the KRA has seven years from the year in which the income in question was earned in which to make an assessment. For years in which fraud, intentional negligence or gross negligence on the part of the taxpayer is suspected, there is no time limit in which the KRA must make an assessment in respect of transfer pricing.

No special penalties apply in respect of additional tax arising from a transfer pricing adjustment. However, the usual penalty, currently 20% of the principal tax and late payment interest of 2% per month applies.[174]

3.7 The Income Tax Transfer Pricing Rules, 2006

The reaction by the Government/KRA was to introduce Rules which sought to cure the problem raised by the decision in the above case. Kenya has always had a general

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[173] See, *International Accounting Standard,* No. 24 (IAS 24), available at http://www.WorldGAAPInfo.com, (last accessed 7 July, 2010).
[174] Section 94 and 95, Income Tax Act, *supra* note 1.

provision within the Income Tax Act requiring transactions between non-resident and resident related parties to be at arm's length. However, until 2006, no guidance had been provided by the revenue authorities on how arm's length standard was achieved. The Unilever Case led to the introduction of Income Tax (Transfer Pricing) Rules, 2006[175] to provide guidance on the application of the arm's length principle.

Transfer Pricing Rules utilizes the OECD use of arm's length and defines it as the price payable in a transaction between independent enterprises. The Rules provide for methods to be employed in determining the arm's length price.[176] It further provides that the methods that are set out under Rule 7 shall be applied in determining the price payable for goods and services in transactions between related enterprises for the purposes of Section 18(3) of the Act.

3.7.1 Application of TP Rules to Branches/Permanent Establishments

Income Tax (Transfer Pricing) Rules 2006 provide under Rule 5 that the guidelines apply to 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; and it also applies to 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.
There are doubts as to the legitimacy of this provision in light of the restrictive application of Section 18 (3) to 'resident persons' which excludes branches. This notwithstanding, the widely held view is that it would be prudent for branches to apply the TP Rules in their dealings with their head offices and other branches for two reasons.

Firstly, the intention, both at the local level and at the international level in the OECD that the arm's length principle should be extended to branches is clear and it is very likely that the KRA will seek an amendment to Section 18 (3) to include branches. Secondly, the

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[175] Legal Notice Number 67 of 2006 published under section 18(8) of the Income Tax Act with an effective date of 1 July 2006, *supra* note 2.

[176] Rule 4, '*Income Tax (Transfer Pricing) Rules, 2006.*' The methods are set out under Rule 7. The methods cover the traditional transactional methods, which include the comparable uncontrolled price method, the resale

arm's length principle is an implicit requirement in other sections of the Act, for instance with respect to the requirement of reasonableness of head office costs incurred by branches.[177]

3.7.2 Transfer pricing documentation

The TP Rules do not make it an express statutory requirement for taxpayers to complete supporting transfer pricing documentation. However, Rule 9 (1) gives the Commissioner permission to request information, including documents relating to the transactions where the transfer pricing issues arise[178] and a non-comprehensive list of the documents which the Commissioner may request is provided in Rule 9 (2). Rule 10 similarly requires a taxpayer who complies with the application of arm's length pricing to avail documentation evidencing the taxpayer's analysis upon request by the Commissioner. The requirement for taxpayers to complete transfer pricing documentation is therefore implied in the Rules and it is in the taxpayers' best interest to complete and maintain such documentation.

The documents which the Commissioner may request are required to be prepared in or to be translated into English and include documents relating to:

a) The selection of the transfer pricing method and the reasons for the selection;
b) The application of the method including the calculations made and price adjustment factors considered;
c) The global organization structure of the enterprise;
d) The details of the transactions under consideration;
e) The assumptions, strategies and policies applied in selecting the method; and such other background information as may be necessary regarding the transaction.

The transfer pricing documentation requirements as provided by the Rules are not elaborate enough. There is no specific statutory requirement that documentation be maintained which means that fiscal documentation relating to transfer pricing can only be

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price method and the cost price method. Then there are the profit based methods, which include the transactional net margin method and the profit split method.

[177] See Jane Kabiru (2009), *'International Transfer Pricing'*, PricewaterhouseCoopers, p. 204, available at: http://www.derecho.usmp.edu.pe/cet/doctrina/11/International_Transfer_Pricing_Book_2008.pdf, (last accessed 24th November 2011).

[178] Rule 9 (1) of *Transfer Pricing Rules, 2006, supra* note 3.

done by implication. There are no requirements as to the time and periodic intervals upon which documentation should be prepared. It seems maintaining documentation is only done by taxpayers in their own interests. As such there are no guidelines on what documents and in what manner they should be maintained.

Regarding the requirements of when to maintain documentation, the regulatory framework should provide that documentation be contemporaneous. Experience shows that it is more difficult and time consuming to collect and prepare documentation with a retrospective approach. As a result, contemporaneous documentation is recommended in order to facilitate tax audits and avoid the risk of entire and automatic disallowance of the transfer pricing policy on documentation.[179]

The unclear documentation requirements make the process costly, complex and time consuming.[180] To this end it would seem that it will only have to be done under the threat of request from the KRA in a haphazard manner. Documentation requirements are part of the effort to maintain tax base in order to avoid income shifting by MNCs. MNCs, on the other hand, should reasonably anticipate that tax authorities will strive to deal with the issue in a uniform manner that will prevent international double taxation. Unfortunately, the natural result of separate and uncoordinated national policies is ever-increasing and divergent documentation requirements and, in consequence, an inappropriate and unnecessary compliance burden on MNCs.[181] Additionally, vagueness of Kenya's laws makes documentation even more complex.

It is in the interest of the taxpayer to maintain proper documentation. The lack of adequate documentation may also make it difficult for the taxpayer to rebut an alternative arm's

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[179] Stephan Schnorberger and Juliane Rosenkranz (2006),*"Transfer Pricing Documentation: The EU Code of Conduct Compared with Member State Rules (Part 2),"* INTERTAX Journal, Volume 34, Issue 8/9, p. 413, available at: http://www.faqs.org/abstracts/Law/Transfer-pricing-documentation-the-EU-code-of-conduct compared-with-member-state-rules-part-2.html, (last accessed 24th November 2011).

[180] See International Chamber of Commerce, Commission on Taxation (2008), *"Transfer Pricing Documentation Model,"* Policy Statement, p. 1, available at: http://www.iccwbo.org/uploadedFiles/ICC/policy/taxation/Statements/Transfer%20Pricing%20Documentation%20Model%20180-498-final.pdf, (last accessed 24th November, 2011).

[181] *supra,* note 178, p.3.

length transfer price proposed by the KRA. However, let it be noted that this does not absolve the KRA from providing proper guidelines on documentation.

Kenyan regulatory framework should have uniform requirements, known before hand, on what documents to be maintained by the tax payers. In this way the KRA would simplify its work for all parties and as well be forced to accept the position documented by MNCs as long as they meet the requirements. It is desirable that where prepared documentation is challenged by the KRA, it should be subjected to alternative and administrative dispute resolution as opposed to unilateral assessment and imposition of penalties by the KRA.

In the interest of business efficacy and saving on cost of compliance the documentation requirements should be comprehensive with detailed guidelines in place. The comprehensiveness of what documentation to maintain can take the example of the Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package.[182] New Zealand has developed comprehensive transfer pricing guidelines which although not mandatory help taxpayers in resolving transfer pricing issues.[183]

The Income Tax Act also makes reference to the OECD's Guidelines on arms length. This is provided for under section 18(3) of the Act. It is imperative therefore to look at the provisions on arms length principle before considering the decision in Unilever case.

3.7.3 Manner of adoption of transfer pricing guidelines

The court in Unilever case ratified the application of OECD guidelines in the absence of specific transfer pricing guidelines in Kenya. KRA lost this case. The judgment in the Unilever case was delivered on 5 October 2005. This prompted immediate reaction from the government by enacting Income Tax (Transfer Pricing) Rules 2006 effective 1 July 2006. These Rules are largely a replica of OECD guidelines.

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[182] Refer to Appendix B, available at: http://www.irs.gov/businesses/international/article/0,,id=156266,00.html, (last accessed 24th November, 2011).

[183] See IRD Tax Information Bulletin, *"Transfer Pricing Guidelines"* Vol 12, No 10, 2000, available at http://www.ird.govt.nz/resources/2/b/2b59ab004bbe5827b784f7bc87554a30/trans-price-guidelines.pdf, (last accessed 6 July, 2010).

Section 18(8) empowers the Minister to make Rules to provide guidelines for the determination of arm's length price and also requirements for the better carrying out of the provisions of Section 18(3). Rule 3 of Income Tax (Transfer Pricing) Rules 2006 provides that the purpose of the Rules is to provide guidelines to be applied by related enterprises, in determining arm's length prices of goods and services in transactions involving them, and to provide administrative regulations, including the type of records and documentation to be submitted to the commissioner by a person involved in transfer pricing arrangements. The purpose of the Rules is to provide guidelines. This raises the question as to the extent of enforcement of guidelines. What legal force do guidelines carry? The wording of Section 18(8) is confusing as it states that the Minister is to make 'Rules to provide guidelines'. Are the guidelines which are so made to have the effect as Rules? What would be the Rules then?

In reference to employers' guide for the PAYE, it provides guidelines on deducting income from employees.[184] It provides that it does not in any way modify the general legislation, Income Tax Act. The purpose of the guide is to assist employers in general operation of PAYE system.[185] It is only a guide and in no way modifies the general legislation. This means that the guidelines provided are merely guidelines which a taxpayer cannot be held against.

The New Zealand transfer pricing guidelines[186] provide that they are guidelines which should be read as supplementing the OECD guidelines, rather than superseding them. This applies for the domestic application of New Zealand's Rules, as well as in relation to issues raised under the New Zealand's double taxation agreements. These guidelines are not exhaustive and in no way modify the general legislation. These guidelines apply only to the application of section GD 13 (as modified by section GC 1 where relevant). They therefore apply only to transactions between separate entities.

The adoption of the guidelines was rather rash as it has the effect of bringing more doubts than clarity. The KRA should have modified the OECD guidelines to be Rules in response to the inadequacies that we had in law. Guidelines do not have the force of law as Rules or

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[184] See KRA (2009), *'Employers' Guide to Pay As You Earn,'* available at; http://www.revenue.go.ke/incometax/pdf/PAYEGuide2009.pdf, (last accessed 24th November, 2011).
[185] *ibid*, p. 7.

regulation and to that extent not legally enforceable as they are supposed just to be guidelines.

3.8 Recent Legal Developments on Transfer Pricing

3.8.1 Self Assessment Return

Pursuant to section 52B of the ITA, every taxpayer is required to file a self assessment return. The return requires a taxpayer to declare the related parties outside Kenya together with the contacts of such related parties.

The KRA introduced a schedule to the annual tax return in the 2010 year of income. The schedule requires related parties to declare whether they have related party dealings together with the quantum of such related party dealings. It also requires the taxpayer to disclose whether they have prepared TP documentation. However, the schedule is only available where a taxpayer completes their annual income tax returns online.

3.8.2 Related parties via related Natural Persons

Parliament expanded the meaning of related parties via the Finance Act, 2010 to include entities managed or controlled by related Natural Persons. Two entities are related if they are managed or controlled by individuals who are related to each other by marriage, consanguinity or affinity.

3.8.3 Substitution of the words "so arranged" with "such"

Section 18(3) was amended via the Finance Act, 2010 by deleting the words "so arranged" and substituting them with "such". The upshot of this amendment is that related party transactions do not have to be "so arranged" or schemed for the KRA to carry out TP adjustments. So long as the KRA can be able to show that the transaction is not at arm's length whether by design or not, TP Adjustments can be made.

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[186] See IRD Tax Information Bulletin (2000), *'Transfer Pricing Guidelines,' supra* note 181.

3.8.4 Information Exchange Agreements

The Government has embarked on an information exchange programme with other governments. To this end, the Minister for Finance in his budget proposals contained in the 2011 Finance Bill proposes to give legal effect to Tax Information Exchange Agreements that the government may enter into with other governments. These agreements will allow KRA to request for related parties in foreign jurisdictions for their records, bank account information and beneficial ownership. These agreements will also provide a key basis for entering into APAs.

3.9 Institutional Framework for Transfer Pricing in Kenya

In Kenya, all the revenue and taxation issues fall under the jurisdiction of the Kenya Revenue Authority (KRA), including transfer pricing. Generally, KRA was established in 1995 as a semi autonomous revenue authority responsible for revenue Administration. Prior to this, tax matters had been handled under different departments in the Ministry of Finance. The KRA was established in an attempt to enhance domestic revenue mobilisation capacity.

The KRA was established under the Kenya Revenue Authority Act,[187] which became effective on 1st July 1995. Essentially, the KRA is the Authority charged with the responsibility of collecting revenue on behalf of the Government of Kenya. It is manned by a Board of Directors, consisting of both public and private sector experts and KRA Management. The Chairman of the Board is appointed by the President of the Republic of Kenya while the Chief Executive of the Authority is the Commissioner General who is appointed by the Minister for Finance. The KRA Act as well as the specialised tax laws define the revenue collection mandate in the country as well establishes the framework for assessment, collection, administration and enforcement of laws relating to revenue.[188]

[187] Chapter 469, Laws of Kenya, available at: http://www.revenue.go.ke/, (last accessed 24th November, 2011).
[188] Fro more detailed background information on KRA, see the KRA website, http://www.revenue.go.ke/, (last accessed 24th November, 2011).

The structure of KRA includes private sector dominated Board of Directors (BOD), with the Commissioner General as Chief Executive overseeing the day-to-day operations of the Authority. The KRA has gradually transformed from a largely tax-type based institution into an organisation organised along functional lines after a series of reforms geared at adapting it to present environmental realities and international best practices. The KRA has four Commissioners who report to the Commissioner General and who are responsible for providing various services to taxpayers including customs, domestic tax, motor vehicle registration, and investigations and enforcement. In the organizational chain, the Commissioners are assisted by Senior Deputy Commissioners who are in charge of KRA's regional offices. There is also a Commissioner in charge of support services, who also reports to the Commissioner General.[189]

In KRA, the Tax collection responsibilities are shared between the following departments' domestic taxes department consisting of Large Taxpayers Office (the "LTO") and Domestic Revenue ("DR") and Customs and Excise. The LTO was established as a fully-fledged department of the KRA in 2006 to provide one-stop-shop services in respect of all tax matters affecting large taxpayers and to specifically monitor and provide services to taxpayers that contribute the bulk of revenues.[190]

The primary eligibility criterion for treatment as a large taxpayer subject to LTO control is annual turnover of Kshs 750 million (USD 9 million) and above. Thus, most MNCs are within the LTO. Currently, the LTO administers about 800 large taxpayers with operations centralised in Nairobi. The LTO is the unit which handles transfer pricing issues.[191]

The KRA has established Transfer Pricing Unit in the Large Taxpayers Office ("LTO"). The unit was established in the LTO because most MNCs in Kenya fall are large taxpayers as defined by the KRA. Around 300 taxpayers have received requests from the KRA to submit TP documentation. The KRA has began audits of the documentation submitted and may begin to raise assessments in respect of TP issues in the near future.

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[189] See PwC (2010), *"Transfer pricing and developing countries – Kenya,'* available at: http://ec.europa.eu/europeaid/what/economic-support/taxation/documents/appendix_d_country_study-kenya.pdf, (last accessed on 14th November 2011).
[190] *Ibid.*
[191] *supra* note 187, p. 4.

KRA policy on transfer pricing is that that, on average, MNCs will comply when appropriate tax legislation is put in place. It believes that any tax revenue leakages due to transfer pricing have either been significantly addressed with the introduction of the TP rules or will be addressed in due course. The government is also of the opinion that the enhancement of exchange of information agreements will go a long way to addressing transfer pricing abuses. At present, KRA's key focus is promoting investment, eliminating double taxation and generally ensuring a conducive environment for foreign investors.[192]

3.9.2 The TP Dispute Resolution Framework in Kenya

3.9.2.1 Tax Assessments and Objections

The Kenyan tax system is a self assessment system. However, when the taxpayer files the self assessment return, the KRA has the power to issue an additional assessment it considers that the taxpayer under declared his income. The taxpayer has the right to object to the assessment within 30 days upon receipt of the additional assessment. If the KRA therefore considers that a taxpayer has underpaid tax as a result of transfer mispricing, it may issue an additional assessment. The taxpayer has the right to object and this marks the beginning of a dispute between the KRA and the taxpayer. Upon receiving the objection, the KRA may amend or refuse to amend the assessment. In practice, a taxpayer may schedule a meeting with the KRA to discuss the objection and the grounds for this objection. If KRA refuses to amend the assessment, it is required to serve a notice to the taxpayer confirming the assessment.

3.9.2.2 The Local Committee

The Local Committee is responsible for adjudicating all the other income tax disputes arising from assessments issued under any other provision of the ITA. Transfer Pricing Assessments arise from Section 18(3) of the ITA as read together with the TP Rules and as such, any dispute arising there would be adjudicated by the Local Committee.

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[192] *ibid*, p. 5.

3.9.2.3 The High Court of Kenya

The High Court of Kenya is established by Article 165 of the Constitution of Kenya. As a matter of practice, there is a specific division of the High Court (the Commercial and Tax Division) which is mandated to hear and determine all tax matters lodged by or against the Kenya Revenue Authority. A taxpayer aggrieved by the decision of the local committee may appeal to the High Court. Such an appeal can only be on a question of law or of mixed law and fact. Before lodging such an appeal, a taxpayer is required to pay the tax arising from the assessment by KRA. This tax is refundable should the appeal succeed.

It is worth noting that under the Kenyan legal framework, a taxpayer has the right at any time to institute judicial review proceedings in the High Court against the KRA or the Local Committee if the taxpayer alleges bias, bad faith, unreasonableness, abuse of discretion or jurisdictional error on the part of the local committee or the KRA as the case may be.

3.9.2.4 Court of Appeal

The Court of Appeal is established by Article 164 of the Constitution of Kenya. The Court of Appeal has jurisdiction to hear appeals from the High Court. An appeal on transfer pricing from the high court can therefore be lodged to the Court of Appeal. Such an appeal can only be on a matter of law or a usage having the force of law.

As noted hereinabove one of the problems facing transfer pricing practice in Kenya is lack of judicial precedents on the issue. In this regard, the courts are obliged to ensure that their judgments in respect to transfer pricing are well reasoned so as to set sound precedence on this inchoate legal issue.

3.9.3 Weaknesses of Transfer Pricing Institutional Framework in Kenya

The key weakness with respect to enforcement of transitional pricing is that there is no special mechanism in place for addressing TP disputes. TP disputes are dealt with in the same manner as other disputes arising under other income tax areas. In general, prior to reaching the courts, a dispute will usually be heard by an administrative (or quasi-judicial) tribunal constituted by the Ministry of Finance. A taxpayer may however decide to take his matter to the courts directly under certain circumstances.

In case a tax payer is unsatisfied with an assessment issued by the KRA, the tax payer first recourse is either to the Tribunal or a local committee. For instance, the Tribunal has jurisdiction to deal with matters relating to tax avoidance. The local committee, on the other hand, is responsible for adjudicating on all other income tax disputes. The local committee will therefore typically sit on TP cases. However, in most cases in Kenya, taxpayers have in practice circumvented this quasi-judicial process by instituting judicial review proceedings in the High Court in the first instance. Such a process is attractive to taxpayers as affords immediate temporary injunctive relief to the taxpayer in instances where the KRA is about to freeze a taxpayer's assets, including bank accounts. However, this avenue results in undue delay in the resolution of the case to the detriment of KRA.

The law provides that appeal against the decision of the Tribunal or local committee be made to the High Court. The Commercial and Tax Division of the High Court is mandated to hear and determine all tax matters lodged by or against the KRA. The Court of Appeal has jurisdiction to hear appeals from the High Court. Thus, an appeal on transfer pricing from the High Court will be lodged at the Court of Appeal.

The nature of the dispute resolution system in Kenya, being adversarial in nature, creates major efficiency difficulties for enforcement of transfer pricing given that the parties to disputes are deeply engrossed in winning the cases as opposed to solving disputes in a principled, cooperative manner. Invariably, the parties adopt procedural technicalities in their case strategy such as unnecessary injunctions and objections that may only relate to the form as opposed to the substance of the case. There is currently a huge backlog of cases in the Kenyan courts and as a result, the dispute resolution mechanism is very time consuming. For instance, the Unilever case took more than two years to resolve. Further, the judges and members of local committees do not have specialist experience in tax and transfer pricing. In the absence of specialist experience in TP, it is not be possible to come up with well reasoned, researched precedents as was evident in the Unilever Case where the court erred in applying the OECD Model TP Guidelines.

3.10 Salient Practical considerations

3.10.1 Absence of External Comparables

There are no databases in Kenya with financial information for local companies to carry out a comparability analysis in order to test the arm's length nature of their transactions. Kenyan taxpayers rely on European Databases such as "Amadeus" in testing the arm's length nature of their transactions. The transfer pricing benchmarking by Kenyan companies are therefore based on the European Databases. There are no country specific adjustments that are carried out because there is no information to carry out these adjustments. As a result, the benchmarking carried out may not be accurate.

3.10.2 KRA Audit Approach

KRA selects tax payers from time to time to look into the books of accounts and records kept by tax payers to ascertain whether they are paying all taxes they are liable to pay. TP audits are presently carried out as part of the general tax audit. The KRA has no specialist experience in TP and therefore, the audit team will concentrate on other tax heads such as VAT, withholding tax, PAYE and general corporate tax at the expense of TP.

3.11 Conclusion

Transfer pricing regulation in Kenya consists of Income Tax Act Section 18 and Income Tax (Transfer Pricing) Rules of 2006. Transfer Pricing Rules were enacted in the year 2006 after the decision in the Unilever case which was delivered in October 2005. The Unilever case ratified the application of OECD Guidelines in the absence of Kenyan Guidelines on transfer pricing. This ratification by the court prompted reaction from KRA to promulgate the TP Rules 2006. The rules provide guidelines on determination of arm's length price for goods and services between related entities. This summarizes the consideration in this chapter on the transfer pricing regime in Kenya.

CHAPTER FOUR: CONCLUSION AND RECOMMENDATIONS

4.1 Conclusion

Transfer pricing manipulation is generally conceived as a permissible malpractice like other administrative or commercial practices of business entities. No country has outlawed transfer pricing practices, nor has any international organization declared it as an undesirable act. Therefore, the regulatory authorities should devise ways of tackling transfer price manipulation. Putting in place effective and clear legislation on transfer pricing helps tax payers have certainty as well as reduce cost of monitoring taxpayers.

This study sought to examine transfer pricing legislation in Kenya. This is in particular to the impact of the decision in the Unilever case which this study has illustrated that the decision was bad in law. The decision in Unilever case prompted reaction from the KRA by promulgating Income Tax (Transfer Pricing) Rules of 2006 which set out the rules to provide guidelines on transfer pricing. The TP rules 2006 are largely modeled on OECD guidelines on transfer pricing. This study also considered the OECD guidelines as they form a basis of Kenyan laws on transfer pricing and how suitable they are to the Kenyan context especially with regard to arm's length principle.

The overall goals of this study were to present a critique of the decision in the Unilever case, critique of the action taken by the KRA/government after the decision in the Unilever case and to assess whether they are any inadequacies in transfer pricing law and to suggest the appropriate way forward.

Transfer pricing regulation in Kenya consists of Income Tax Act Section 18 and Income Tax (Transfer Pricing) Rules of 2006. Transfer Pricing Rules were enacted in the year 2006 after the decision in the Unilever case which was delivered in October 2005. Unilever case ratified the application of OECD Guidelines in the absence of Kenya Guidelines on transfer pricing. This ratification by the court prompted reaction from the KRA to promulgate the Rules. The rules provide guidelines on determination of arm's length price for goods and services between related entities.

This study analyzes the decision in the Unilever case showing the areas where the court erred in its decision to apply OECD guidelines in Kenya. The decision in the Unilever case ratified the application of OECD Guidelines in the absence of Kenyan Guidelines on transfer pricing. Similarly the use of the words 'so arranged' in Section 18(3) makes this section ambiguous as it denotes that there has to be deliberate act of arrangement or scheming between the parties. This decision does not augment well with the widely held principle that a subject can be subjected to tax only on the basis of clear and ambiguous provision of the taxing Statute. In this case the court erred in holding that OECD guidelines are applicable in the absence of Guidelines in Kenya. In the court reaching the decision that Kenyan tax law should be applied in light of OECD guidelines, does it mean that we should abandon our own law and apply those of '*the global village?'* Did the court have to engage in laboured construction including the reference to OECD guidelines? It is important to note that the court would have reached the same decision by interpreting the applicable law and the lack of guidelines against the state.

The purpose of the Rules is to provide guidelines. This raises the question as to the extent of enforcement of guidelines. The wording of Section 18(8) is confusing as it states that the Minister is to make 'Rules to provide guidelines'. In reference to employers' guide for the PAYE, it provides guidelines on deducting income from employees. It provides that it does not modify in any way the general legislation, the ITA. The purpose of the guide is to assist employers in general operation of PAYE system. It is only a guide and in no way modify the general legislation. This means that the guidelines provided under the transfer pricing rules are merely guidelines which a taxpayer cannot be held against. This cast doubt on the enforceability of the transfer pricing rules of 2006.

The arm's length principle under the Kenyan transfer pricing regimes was adopted from the OECD guidelines. Critical to this analysis was the extent to which such guidelines are relevant and credible in the Kenyan context. This study sought to examine the extent to which OECD guidelines have been adopted. The adopted OECD guidelines have inherent weaknesses such as:

a) The arm's length standard does not reflect the economical reality of MNCs. MNC's are integrated enterprises and it would be affront to economic realities to compare transactions of MNC's/related entities with those of independent parties operating at arm's length. It is argued that, this very integration is the reason why suitable economic advantages are gained in areas such as logistics, brand development, risk management and technology.

b) The arm's length standard cannot be efficiently applied in some circumstances. For example where MNCs take part in transactions that independent parties would not undertake. Arm's length principle is hinged on comparability analysis. Comparability analysis is dependent on determination of prices under which a third party would charge under similar circumstances. The problem of comparability analysis is that of ascertaining consistent facts which to measure a transaction and also obtaining reliable data for comparison analysis. For a small market like Kenya, the use of comparables is even harder. This is because, comparables that could be used relates to a small set of comparables, small number of parties or companies.

c) It is difficult to prove, after a lapse of time, that a transaction that took place was in fact effected at arm's length. Comparability analysis is weak in the sense that it may yield wrong results in case of lapse of time before the transfer pricing adjustment is done.

In adopting these guidelines, no adjustments were to be made to alleviate or minimize the impact of the weaknesses inherent in the OECD guidelines, in Kenya's transfer pricing regime. It seems that the same reason given by the OECD that there is no justifiable substitute to arm's length principle applies to Kenyan context. Since 2006 there has not been any attempt to revise Kenyan laws to factor in the inherent weaknesses of arm's length principle.

In sum, Kenya adopted some aspects of the OECD regulations on transfer pricing as a basis of and with a view of improving its tax regime after the decision in the Unilever case which the government/KRA seemed to have lost. These developments show that Kenya has significantly managed to keep abreast with the international developments in transfer pricing albeit insufficiently. This is because the resultant transfer pricing rules created more uncertainty than clarity on issues relating to transfer pricing in Kenya.

4.2 Recommendations

From the foregoing and having drawn the above conclusions, the following recommendations are relevant and useful in improving the quality and character of the resultant legislations as well as the rules and regulation made pursuant to transfer pricing legislation.

The KRA should consider devising a means in which it encourages compliance to transfer pricing issues rather than relying on the current penalty policy. This will save time and resources that are wasted in adjustments as well as ensuing processes such as the alternate dispute resolution process.

4.2.1 Advance Pricing Agreements

The KRA should boost its administrative capacity by giving more consideration to the issue of APAs for purpose of building in roads to eventually utilize them in the future. This is because APAs are binding for a fixed number of years and sometimes retrospective. APAs can be beneficial in that they avoid long drawn-out audits, queries and controversies. This approach is more proactive than reactive and is likely to yield more results.

Kenya is still a small economy; the application of arm's length principle may yield unjustified results since there may not be available many sufficient comparables. Although the APA application process is time-consuming and costly, the benefit of tax certainty, which assists in the prevention of non-compliance penalties and costly transfer pricing disputes, outweighs the cost advantage. The KRA should consider adopting APAs in order to reduce transfer pricing disputes.

While this study concentrated on consideration of APAs as one of the alternative methods of resolving transfer pricing disputes there are many other forms of alternative methods of solving transfer pricing disputes. Some of the other methods that should be adopted include formulatory apportionment method, keeping proper documentation and tax treaties.

4.2.2 Building KRA TP Capacity

In developing countries like Kenya with basic transfer pricing regulations, problems arise from the lack of experience and/or expertise of accountants and auditors in analyzing complex transfer pricing situations. The KRA lacks capacity to conduct transfer pricing adjustments and such complex application of the arm's length principle is likely to be misapplied if its complexity is combined with lack of experience and expertise. This fact makes transfer pricing adjustments in Kenya attach more risk for taxpayers. A lack of administrative experience may allow firms to take advantage of the situation and shift income, or to be unfairly taxed due to a misapplication of the regulations. This further justifies the adoption of APAs in order to solve transfer pricing issues proactively which the cooperation between KRA and taxpayers.

4.2.3 Legal Reforms

The government should consider putting in place proper guidelines to guide taxpayers or related entities in determining transfer prices. The adoption of the guidelines was rather rash as it has the effect of bringing more doubts than clarity. Taxpayers in Kenya do not have proper guidelines for determination of transfer price. This will promote certainty which is a basic tenet of tax law. The KRA should have modified the OECD guidelines to be Rules in response to the inadequacies that we had in law. Section 18(8) empowers the minister to make Rules to provide guidelines for the determination of arm's length price and also requirements for the better carrying out of the provision of Section 18(3). Rule 3 of Income Tax (Transfer Pricing) Rules 2006 provides that the purpose of the Rules are to provide guidelines to be applied by related enterprises, in determining arm's length prices of goods and services in transactions involving them, and to provide administrative regulations, including the type of records and documentation to be submitted to the Commissioner by a person involved in transfer pricing arrangements. New Zealand and Australia have developed detailed guidelines to guide related parties who engage in transactions between themselves. It is recommended that Kenya should develop such comprehensive guidelines to provide certainty to the taxpayers on what to expect in transfer pricing audits.

In relation to transfer pricing rules, the government should consider promulgating comprehensive rules. As it currently stands, the transfer pricing rules provide guidelines raising questions as to the enforceability of these guidelines. Section 18(3) and the transfer pricing rules should be amended appropriately so as to make them clear on whether they are rules or guidelines.

All taxpayers are under obligation to keep books of account under section 54 of the ITA. A general penalty is applicable for failure to keep records which is an offence, it is not specific to transfer pricing corporate taxpayers. Specific to this however is section 94 (1) and 95 interest which is also general. This may be contrasted to other jurisdictions where specific penalty has been prescribed for taxpayers who fail to maintain books in the specified form. Australia for example reduces penalty if the taxpayer has a reasonably arguable case evidenced by documentation. In the U.S, a penalty is only imposed if an audit leads to a transfer pricing adjustment. Kenya should consider prescribing a penalty specific to taxpayers affected by transfer pricing principles which should maintain proper documentation, whether an audit is anticipated or not.

The key TP provisions are anchored in the Kenyan regime via subsidiary legislation in the form of Ministerial rules. This makes them susceptible to challenge especially if multinationals, for whatever reason, were to show that the rules are ultra vires the parent Act (Income Tax Act). Kenya should consider borrowing the Indian TP model. The key TP provisions in the India TP regime are entrenched in the Indian Income Tax Act. These provisions 92, 92A, 92B, 92C, 92CA, 92D, 92E, 92F of Chapter X of Income Tax Act. These provisions are exhaustive and incorporate the key TP aspects in the Indian Legal regime via the statutory plane

4.2.4 Prescriptive Transfer Pricing Model

The Kenyan TP Rules allow the adoption of a liberal model when applying the TP Methods in order to determine the arm's length nature of a transaction. Rule 4 of the TP Rules provide that; *"The taxpayer may choose a method to employ in determining the arm's length price from among the method set in Rule 7."* Rule 7 lists the OECD TP methods. Kenya should consider adopting a prescriptive TP model where the methods to be used by players in certain industries and the arm's length range is prescribed by the regulations. This will create legal certainty and avoid legislative ambiguity as to the meaning of arm's length. This will avoid an array of arguments as to whether a transaction was at arm's length or not. The current model may be subjected to abuse especially where a taxpayer employs a method not on the basis of sound TP Principles but only because it favours his exposition that a transaction was at arm's length.

4.2.5 TP Practice Notes

General directions may be issued by KRA by way of Practice Notes on the transfer pricing methods to be employed by the taxpayers under different circumstances with due regard to the taxpayer's industry, the assets employed, the functions performed and the risks assumed in transactions with related parties. The Practice Notes can be modelled along the lines of Practice Note 7 issued by the South Africa Revenue Service which clearly provides that the Practice Notes are intended to be a practical guide and every case will be decided on its merits.

The KRA does not issue practice notes. However, practice notes are not uncommon in the Kenyan dispute resolution framework. For instance, Section 81(3) of the Kenyan Civil Procedure Act empowers the Chief Justice, in consultation with the Rules Committee, to; *"issue practice notes or directions to resolve procedural difficulties arising under the Act, in order to facilitate the attainment of the overriding objective of the Act......"*

In the same breadth, a statutory provision may be enacted to allow KRA to issue Practice Notes to help in the attainment of the overriding objective of the TP Rules (that transactions with related parties should be at arm's length).

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The Income Tax (Transfer Pricing) Rules, 2006

LN No. 67

15 June 2006 In the Exercise of the powers conferred by Section 18(8) of the Income Tax Act, the Minister for Finance makes the following Rules"-

1) Citation and commencement — These Rules may be cited as the Income Tax (Transfer Pricing) Rules, and shall come into operation on the 1st July, 2006.

2) Interpretation — In these Rules, unless the context otherwise requires:-

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

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

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

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

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

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

3) Purpose of Rules — The purpose of these Rules are:-

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

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

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

5) Scope of guidelines — These guidelines shall apply to:-

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

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

6) Transactions subject to Rules — The transactions subject to adjustment of prices under these Rules shall include:-

(a) the sale or purchase of goods;

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

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

(d) the provision of services

(e) the lending or borrowing of money; and

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

7) Methods

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

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

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

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

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

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

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

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

8) Application methods

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

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

9) Power of Commissioner to request for information	(1)	The Commissioner may, where necessary request a person to whom these Rules apply for information, including books of accounts and other documents relating to transactions where the transfer pricing is applied.
	(2)	The documents referred to in paragraph (1) shall include documents relating to:-
		(a) the selection of the transfer pricing method and the reasons for the selection;
		(b) the application of the method, including the calculations made and price adjustment factors considered.
		(c) the global organization structure of the enterprise:
		(d) the details of the transaction under consideration;
		(e) the assumptions, strategies and policies applied in selecting the method; and
		(f) such other background information as may be necessary regarding the transaction.
	(3)	The books of accounts and other documents shall be prepared in, or be translated into, the English language, at the time the transfer price is arrived at.

10) Application of arm's length pricing	Where a person avers the application of arm's length pricing, such person shall:- (a) develop an appropriate transfer pricing policy; (b) determine the arm's length price as prescribed under the guidelines provided under these rules; and (c) avail documentation to evidence their analysis upon request by the commissioner.
11) Certain provisions of Act to apply	The provisions of the Act relating to fraud, failure to furnish returns and underpayment of tax shall apply with respect to transfer pricing.
12) Unpaid tax to be deemed additional tax	Any tax due and unpaid in a transfer pricing arrangement shall be deemed to be additional tax for purposes of section 94 and 95 of the Act.

Made on the 15th June 2006
AMOS KIMUNYA,
Minister of Finance