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Introduction

Kenya has always had a general provision within its tax legislation requiring transactions between non-resident and resident-related parties to be conducted at arm's length. However, until 2006, no guidance had been provided by the revenue authorities on how the arm's-length standard was to be met. This failure to provide guidance led to protracted disputes between taxpayers and the Kenya Revenue Authority (KRA), culminating in a landmark case involving the Commissioner of Income Tax and Unilever Kenya Limited (the Unilever case). The judgment of the High Court in the Unilever case led to the introduction of transfer pricing rules in July 2006, which provide guidance on the application of the arm's-length principle.

Statutory rules

Section 18 (3) of the Income Tax Act, Chapter 470 of the Laws of Kenya (the Act) requires business carried on between a non-resident and a related Kenya resident to be conducted at arm's length and gives the commissioner the power to adjust the profits of the Kenya resident from that business to the profits that would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length. The Income Tax (Transfer Pricing) Rules, 2006, Legal Notice No. 67 of 2006 (TP rules) published under section 18 (8) of the Income Tax Act (the Act) with an effective date of 1 July 2006, provide guidance on the determination of arm's-length prices.

Under section 18 (3) of the Act and the TP rules, persons or enterprises are related if either of them participates directly or indirectly in the management, control or capital of the other or if a third person participates directly or indirectly in the management, control or capital of both. Control is not specifically defined in this section, but is elsewhere defined in the Act to mean the holding of shares with voting power of 25% or more. In practise this definition has been adopted for transfer pricing purposes. The definition of related parties has been expanded to include relationships with natural persons, and the section has been amended to ensure that it is not interpreted only in an anti-avoidance context. Prior to the amendment, there may have been an (untested) legal interpretation that the KRA could make transfer pricing adjustments only if it could prove a tax avoidance motive. The TP rules state that they apply to transactions between branches and their head office or other related branches. Doubts as to the legitimacy of this provision have arisen in light of the restrictive application of section 18 (3) to "resident persons", which excludes branches. Notwithstanding, the widely held view is that it is prudent for branches to apply the TP rules in their dealings with

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their head offices and other branches for two reasons. Firstly, the intention that, at the local level and at the international level in the OECD, the arm's-length principle should be extended to branches is clear. Secondly, the arm's-length principle is an implicit requirement in other sections of the Act, for instance with respect to the requirement for reasonableness of allocation of head-office costs incurred by branches.

Transactions subject to adjustment include: the sale or purchase of goods; sale, transfer, purchase, lease or use of tangible and intangible assets; provision of services; lending or borrowing of money; and any other transactions that affect the profit or loss of the enterprise involved.

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 and a non-comprehensive list of the documents that the Commissioner may request is provided in Rule 9 (2). Rule 10 similarly requires a taxpayer who asserts the application of arm's-length pricing to provide supporting documentation evidencing the taxpayer's analysis upon request by the Commissioner. The KRA has interpreted these provisions to mean that a taxpayer is required to have documentation in place in readiness for any such request from the Commissioner.

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

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

In providing guidance on the nature of documentation required, Rule 9 (2) does not include any hard and fast rules for compiling documentation or the process that taxpayers should follow.

The rules specify that the five primary methods specified in the OECD Guidelines may be used to determine the arm's-length nature of the pricing for goods and services in transactions between related parties. In circumstances where one of the five methods cannot be used, another method approved by the Commissioner of the KRA can be applied.

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

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.

Controlled foreign companies
The concept of controlled foreign companies is not a feature of Kenyan tax law, and Kenya does not have any rules that would deem a foreign company controlled by Kenya residents to be resident for transfer pricing purposes.

Other regulations
For financial years ending on or after 31 December 1999, companies are required to disclose all transactions with related parties under IAS 24. The wide definition of "related parties" in IAS 24 ensures that financial statements prepared in accordance with IFRS will provide the KRA with information concerning related party transactions, and this will likely be the starting point for KRA enquiries into transfer pricing.

In 2010, the KRA introduced a schedule to the annual tax return requiring taxpayers to declare whether they have any related party transactions, their quantum and whether they have prepared TP documentation. The schedule applies to 31 December 2010 year ends onwards, but appears only when a taxpayer completes its return online. As most taxpayers in Kenya do not make online filings, this schedule may not be serving the purpose for which it was intended.

Legal cases
Of the two transfer pricing cases instituted before the courts in Kenya, the Unilever case is the only one on which a judgment was delivered. In this case, the High Court of Kenya endorsed the use of OECD Guidelines in the absence of detailed guidance from the KRA. The government's response to this judgment was the introduction of the TP rules, which are largely based on the OECD Guidelines. There have been no court cases since the introduction of the TP rules.

Burden of proof
In Kenya, the burden of proof is on the taxpayer to demonstrate that the controlled transactions have been conducted in accordance with the arm's-length standard.

Tax audit procedures
Beyond the requirement to produce documentation in support of the application of the arm's-length principle, the TP rules do not contain any guidance to taxpayers as to what they may expect in connection with a transfer pricing investigation, and nothing is known of such guidance communicated internally within the KRA. However, the KRA appears to be taking guidance on transfer pricing from the OECD Guidelines, and the expectation is that KRA officers will be guided by the OECD Guidelines in conducting a transfer pricing investigation.

The indications are that the KRA regards transfer pricing as a potentially major revenue earner and that it will be taking a rigorous approach. The KRA is currently requesting transfer pricing documentation from all taxpayers with cross-border-related-party transactions with the intention of risk profiling them for the purpose of conducting transfer pricing audits. All multinationals are potential targets for a transfer pricing audit, and those multinationals with transactions which fall within the provisions of section 18 (3) and the TP rules should take transfer pricing seriously and develop and maintain properly documented and defensible transfer pricing policies. The present recommendation is that documentation should, where possible, be contemporaneous and regularly updated. Until KRA practice in this respect is clearly established, taxpayers are advised to regularly update their transfer pricing documents, especially where there are changes in the operations.

Resources available to the tax authorities
A specialist transfer pricing unit has been established within the Domestic Taxes Department of the KRA and it is responsible for conducting transfer pricing audits. Investment has been made in developing specialist expertise within the KRA through training locally and abroad. Additionally, the KRA is a member of the African Tax Administrators Forum, a technical body supported by the OECD.

Use and availability of comparable information
Use
The TP rules, which are based on the OECD Guidelines, are the basis for determining an acceptable transfer pricing methodology. Within the context of these rules and guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

Availability
Information on the performance of public companies in Kenya is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available. Although the KRA has in the past confirmed that, under certain circumstances, it would accept the use of financial databases used elsewhere in the world, and specifically Amadeus/Orbis, the KRA has recently advocated for the use of local comparables or for applying geographic adjustments to overseas comparables.

Risk transactions or industries
In general all multinationals are at risk of transfer pricing investigations.

Competent authority
Little information is available on the process for competent authority claims. Experience suggests that the competent authority process has not been widely used in Kenya. The lack of experience means that competent authority claims or reliance on MAP to resolve disputes will be problematic.

Advance pricing agreements
Kenya has no procedures in place by which a taxpayer might achieve an advance agreement to its transfer pricing policy. In general terms, the KRA is reluctant to give binding rulings regarding practices or policies adopted by a particular taxpayer or group of taxpayers. This same reluctance is to be expected in connection with agreements or rulings on transfer pricing matters.

Anticipated developments in law and practice
The KRA intends to introduce Practice Notes to assist taxpayers in their review of their transfer pricing policies.

Liaison with other authorities
Although customs and income tax are under the same authoritative body, they are administered by distinct and separate departments within the KRA, and there is very little sharing of information between the two departments. However, KRA is on a general drive to improve its systems, and better cooperation between the various authorities is expected in the near future.

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OECD issues
Kenya is not a member of the OECD, but does follow the OECD Guidelines and models.

Joint investigations
The KRA has not teamed with any other tax authorities for the purposes of undertaking a joint investigation into transfer pricing. However, the KRA is part of the African Tax Administrators Forum, a body that is partly responsible for enhancing the technical expertise of African tax authorities.

Thin capitalisation
The relevant sections of the Income Tax Act which deal with thin capitalisation are sections 4A (a),16(2)(j) and 16(3).

Thin capitalisation rules apply where financial assistance is granted to a resident company by a related non-resident company, which alone or together with no more than four other persons, controls the resident company, and the loan exceeds the greater of:

- Three times the sum of the revenue reserves and the issued and paid-up capital of all classes of shares of the company; or
- The sum of all loans acquired by the company prior to 16 June 1988, and still outstanding at the time of determining the thin capitalisation status of a company.

An interest payment on that part of the loan that exceeds the permissible ratio of 3:1 is not deductible for tax purposes. In 2010, the ITA was amended to provide for deemed interest on non-interest-bearing loans from non-resident related parties. The deemed interest is calculated at the average 91-day Treasury Bill rate and is not deductible.

Thin capitalisation rules are typically designed to prevent erosion of the tax base through excessive interest deductions in the hands of companies that obtain financial assistance from non-resident affiliates.