TRANSFER PRICING 101

Simply put, transfer pricing is the pricing of transactions between related parties within the context of a multinational enterprise (MNE). It is the practice through which MNEs allocate income and expenditure in different jurisdictions by applying the *arm's length principle* (ALP) - that is, by applying prices to their transactions as though there was really no controlling relationship or by using prices that independent parties would have agreed to.

Section 18(3) of Kenya's Income Tax Act (the Act), provides that transfer pricing will arise where there is relationship between two parties (a resident person and a non-resident person or the non-resident's permanent establishment) and those parties enter into prescribed/controlled transactions. The Act states that such transactions should be carried out at an arm's length price and where related parties fail to adhere to the arm's length principle, the Act gives the Commissioner power to adjust the results of such transaction(s) to produce arm's length results.

Transfer pricing is in itself, legal and not necessarily abusive as is the case with transfer mis-pricing. That said, although there is a general consensus as to what the ALP means, the application of the ALP is more complex since there is subjectivity in its application. In addition to this, it relates to the competing optimising objectives of three parties i.e. the revenue maximising objectives of both the domestic tax and foreign tax authorities as well as the tax minimizing objective of the taxpayer.

According to the Act, parties are related where,

a. A person or a third party participates directly or indirectly in the management, control or capital of the business of the other or,

b. An individual, who participates in the management, control or capital of the business of another, is associated by marriage, consanguinity or affinity to an individual who participates in the management, control or capital of the business of the other.

It is, however, imperative to note that the Act does not give a threshold for shareholding that would make parties be related. Presumably then, even one-percent shareholding could be construed as creating a

controlling relationship although there may be no effective control by the shareholder holding the said one-percent.

Although the Transfer Pricing (TP) Rules of 2006 do not provide a materiality threshold for transactions (say how large transactions must be) for the rules to apply, the rules have highlighted the transactions that are subject to transfer pricing, including: the sale or purchase of goods and tangible assets, the transfer of tangible assets, the transfer or use of intangible assets, the provision of service as well as the lending and borrowing of money. Few taxpayers pay attention to the "catch-all" provision of Paragraph 6(f), *"any other transactions which may affect the profit or loss of the enterprise involved".* The import of this provision is that the Commissioner may deem a transaction to have taken place (and ascribe a value to it) even where the taxpayer had not recognised such a transaction.

With regard to the pricing methods, the TP Rules are in agreement with the OECD Guidelines (a unique forum where governments work together to address the economic, social and environmental challenges of globalisation) that the selection of the transfer pricing method should aim at finding the most appropriate method for a particular transaction(s). Broadly, the TP methods are divided into two; transactional methods which assess prices for similar products; and profit-based methods that benchmark profitability based on similarity of functions (for example, manufacturing to manufacturing, distribution to distribution, and so on). The TP rules also empower the Commissioner to prescribe another method where in his opinion an arm's length cannot be obtained.

The TP Rules have clarified the mandate of the taxpayer with regards to compliance. Plainly, the rules require a taxpayer to defend its transfer price(s) through a documented policy. This policy should highlight the TP method selected, the reasons, assumptions and strategies made for the selection, the application of the method and the details of the transaction(s) under consideration, as well as the global structure of the organization. To this end, if the pricing is arm's length, then there is no adjustment required and, hence, it places the burden of proof solely on the revenue authority to demonstrate that the pricing is not arm's length or rather unreasonable.

In conclusion, the primary TP process typically involves the identification of the related parties and the controlled transaction(s), contribution of each party to the controlled transaction and determination of the arm's length price. Though the rules do not make it a requirement for the taxpayer to file with the Commissioner the TP Policy upon preparation, it is important for the taxpayer to maintain current and relevant transfer pricing documentation. When all is said and done, this process ought to follow the simplicity principle of taxation rather than be a cause of distress to taxpayers. Remember, each transaction must be defended in at least two jurisdictions (or before two competing revenue authorities).

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