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AN EMPIRICAL REVIEW OF TRANSFER PRICING IN KENYA

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Abstract

Transfer pricing generally entails the price at which divisions of a company or related companies transact with each other. Taxation issues in Kenya have been a hot topic both in the government and in the private entities especially multinational companies. The objective of the study was to get into the insights of transfer pricing and its taxation implications on multinational companies in Kenya. Specifically, transfer pricing shifts profits as long as transfer price was not at arm's length and also minimizes tax burden or rearrange the direction of cash flow because transactions between related entities not governed by open market considerations. The research adopted the desktop review. The target population was the multinational companies in Kenya. The study collected secondary data by reviewing literature from relevant journal articles and books. Documentation, advantages, disadvantages and methods of transfer pricing considered. Further, factors affecting transfer pricing and its tax implications empirically reviewed. From the study findings majority indicated that the most commonly used transfer pricing techniques is cost-based transfer pricing and that the most approach to resolving the transfer pricing conflicts is that goods can be transferred between the divisions at a variable cost

with profit to the supplier provided by a periodic charge. The study recommends that multinational companies should consider implementation of transfer pricing techniques to minimize the associated costs and that the challenges involved in transfer pricing techniques should be taken in to consideration by the concerned management team to reduce the unplanned losses that may occur during implementation phase.

Keywords: Transfer Pricing, Price, Taxation, Tax laws, Kenya

INTRODUCTION

Transfer price is the price at which goods or services transferred from one process or department to another or from one member of the group to another (Kaplan and Atkinson, 1998). Transfer pricing implies that intra-company and inter-company (associates) trade between themselves. According to Garrison, Noreen and Seal (2008), transfer price is the price charged between the company divisions or its associates. Taxation of transfer prices brought in when different divisions of a multi-entity company are in charge of their own profits. When divisions are required to transact with each other, a transfer price used to determine costs. The rule of transfer pricing is to ensure that related parties not disadvantaged in any way. According to Lakhal (2006), state jurisdictions enforce an arm's length transaction rule that states that harmonization of prices be done in both related and unrelated entities. An arm's-length price for a transaction is therefore the market price of that transaction (Borkowski, 1997).

Globally, the growth of international business has resulted in the rise of cross border transactions between entities in various jurisdictions. Many jurisdictions have become sensitive to the potential shifting of profits through transfer pricing, and have adopted rules regulating the setting, testing of prices, and allowance of deductions or inclusion of income for related party transactions. Transfer pricing offers many advantages for a company from a taxation perspective, although regulatory authorities often frown upon the use of transfer pricing to avoid taxes. Transfer pricing avoids taxes based on the various tax regimes of different states (Gideon, Clement & Bamikole, 2018). In some cases, trading organizations do away with international tariffs by ensuring low expenses incurred in the process of business. Organization for Economic Cooperation and Development (OECD) governs tax laws across borders and the auditing firms under OECD review and investigates the accounts of Multinational Corporations (MNCs) (OECD, 2013).

Regionally, many jurisdictions for example Tanzania have adopted broadly similar TP rules so as to counter aggressive tax planning techniques used by MNCs to shift profits to other

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jurisdictions. The Tanzania Revenue Authority (TRA) established an International Taxation Unit (ITU) in the year 2011 under the Large Taxpayers.

Department, a specialized unit dedicated to handle all International Taxation issues. Prior to 2014, the TP issues dealt with under Section 33 of ITA 2004, Regulation 6 of the Income Tax Regulations and Section 27 of the ITA 1973.

The transactions were be undertaken at arms' length and the Commissioner given power to undertake adjustments, re-characterize the transactions and re-allocate costs, revenues, losses etc. In the year 2014, the Income Tax (Transfer Pricing) Regulations 2014 and Transfer Pricing Guidelines introduced as a guide in the application of Section 33 and replace Regulation 6 of the Income Tax Regulations. In the publication of April 2018, the Transfer Pricing Regulations 2014 incorporated in the Income Tax Act amended and replaced by the Transfer Pricing Regulations 2018 incorporated in the Tax Administration Act.

It is within the tax laws that the arm's-length principle between inter and intra-company transactions as per Section 18 of the Income Tax Act should be applied (Garrison, Noreen & Seal, 2008). Rules under the tax laws describing Arm's Length Principle entailed in Article 9 of the OECD Model Tax Convention. Definition of it means that holding and subsidiary companies together with their associates should trade independently (OECD, 2013). International taxation applies because the Arm's Length Principle based on real markets, thus enabling concurrent collection of taxes between states; double taxation relief by the MNCs necessitated (Needham, 2013). Transfer pricing rules based on the OECD guidelines incorporated into the ITA in 2006. These rules necessitates on guiding companies on how to comply with the Arm's Length Principle (Garrison, Noreen & Seal, 2008).

The arm's-length principle in order to be applied needs comparable units these comparable units are lacking in some regions of the World, for instance Africa. Lang (2018) states that this has adverse consequences both for taxpayers and for tax administrations, rendering Transfer Pricing administration and audit difficult. The Toolkit for addressing difficulties in accessing comparable data for Transfer Pricing analyses, by the platform of cooperation on tax are the comprehensive documents of the IMF, OECD, UN and WBG.

Example

XYZ Ltd sells a locally made pen at Ksh 5 per unit. Pen manufactured by passing raw materials through two departments, A and B, at costs of Ksh 1.50 and Ksh 2.50 respectively. A transfer price of Ksh 2 established to measure the profit achieved by department A.

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Interpretation

The total cost of the product is Ksh 4 per unit providing a profit to the company of Ksh 1 per unit. Department A has costs, or inputs, of Ksh 1.50 per unit and a transfer price of Ksh 2 per unit as a measure of output value. It thus shows a profit of Ksh 0.50 per unit. Department B has input costs of Ksh 2.50 per unit, plus a transfer price of Ksh 2 per unit, and an output value of Ksh 5. Department B also shows a profit of Ksh 0.50 per unit, therefore, the profit of both departments together is Ksh 1 per unit (Ksh 0.50 plus Ksh 0.50). The organization's profit of Ksh 1 per unit is unaffected by the transfer price because the output value attached to department A's production becomes an input value for department B.

If a transfer price of Ksh 1.50 per unit used in this same example, department A appears to show Ksh 0 as a profit. The costs to department B are Ksh 1.50 plus Ksh 2.50, giving a Ksh 1 profit per unit for a selling price of Ksh 5 per unit. This transfer price ensures that department A's costs are transferred to department B but does not offer a profit motivation to department A's manager. Department A is unlikely to take action to improve performance if all credit for such effort under department B's results is shown. According to Lang (2018), different transfer prices allocate profit in different ways between divisions and it should be clear that:

- Transfer pricing shares profits between divisions but does not, on its own, affect total profits (Lang, 2018);

Transfer pricing can motivate managers to take actions to improve profits for their divisions and for the organization as a whole (Lang, 2018). The transfer price should allow the opportunity for effort translated into a positive measurement of performance.

Objectives of Transfer Pricing

i) To shift profits as long as that transfer price was not at arm's-length.
ii) To minimize tax burden or rearrange the direction of cash flow because transactions between related entities not governed by open market considerations.
iii) Other objectives

McKinley, CGMA and Owsley (2003) assert that intra-company transactions not dictated by the market except other considerations such as:

- To reduce profits artificially in order to reduce taxation costs in a specific country (McKinley, et al., 2003)

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- To enhance decentralization of production in order to concentrate profits in the state of production efforts in situations where there is no or least competition (McKinley, et al., 2003)
- To enhance beyond ceilings remittance of profits imposed for repatriation (McKinley, et al., 2003)
- To enhance exploitation of foreign exchange fluctuation to the advantage of the company (McKinley, et al., 2003)

Transfer Pricing Documentation

According to (Allain & Holmes, 2010) transfer pricing documentation refers to the compliance of the Arm's Length Principle by the taxpayers through proper bookkeeping of their respective accounts. This will necessitate compliance with the Government regulations by allowing reviews to the taxation information contained in the records of the taxpayers (Garrison, 2008). Failure to comply with the documentation of transfer pricing may lead to double taxation, none enforcement with tax authorities and other related issues (Lang, 2018).

Transfer pricing documentation not contained in the OECD guidelines. Individual member nations handle their own transfer pricing documentation. Financial reporting statements when disclosing transfer pricing matters under strict scrutiny requires full compliance with the laws of documentation to necessitate proper audit and investigation of the company books of accounts (Hirshleifer, 1956). OECD (2013) points out that none compliance to tax documentation rules may lead to additional expenses to the company in the form of added taxation. Transfer prices monitored closely to ensure correct reporting within the Arm's Length Principle for accurate taxation. According to Gideon, Clement and Bamikole (2018), the following documentation is required:

i) Selection of TP method and reason why selected
ii) Application of method, including calculations and price adjustment factors considered.
iii) Global organization structure.
iv) Details of transactions considered.
v) Assumptions, strategies and policies applied in selecting method.
vi) Any other background information.

There is no exemption in the case of providing transfer pricing documentation thus must be maintained no matter how small or how insignificant the related party dealings. KRA has a

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dedicated Transfer Pricing department and specialized team that carries out TP compliance audits.

Arguments for Transfer Pricing

i) **Motivates division managers**

Through adequate supply of information the decision managers will be encouraged to make good economic decisions or capital budgeting.

ii) **Aids business analysis**

Evaluation of managerial and economic performance of divisions made possible through useful and transparent information provided.

iii) **Economic resources redistribution within the company**

Company's wealth between divisions or locations well distributed.

iv) **Divisional autonomy within the company applauded**

Respect and protection of the division within the company is encouraged.

v) **Helps in reducing duty costs**

Trading with states having less transfer price, partner states will trade their good given that the tariff rates are high in oversees thus lowering the duty costs (Needham, 2013).

vi) **Reduces income and corporation taxes**

This happens by charging highly on goods shipped to oversees given that the tax rates of the foreign country is lower thus granting bigger profit margin in countries with tax rates that are high.

Arguments against Transfer Pricing

i) **Disagreements between divisions of the company**

Regarding the policies of pricing and transfer.

ii) **Additional costs incurred**

Through the complexity of transfer pricing, additional time and work force, be factored in for proper maintenance of accounting system.

iii) **Difficulty in pricing intangible items**

Pricing of services is hard because it does not provide measurable benefits.

iv) **Variance of risks between sellers and buyers**

Because buyers and sellers perform different functions, they face different risks such as financial and currency risks, collection risks, market and entrepreneurial risks, product obsolescence risks, credit risks among others (Lantz, 2009).

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OECD Methods of Transfer Pricing

1) **Traditional transaction methods**

a) Comparable uncontrolled price method (CUP) - Most direct and reliable method Compares controlled and uncontrolled third party transaction's terms and conditions (including the price) (Lakhal, 2006).

- Internal CUP - Between the related party and third party (Lang, 2018)
- External CUP - Between independent and unrelated parties (Lang, 2018)

b) Resale price method (RPM) – Alternative of CUP where routine distribution functions are implemented (Lakhal, 2006).
Determines inter-company price of a good bought from intra-company transaction. Th right gross margin applied to cover both the reseller costs and profit (Emmanuel & Mehafdi, 1999). Further, import duties adjusted to comply with the Arm's Length Principle.

c) Cost plus method (CPM) – Entails both the manufacturing functions and provision services of the company
Relates cost profit to the cost of sales in order to know production cost by the supplier. Required profit derived by adding the desired mark-up cost. The prevailing market conditions and the functions performed incorporated during decision-making

2) **Transactional profit methods**

a) Transactional net margin method (TNMM) – Entails net profit relative analysis (Lang, 2018)

Appropriate base for example costs, sales, assets relative to the net profit used as indicators of profit level. Several companies prefer this because transactional diffrences less affects the net profit indicators (McKinley et al., 2003).

b) Transactional profit split method (TPSM) - Highly integrated and valuable contributions
McKinley, CGMA and Owsley (2003) denotes that associated enterprises engaging in transactions that are very interrelated agree to split the profits. It seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results achieved between independent enterprises engaging in a comparable transaction(s).

- Contribution analysis – Relied on the assets used, functional duties and company risk prevailing (OECD, 2013).

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- Residual analysis – According to Lang (2018), profit allocated in two stages:
- ✓ Remuneration for non-unique contributions or routine activities (Stage 1)
- ✓ Remuneration for unique contributions from the residual profit (Stage 2)

Factors Affecting Transfer Pricing in Multinational Companies

a) **Inflation**: Managers and top management would not want to transfer profits to countries with hyperinflation as doing so may mean exposing the earnings to unnecessary capital erosion.

b) **Exchange rate fluctuations**: Managers and top management would not want to transfer profits to countries with high exchange rates fluctuation as doing so may mean exposing the earnings to unnecessary capital erosion.

c) **Tax regime of different countries**: The relevant tax laws and potential tax implications of the countries involved in the transfer pricing scheme has to be evaluated before deciding on what transfer price to set (Lantz, 2009).

d) **Goods and services Exchange controls**: For a transfer price to be effective, management must assess the impact of goods and services exchange control (Needham, 2013).

e) **Nature of the transaction**: Companies can easily fix a transfer price of their choice for transactions that are unique and Novell (Gideon, Clement & Bamikole, 2018).

f) **Impact of the transfer on host nation**: A competing company can easily take a jibe on your brand and reputation simply by evoking the moral implications of the competitor's transfer pricing scheme especially when used to move taxable income abroad - even though done legally (Lang, 2018).

g) **Impact on the motivation of participating parties**: Make consideration on how the managers of the transferee company feel about a multinational's transfer pricing policy when it is likely to affect their appraisal and other human capital measures (Garrison, 2008).

h) **Import duties**: A cost-benefit analysis has be done in order to ensure that the company will not be financially worse-off in terms of import duties.

i) **Anti-dumping legislations**: A multinational planning to fix a transfer price must consider how anti-dumping legislations in specific country will affect the whole process.

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j) **Competitive pressure and goal congruence implications**: Management of a multinational company have to ensure that any price that is fixed will not lead to dysfunctional behaviours (Clausing, 2003).

Transfer Pricing Tax Implications

According to Gideon, Clement and Bamikole (2018), given the rise in technology, infrastructural developments over the years, international trading has risen through MNCs. This leads to direct and indirect taxation implications both locally and internationally given the cross-border activities rising tremendously (Lang, 2018).Taxation implications on any international company seem straightforward (Needham, 2013). This is evident from the perspective of management accounting and reporting, expenses and returns to subsidiaries in different countries (CGMA, 2013). In addition, the parent country focuses on the returns of the local MNCs exclusively (CGMA, 2013).

Every state is concerned in boosting the tax base of its country through any viable means. This implies that tax implications of the cross-border activities in the subsidiaries present in these countries remains squarely on the tax authorities of the respective Governments (Clausing, 2003). McKinley, CGMA and Owsley (2003) notes that transfer pricing is one of the top concerns in the International Financial Reporting Standards (IFRS) and other concerned taxation authorities thus international businesses could risk incurring non-compliance penalties of 20-40 percent on the variability of transfer pricing. This gives green light to international companies especially the MNCs fully exhaust all the principles of transfer pricing in order to benefit themselves (Lang, 2018).

CONCLUSIONS AND RECOMMENDATIONS

The study indicates that the most commonly used transfer pricing techniques is cost- based transfer pricing, followed by negotiated transfer pricing techniques, then market- based transfer pricing with only few indicating central management based transfer pricing. Transfer prices set by multinational firms differ between independent third parties, related party entities, and the extent to which these differences are elastic to product and firm characteristics, market structure, and government. Tax minimization may indeed play a role in transfer pricing decisions made by firms, as firms appear to make substantial price adjustments to changes in country tax and tariff rates. Obtaining information across borders is cumbersome since international relations between countries differ thus some countries recover very little tax from their transfer pricing audits or enquiries whereas others recover very large amounts from almost all their audits.

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The study recommends that multinational companies should consider implementation of transfer pricing techniques to minimize the associated costs and that the challenges involved in transfer pricing techniques should be taken in to consideration by the concerned management team to reduce the unplanned losses that may occur during implementation phase. Further, if goods transferred at a variable cost with profit to the supplier, this leads to an appropriate approach to resolving the transfer pricing conflicts.

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