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Transfer Pricing Disputes in Kenya: Advance Pricing Agreements the Way Forward?

by

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Abstract

Kenya, like the rest of the world, in an effort to protect its tax base, has enacted a transfer pricing (TP) legislation requiring, among other things, that inter-company transactions be conducted at arm's length. However, due to the very nature of TP transactions, the determination of the correct arm's length price or profit margin has remained a major challenge, not only for the taxpayers, but for the tax authority as well. Given the divergent interests of the parties concerning the tax consequences of a transaction, this uncertainty escalates the potential of disputes between tax authorities and taxpayers. Advance Pricing Agreements (APAs) provides a mechanism through which disputes may be avoided ex ante by parties agreeing in advance on the methodology to be applied in determining the arm's length price or profit margin, thereby offering the much needed certainty in transfer pricing issues. However, Kenya, and indeed the rest of Africa are yet to embrace APAs despite the existence of evidence of its success from other jurisdictions.

This work explores the possibility of adoption of APAs within Kenya's tax and legal system to help in the resolution of TP disputes, an issue which is currently one of the major international tax challenges facing the country. The study commences by briefly outlining the transfer pricing problem and the various TP dispute resolution mechanisms currently available. The study then examines the OECD recommendations on APAs and how those recommendations have been implemented at the domestic level by a selected OECD and non-OECD members. Based on the countries' experience, the study then critically assesses the possibility of adoption of the programme in Kenya by focusing mainly on the legal considerations that the implementation of APAs would raise. A conclusion is then reached that while there may be some criticisms against the programme, the advantages offered by APAs outweigh such disadvantages. Consequently, a recommendation is made for the Kenya Revenue Authority (KRA) to consider implementing the programme, by learning from the experiences of the early implementers such as the United States (US), but taking precaution to adapt such experiences to fit Kenya's unique socio-economic and legal circumstances.

Abbreviations

ALP	Arm's Length Principle
APA	Advance Pricing Agreement
APAs	Advance Pricing Agreements
BAPA	Bilateral Advance Pricing Agreement
BCL	Bamburi Cement Limited
BEPS	Base Erosion and Profit Shifting
BNA	Bureau of National Affairs
Cap.	Chapter
CBDT	Central Board of Direct Taxes, India
EAB	Ericsson AB-Sweden
EC	European Commission
EKL	Ericsson Kenya Limited
EY	Ernst & Young
FCMU	Full Cost Mark Up
FE	Flower Express
FOIA	Freedom of Information Act
G20	Group of 20
GSK	GlaxoSmithKline
IRS	The US Internal Revenue Service
ITA	Income Tax Act
KRA	Kenya Revenue Authority
LC	Local Committee
LTO	Large Taxpayers Office
MAP	Mutual Agreement Procedure
MNE	Multinational Enterprise
MNEs	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development

OECD Model Tax Convention	OECD Model Convention on Income and on Capital
OECD TP Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
PATA	Pacific Association of Tax Administrators
SAT	State Administration of Taxation, China
Sh	Shilling
TAT	Tax Appeals Tribunal
TATA	Tax Appeals Tribunal Act
TP	Transfer Pricing
TP Rules:	Income Tax (Transfer Pricing) Rules, 2006
UGL	Unilever Uganda Limited
UK	United Kingdom
UKL	Unilever Kenya Limited
UN	United Nations
UN TP Manual	United Nations Practical Manual on Transfer Pricing for Developing Countries
US	United States
USD	United States Dollar

Background and Purpose

*Section 18(3) of the Act does not tell tax payers what KRA will accept as an arm's length or how to prove it to them or if they are willing to negotiate pricing arrangements. I do hope KRA will lead in this initiative to make rules in this regard as India did as early as 2001.*¹

*For many corporate taxpayers, a five-year audit, three years at Appeals, and then another five years in court and two more on appeal usually proves to be just a bit too much. Quick math = 15 years.*²

On 5th October 2005, the High Court of Kenya delivered its judgment in the case of *Unilever Kenya Ltd v Commissioner of Domestic Taxes*.³ It is this decision that has been credited with the enactment of transfer pricing (TP) rules in Kenya.⁴ Indeed, the rules were in place barely nine months after the judgment.⁵ The judgment also acknowledged the relevance in Kenya of the Organisation for Economic Co-operation and Development ('OECD') Model Convention on Income and on Capital ('OECD Model Tax Convention') and the accompanying rules, more specifically, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('OECD TP Guidelines').⁶

Apart from these two significant contributions by the *Unilever* judgment to the Kenyan tax jurisprudence, the judgment also gave an indication of the need for the enactment of Advance Pricing Agreements (APAs) into the Kenyan tax law.⁷ This latter recommendation however has not received much attention and as far as the author is aware, no extensive research has been done towards this end.⁸ Most of the existing literature has only taken a general look at the subject of transfer pricing from the Kenyan perspective. Rispha (2008),⁹ Jasper (2011),¹⁰ Ann (2011),¹¹ Ratemo (2012),¹² and Chege (2013),¹³ as part of fulfillment of their respective degree exams

¹ *Unilever Kenya Ltd v Commissioner of Income Tax*, [2005]eKLR, p. 15 [Visram J], available at <<http://kenyalaw.org/caselaw/cases/view/12804/>> accessed on 28th March 2015. In this statement, the Judge must have been at that time referring to the transfer pricing rules in general. Advance pricing rules were only introduced in India with effect from July 2012 vide Finance Act, 2012, with the Central Board of Direct Taxes (CBDT) notifying the implementing rules in the official gazette of August 31, 2012.

² John. C. Klotsche, 'United States: Jousting With The Tax Man: An Extreme Makeover, IRS Edition' (3 Jul. 2009) quoted in Michelle Markham, *Advance Pricing Agreements; Past Present and Future* (Kluwer Law International 2012) p.19

³ *Unilever*(n.1)

⁴ See for example, Lee Corrick, 'Transfer Pricing Disputes in Africa' in Eduardo Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis* (Cambridge University Press 2012)

⁵ The Income Tax (Transfer Pricing) Rules, 2006; Effective date: July 1, 2006

⁶ OECD (2010): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*, OECD Publishing 2010 (hereinafter referred to as 'OECD TP Guidelines')

⁷ *Unilever* (n 1) p. 15

⁸ There have been however newspaper reports to the effect that the Kenya Revenue Authority (KRA) could be currently considering introducing the programme; See, Titus Nguhiu, 'Taxman's new take on transfer pricing will attract foreign investments', *The East African* (Nairobi, 15 November 2014) <<http://www.theeastafrican.co.ke/OpEd/comment/-/434750/2523572/-/dbfo67/-/index.html>> accessed on April 4, 2015

⁹ Rispha Mwangi, 'Transfer Pricing: Does Kenya's Tax Law Provide Adequately for This?' (LLM thesis, University of Nairobi 2008)

¹⁰ Jasper Mbiuki, 'The Legal and Institutional Framework of Transfer Pricing in Kenya: A Case Study of the Unilever Case and its Aftermath' (LLM thesis, University of Nairobi 2011)

¹¹ Ann J. W, 'The Kenya Income Tax Law: Its Inadequacies in the Regulation of Transfer Pricing' (LLM thesis, University of Nairobi 2012)

¹² Mosota J. R, 'Transfer Pricing Regulation in Kenya: A Critique' (LLM thesis, University of Nairobi 2011)

wrote on the subject, but none of the studies focused expansively on the dispute resolution aspects of TP issues, particularly APAs. Another Kenyan researcher, Bosire Nyamori (2012) has also done some work on the subject but he too took a general perspective on the topic and concluded that while the introduction of TP Rules in Kenya would serve to ensure some measure of certainty, its success would however be impeded by the lack of requisite expertise and comparable data.¹⁴

This thesis is therefore intended to be an effort towards bridging this gap by looking at the concept of APAs and assessing the possibility of the programme's adoption in Kenya. The study, among others, looks at the at the OECD recommendations on APAs and how such recommendations have been implemented at the domestic level by a selected OECD and non-OECD countries. The study then proceeds to assess whether the programme, if it were to be adopted by Kenya, would be compatible with the Kenya's tax and legal systems, including the country's constitutional provisions and the prevailing judicial practice.

Methods and Materials

The methodology adopted for this work is largely qualitative research, consisting of a critical and comparative legal analytic review of the relevant legislation, case law, and literature. To some extent, a quantitative approach is also adopted, particularly in relation to Chapter 3 of the study regarding the analysis of the statistical APA reports as published by the countries under study, to wit, China, India and the Unites States (US) on the performance of their respective APA programmes.

Delimitation and Scope

First, this study will be limited to the concept of APAs as a mechanism for resolving TP disputes prospectively. Although references are made to the other TP dispute resolution mechanisms such as litigation, mutual agreement procedure (MAP) and arbitration, such a references are only limited to the drawing of parallels and to aid in the better understanding of APAs as a concept. Second, the study will not deal extensively with the non-legal aspects of APAs such as the programme's costs implications, the need for staff with the requisite transfer pricing knowledge and the other administrative features of the programme.

Secondly, the study will pay particular attention to the OECD recommendations on APAs and how those recommendations have implemented in practice by a selected OECD and non-OECD member countries. While it is acknowledged that apart from the OECD, other bodies such as the United Nations¹⁵ and the European Union¹⁶ have also done some work in the area of APAs, such

¹³ Patrick N. Chege, 'The Organisation of Economic Cooperation and Development (OECD) Transfer Pricing Guidelines: An Evaluation of their Effectiveness in the Kenya's Tax Regime' (LLM thesis, University of Nairobi 2013)

¹⁴ Bosire Nyamori, 'An Analysis of Kenya's Transfer Pricing Regime', *International Transfer Pricing Journal*, (2012), March/April, pp. 153-60

¹⁵ Through the works of the UN Committee of Experts on International Cooperation in Tax Matters which has developed a number of documents on transfer pricing. See for example; UN, *Practical Manual on Transfer Pricing for Developing Countries*, 2013, Chapter 9

¹⁶ Through the work of the EU Joint Transfer Pricing Forum; See for example, COM (2007) 71 final, *Communication from the Commission to the Council, the European Parliament, and the European Economic and Social Committee on the Work of the EU*

works will not be considered extensively (although reference may be occasionally made thereto) due to the fact they heavily borrow from the OECD recommendations,¹⁷ which itself also borrowed from the works of the Pacific Association of Tax Administrators (PATA) on APAs.¹⁸ For the purposes of this study, the works of the OECD have been chosen over the latter because of the organisation's wide membership.¹⁹ Finally, although there are a number of OECD member countries currently running the APA programme, the US has been chosen due to the country's longest history and extensive experience on APAs.²⁰ Due to the fact that APAs are yet to be embraced by the African countries,²¹ experiences from China and India, which are some of the leading Kenya's trading partners,²² are integrated into the study to get the developing countries' perspective.

Finally, due to language limitations, materials used in the research will be limited only to those in English. It is however acknowledged that there could be lots of valuable literature on the subject in other languages, especially regarding the Chinese APA which forms the part of this study.

Outline

This work is divided into five chapters as follows: Chapter 1 briefly describes the TP problem and also outlines the various TP dispute resolution mechanisms that may be available to a taxpayer for this purpose. Chapter 2 then looks at the Kenyan TP legislative framework with particular focus on the dispute resolution aspects of the TP issues. A brief assessment of the various TP dispute resolution mechanisms currently available under the Kenyan law is also done. Chapter 3 commences by setting out the OECD recommendations on APAs and then proceeds to assess how those recommendations have been implemented at the domestic level by the US, one of the OECD member countries with the longest (currently more than 20 years) experience of the programme. To get the developing countries' perspective, the study also integrates the experiences from China and India. Chapter 4 then examines the possible legal considerations that may underlie the implementation and application of an APA programme. The identified issues are then be mirrored against the Kenyan legislative and constitutional framework with a view of assessing the programme's compatibility with the Kenyan legal system. Chapter 5 concludes.

joint transfer pricing forum in the field of dispute avoidance and resolution procedures and on guidelines for advance pricing arrangements within the EU, February 26, 2007, Annex.

¹⁷ *ibid* n. 15 and n. 16

¹⁸ PATA, 'BAPA Operational Guidance for Member Countries of the Pacific Association of Tax Administrators', February 6, 2004; PATA was reconstituted to Leeds Castle Group in 2006 bringing in as new members, China, Germany, India, France, South Korea and UK in addition to the four countries (Australia, Canada, Japan and the US) originally forming PATA; See, Toshio Miyatake, 'Transfer Disputes in Japan' in Edward Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis* (Cambridge University Press 2012)

¹⁹ Currently, the OECD has 34 Member Countries compared to EU's 28. (see note 18 above and the OECD website available at, <<http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm>> accessed on May 12, 2015

²⁰ Michelle Markham, *Advance Pricing Agreements: Past Present and Future* (Kluwer Law International 2012), Preface

²¹ See, Lee Corrick, (n 4))

²² KNBS, Statistical Abstract 2014, Available at, <http://www.knbs.or.ke/index.php?option=com_phocadownload&view=category&id=106&Itemid=1177> accessed on May 12, 2015)

CHAPTER 1

1 THE TRANSFER PRICING PROBLEM

1.1 Introduction

In an increasingly globalised business environment, transfer pricing has become one of the major international tax challenges currently facing most countries. Consequently, a number of supranational organisations, key among them the OECD, have dedicated substantial effort towards strategies to help in dealing with these challenges.²³ The issue has become the center of focus in the ongoing OECD/G20 BEPS Project where, apart from being listed as one of the six ‘key pressure areas’,²⁴ the topic has been exclusively assigned three out of the 15 Action Points of the BEPS Project.²⁵ The remaining 12 Action Points though not listed as TP ‘key’ areas, relates in a significant way to the subject.²⁶ For example, Actions 13 and 14 which deals Transfer Pricing Documentation and Dispute Resolution respectively, have as their core major TP issues.²⁷ The increased focus on TP issues has been attributed to among other things, the realisation of the fact that inter-company transactions constitutes approximately 60 percent of the world trade.²⁸

With this kind of international focus on TP issues, it is by no surprise that a 2013 global transfer pricing survey of 878 MNEs across 26 countries revealed that globally, tax authorities have stepped up their enforcement measures, with particular attention being given to transfer pricing matters. Consequently, a majority (66 percent) of the respondents MNEs identified transfer pricing risk management as their highest priority, an increase of 32 percent from the 2007 survey.²⁹ With most countries experiencing shortfall in their revenues, tax administrations globally have focused more on transfer pricing enforcement to bridge this gap.³⁰

In Kenya, since the landmark decision in the *Unilever* case, transfer pricing has equally been an area of significant focus by the Kenya Revenue Authority (KRA) which has put more emphasis on the legislative, administrative and capacity building initiatives to address the issue.³¹ The latest legislative action by the Kenyan Government in the area of international tax, a transfer pricing related area, is the 2014 amendment to the Income Tax Act (ITA) by broadening of the

²³ See for example, OECD (2012), *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing.

<<http://dx.doi.org/10.1787/9789264169463-en>> accessed on April 8, 2015

²⁴ See, the OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, available at <<http://dx.doi.org/10.1787/9789264192744-en>> accessed on April 8, 2015; The other five ‘key’ areas of focus by the BEPS project are, Aggressive Tax Planning, Tax Treaties, Tax Policy and Statistics, Tax & Development and Tax Compliance

²⁵ Action Points 8, 9 and 10, ‘Ensuring that Transfer Pricing outcomes are in line with value creation’ (see, OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, , OECD Publishing, available at, <<http://dx.doi.org/10.1787/9789264202719-en>> accessed on April 8, 2015

²⁶ See, OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, (n. 25)

²⁷ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, (n. 25)

²⁸ OECD: *OECD Insights*, 18 April 2013 Debate the Issues < <http://oecdinsights.org/2012/03/26/pricifixing/>> accessed on April 8, 2015

²⁹ Ernst & Young 2013 *Global Transfer Pricing Survey; Navigating the Choppy Waters of International Tax*, available at <<http://www.ey.com/GL/en/Services/Tax/2013-Global-Transfer-Pricing-Survey>> accessed April 8, 2015

³⁰ See, Michelle Markham, (n.20) p. 6

³¹ European Commission (2011): *Transfer Pricing and Developing Countries*, p 24, 26 and 52, available at <https://www.google.co.ke/?gws_rd=ssl#q=European+Commission+%282011%29:+Transfer+Pricing+and+Developing+Countries> accessed on April 8, 2015

definition of a Permanent Establishment (PE) to include among others, the activities of a dependent agent. Further, in a move apparently intended to address the problem of risk-stripping which may occur as a result of restructurings, taxpayers are with effect from January 1, 2015 required to notify the KRA of any changes in their corporate and business structures.³²

At approximately 22 percent of the country's gross domestic product, taxation remains the single largest source of revenue for the Kenyan Government.³³ Statistics indicate that approximately 75 percent of the country's tax revenue comes from the large taxpayers of which multinational enterprises (MNEs) forms a substantial part.³⁴ Consequently, in recognition of this central role played by MNEs in the country's tax system, the KRA created a specialist transfer pricing unit within the Large Taxpayers Office (LTO) which is currently aggressively pursuing TP audits.³⁵ As of 11th July 2014, it was reported that the unit had carried out TP audits on approximately 50 MNEs, resulting into a total tax yield of over Sh25 billion (approximately USD 272 million).³⁶ Some of these assessments have been contested with only a few finding their way to the administrative tribunals and ultimately to the courts. A majority of the contested cases have however been settled at the KRA level.³⁷ It is against this backdrop, and in recognition of APAs ability to avoid disputes ex-ante, on a principled basis, that the need for a possible adoption of the APA programme in the Kenyan tax system will be evaluated.

1.2 Description of the TP Problem

Transfer pricing has been defined as '[t]he area of tax law that is dedicated to the tax consequences of the pricing of cross-border intercompany transactions'.³⁸ International transfer pricing issues arise when entities of a multinational enterprise (MNE) resident for tax purposes in different tax jurisdictions transact with each other. Unlike independent enterprises whose dealings are generally determined by market forces, associated enterprises (whether legally or economically),³⁹ are in principle free to set transfer prices for their intra-firm transactions. The prices so set may deviate from what they would have been in an open market scenario with the result that the profitability of the individual entities of the MNE may be affected in one way or the other. This will in turn have an effect on the taxes payable in the various jurisdictions where the individual entities are tax resident. MNEs normally use this 'internal market pricing mechanism' to reduce their overall tax burden by shifting profits from high tax jurisdictions to relatively low tax jurisdictions. This could be achieved, for example, by overstating the price of goods sold by a subsidiary established in a low tax jurisdiction to a subsidiary established in a high tax jurisdiction. This way, the subsidiary in the high tax jurisdiction would declare higher costs and therefore lower profits than the comparable market conditions. The excess profit would however be registered by the MNE in the jurisdiction with a lower tax rate, hence minimising the MNE's overall tax burden.⁴⁰

³² See Finance Act 2015, Section [2], [15]

³³ See for example, EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p. 9

³⁴ KRA: *Large Taxpayers Office*, available at <<http://www.revenue.go.ke/index.php/domestic-taxes/large-taxpayers-office/about-lto/vision>> accessed on 8th April 2015

³⁵ *ibid*; see also, EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p. 18

³⁶ John Njiraini, 'Remarks at the AIBUMA Conference' (Nairobi, 11 July 2014), available at, <http://www.revenue.go.ke/index.php/notices/kra-news/1034-kra-cg-mr-njiraini-speech-aibuma-conference-11-july-2014> (accessed on 8th April 2015)

³⁷ See for example, Patrick Chege, (n.13), p.119; Patrick Chege is currently the head on TP unit in KRA

³⁸ Jérôme Monsenego, *Introduction to Transfer Pricing* (Studentlitteratur AB 2013) p. 13

³⁹ See, the OECD TP Guidelines, para 1.2

⁴⁰ For further illustration Jérôme Monsenego (n.38), p.18-20

In order to protect their respective tax bases against such TP manipulation, countries around the globe have enacted TP legislations. These legislations are generally predicated upon the arm's length principle (ALP),⁴¹ a standard which endeavours to replicate the 'working of the open market in cases where goods and services are transferred between associated enterprises.'⁴² This principle which was first developed and applied in the USA before being adopted by the OECD,⁴³ requires MNEs to set prices for their internal transactions (transfer price) in such a way as reflect the price that would have been charged for similar transaction(s) entered into by independent parties in similar circumstances (arm's length price).⁴⁴ Therefore if a particular intra-firm transaction happens to be inconsistent with a comparable independent transaction, such legislation generally authorises tax authorities to adjust, for tax purposes,⁴⁵ the relevant transfer price in order to achieve consistency with the comparable transaction. It is this adjustment by the tax authorities that has always been the source of transfer disputes globally.⁴⁶

Transfer pricing disputes are further escalated by the fact that the TP legislations, acceptable methodologies and interpretation of the ALP and how it is to be applied in practice are still not uniform internationally, with variations from country to country.⁴⁷ This has led to disputes not only between the tax authorities and the MNEs, but also between the tax authorities *inter se*. A case in point is the *GlaxoSmithKline* ('GSK') case,⁴⁸ where, on the one hand, the US took the position that pharmaceutical products marketed in the US by the United Kingdom ('UK') parent through their US associate derived their primary value from the marketing activities in the US; the UK (and GSK) on the other hand, took the position that it is the Research and Development ('R&D') owned by the UK parent that gave the pharmaceutical products their primary value. Despite the fact that the case was eventually settled with GSK paying to the United States USD 3.4 billion, which was then described as 'the largest single payment to IRS [...] in the resolution of a tax dispute',⁴⁹ the 16 year dispute not only resulted into the company being double taxed (since no corresponding adjustment was made by the UK), but also demonstrated the deficiencies of the mutual agreement process as a dispute settlement mechanism under the income tax treaties.⁵⁰

1.3 Dealing with the Transfer Pricing Disputes

International juridical double taxation is considered a hindrance to international trade,⁵¹ and therefore in recognition of the need to avoid it, countries have entered into double tax treaties

⁴¹ See for example S. 18(3) of the Kenyan ITA and the rules made thereunder.

⁴² OECD TP Guidelines, paras 1.1-1.5

⁴³ See Mark Bronson et al, 'Overview/Best Practices' in Duff & Phelps (eds), *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International 2013)

⁴⁴ *ibid* (n 31)

⁴⁵ The adjustments are only for tax purposes, without affecting other (non-tax) rights and obligations that may underlie a transaction, see, OECD TP Guidelines, para 1.2

⁴⁶ See for example, Ian Roxan, 'Introduction' in Edward Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis* (Cambridge University Press 2012)

⁴⁷ Brazil, China and India are examples some of the countries that do not strictly follow the OECD TP Guidelines; see for example, Patrick Chege (n. 13), pp. [3-4], [46-64]

⁴⁸ IR-2006-142, 11 Sept. 2006

⁴⁹ *ibid*; see also, Michelle Markham (n. 20), p10

⁵⁰ *ibid*

⁵¹ Juridical double taxation is defined by the OECD Model Tax Convention as 'imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods' (See, Introduction to the 2010 OECD Model Tax Convention, para 1)

modeled alongside the OECD Model Tax Convention which generally recommends that where an upward TP adjustment (primary adjustment) by one country results into a MNE being double taxed, the double taxation may be relieved by either the tax administration of the other contracting party making a corresponding adjustment, or where that is not possible, the tax administration that made the primary adjustment may as well reverse the adjustment.⁵² The treaties also provide for a mechanism for the resolution of any disputes that may arise in the process. This is however generally without prejudice to a taxpayer's right of access to the national courts.⁵³

Currently, there exist four main dispute settlement and avoidance mechanisms which have been recognised by the OECD for resolving transfer pricing disputes. These mechanisms include, first, litigating before the national courts,⁵⁴ second, Mutual Agreement Procedure ('MAP'),⁵⁵ third, Arbitration,⁵⁶ and finally Advance Pricing Agreements (APA). A global survey⁵⁷ on these mechanisms has however revealed the APA process as the most preferred of the four in ensuring certainty and predictability on transfer pricing issues, with 79% of the respondents recording their satisfaction with the process.⁵⁸ Safe harbour rules are strongly discouraged by the OECD TP Guidelines and will not therefore be considered in this study.⁵⁹

1.3.1 Transfer Pricing Litigation

Litigation though sometimes preferred by MNEs due to its ability to deliver some sort of immediate temporary injunctive relief,⁶⁰ is generally the least preferred mechanism in resolving transfer pricing disputes. According to the Ernst & Young 2013 global survey,⁶¹ only 15% of the respondents had referred their cases to litigation as opposed to 28% and 26% for MAP and APAs respectively. The primary source of dissatisfaction with litigation was found by the survey to be the length of the process.⁶² A study conducted by the European Union (EU) on company taxation also concluded that the delay in the litigation of transfer pricing disputes is primarily due to the fact that transfer pricing is not a juridical discipline as it focuses more on economics.⁶³ There is therefore the possibility that some judges may not be possessed of the requisite specialist knowledge and experience in transfer pricing matters. A case in point is the decision in the *Unilever* case where the court took the view that for a transfer pricing adjustment by a tax authority on a MNE's transactions to be upheld, it is necessary for the tax administration to prove 'fraud or ill will' on the part of a taxpayer. The court stated that:

The respondent has submitted that this arrangement has been made deliberately to show lesser earnings. But is that really so? *There is no evidence of tax fraud or tax cheating.* The

⁵² See Article 9(2) of the OECD Model Tax Convention

⁵³ See Article 25 of the OECD Model Tax Convention

⁵⁴ In the European Union, there is an option of having tax matters ventilated up to, for example the Court of Justice of the European Union (see for example Art. 263 Treaty on the Functioning of the European Union).

⁵⁵ OECD Model Tax Convention, Article 25(3)

⁵⁶ OECD Model Tax Convention, Article 25 (5)

⁵⁷ Ernst & Young 2013 *Global Transfer Pricing Survey* (n. 29)

⁵⁸ *ibid* p.25

⁵⁹ See OECD TP Regulations para 4.96

⁶⁰ See, EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p. 16

⁶¹ Ernst & Young 2013 *Global Transfer Pricing Survey* (n. 29) p.27

⁶² *ibid*

⁶³ European Commission (2001): Commission Staff Working Paper: Company Taxation in the Internal Market, p275, available at https://www.google.se/?gfe_rd=cr&ei=bNkrVaTHHcvw-gaSplGoBw&gws_rd=ssl#q=company-tax-study-EU+2001.pdf accessed on 8th April 2015

only evidence, material, is in regard to **methods** used for computation of tax. Use of different methods, so long as proper or lawful or rather not unlawful, is permissible and ought to be permissible so long as there is no fraudulent trading with a view to “evading” tax.⁶⁴ (Italics supplied)

This position is clearly contrary to the principles that underlie a transfer pricing adjustment. According to the OECD, for a transfer pricing adjustment to be made, the primary consideration should always be whether a transaction meets the arm’s length standard. The existence of a motive or intention on the part of a taxpayer to evade or avoid taxes is therefore immaterial.⁶⁵ The United Nations Practical Manual on Transfer Pricing for Developing Countries (UN TP Manual) also echoes the OECD position.⁶⁶

Further, litigation in most cases only addresses a transfer pricing problem from the perspective of one of the jurisdictions and therefore takes a one-sided approach and does not look into the other side of the border and consequently may not guarantee elimination of double taxation.⁶⁷ Transfer pricing, by its very definition affects taxable revenue in more than one jurisdiction, any dispute resolution mechanism that does not take a holistic view in addressing a transfer pricing problem therefore runs the risk of being ineffective.

Additionally, where a national court has failed to relieve any double taxation that may have arisen, the possibility of getting the same relieved in a subsequent MAP will be significantly reduced since in some jurisdictions, tax authorities may be bound by the decision of the court and may not therefore have any legal authority to pursue MAP subsequent to the court’s decision.⁶⁸ Other disadvantages of litigation include the fact that it can be a very costly and time consuming process in view of the fact that transfer pricing disputes are usually fact intensive and involve substantial amounts of background material.⁶⁹ There is also the question of independence of the national courts and the possibility that courts may be influenced by what Markham (2012) calls ‘economic nationalism’, that is, the courts being predisposed towards securing what they may perceive as their country’s fair share of the global revenue.⁷⁰

In view of the above reasons, it is by no surprise that the EY global survey revealed that not many MNEs venture into transfer pricing litigation and even the few that do, are generally not satisfied with the process.⁷¹ This finding was confirmed by the EU study,⁷² which also concluded that the general and satisfactory transfer pricing dispute settlement mechanism within the EU is unlikely to be litigation.

1.3.2 Article 25 Procedures (MAP, Arbitration and APA)

The other TP dispute resolution mechanisms are the mutual agreement procedure (MAP) and arbitration, outlined under Article 25(3) and 25(5) respectively of the OECD Model Tax

⁶⁴ *Unilever*, (n 1) p. 13

⁶⁵ OECD TP Guidelines para 1.2

⁶⁶ UN, *Practical Manual on Transfer Pricing for developing Countries* (‘UN TP Manual’), 2013, para. 3

⁶⁷ European Commission (2001): Commission Staff Working Paper (n.63)

⁶⁸ See UN, *Guide to the Mutual Agreement Procedure Under Tax Treaties*, 2012, para 79; See also, OECD Model Tax Convention, Commentary on Article 25, para 24

⁶⁹ See for example, European Commission (2001): Commission Staff Working Paper (n.63)

⁷⁰ Michelle Markam (n.20), p. 9-10

⁷¹ Ernst & Young 2013 *Global Transfer Pricing Survey* (n. 29)

⁷² European Commission (2001): Commission Staff Working Paper (n.63)

Convention. Article 25(3), apart from authorising MAP also recognises APAs.⁷³ While the MAP process has been fairly helpful in the resolution of TP disputes, it has been found wanting in some aspects. Article 25 allows a taxpayer to lodge a complaint with the country in which he is a resident whenever such a taxpayer is of the view that through the actions of one or both countries, he has suffered, or he is likely to suffer double taxation. Once such a complaint is filed, the ‘competent authority’⁷⁴ in which the taxpayer is tax resident has the option of either granting a unilateral relief or where that is not possible, to have the same resolved through a MAP with the competent authority of the other contracting state.⁷⁵

The MAP process is conducted on the basis of *panctum de negotiando* and there is therefore no obligation on the parties to reach an agreement. The Article provides that the competent authorities are only to ‘endeavour’ to resolve the case by mutual agreement.⁷⁶ This lack of obligation on the part of the competent authorities to reach agreement has the potential of leaving double taxation unrelieved as was the case in *GlaxoSmithKline* case where the US and the UK competent authorities failed to reach a settlement.

Another limitation of the MAP process is that not all bilateral treaties have a provision for granting a corresponding relief in case of double taxation as recommended by Article 9(2) of the OECD Model Tax Convention. One such treaty is the Kenya – Sweden income tax treaty.⁷⁷ While it has been suggested that the mere absence of such a provision in a treaty may not be ground enough for a contracting state to deny a corresponding relief under a MAP procedure since such a position would be seen to be contrary to the very essence of entering an income tax agreement and would therefore amount to a breach of the obligations under the treaty,⁷⁸ it is equally asserted,⁷⁹ that in the absence of rules similar to those of Art. 9(2) OECD Model Tax Convention, economic double taxation resulting from a TP adjustment is not to form part of MAP. This uncertainty undermines the effective resolution of transfer pricing disputes.

Prior to the 2008 update of the OECD Model Tax Convention which introduced arbitration within the MAP process,⁸⁰ there existed no mechanism within the OECD framework to compel competent authorities to reach an agreement in respect of disputes under income tax treaties double taxation complaint filed with them.⁸¹ However, despite this modification, only a few countries have so far included this provision in their treaties.⁸² Possible reasons for this reluctance have been said to be related to among others, sovereignty concerns which includes trepidations as to ‘whether it is constitutionally possible to bind one’s country by an arbitrated outcome and whether it would be possible to attain sufficient political support for adding such an

⁷³ See OECD Model Tax Convention, Commentaries to Art. 25, para 50

⁷⁴ The term ‘competent authority’ generally refers to a person or persons designated by a State for purposes of representing its consent with regard to a treaty; see, OECD Model Tax Convention, Commentary on Art. 3, para 7; See also, *Vienna Convention on the Law of Treaties*, Art. 2(1) (c).

⁷⁵ OECD Model Tax Convention, Art. 25 (2)

⁷⁶ *ibid*, Art. 25(3)

⁷⁷ See for example, Article VI of the Kenya-Sweden Treaty on Income and Capital, entered in force on 28th December 1973; See also Germany-Kenya Income and Capital Treaty

⁷⁸ See paragraph 10 of the Commentary on Article 25 OECD Model Tax Convention

⁷⁹ For example, by countries such as Brazil and India; See, OECD Model Tax Convention, *Non-OECD Economies’ Positions on the OECD Model Tax Convention, Positions on Art. 25 (Mutual Agreement Procedure) and Its Commentary*, para 5

⁸⁰ See Article 25(5) OECD Model Tax Convention

⁸¹ The EU began this trend in the 1990 before OECD adopted it in 2008; see also US-Canada income tax treaty which has a mandatory binding Arbitration

⁸² Michelle Markham (n 20) p 22-3

obligation under the treaty.⁸³ For these reasons, even the OECD itself has acknowledged that a move towards a universal mandatory arbitration is currently not foreseeable.⁸⁴

Due to the various limitations associated with the competent authority process (including arbitration), like litigation, a 2010 survey by the EY revealed less reliance by MNEs on this process as a mechanism for resolving transfer pricing disputes.⁸⁵ It has been speculated that the decline in the use of the other dispute resolution mechanisms could be attributable to the increased availability of APAs and a general desire by taxpayers to manage tax controversy prospectively.⁸⁶ As had been noted earlier, the 2013 EY survey, compared to the 2010 and 2007 surveys revealed an improvement in the use of APAs with 26 percent of the respondents reporting the use of APAs in 2012 up from 21 percent in 2007.⁸⁷ The level of satisfaction with APA as a process of preventing transfer pricing disputes was equally found to be very high, with 79 percent of the parent companies surveyed recording their satisfaction.⁸⁸ From these statistics, it may be safe to conclude that it is APAs' ability to proactively resolve transfer pricing issues ex ante, and the certainty that it offers, that has perhaps made the programme to become a tool of choice not only for MNEs, but for tax administrations as well.

⁸³ UN TP Manual, para 9.6.3.7

⁸⁴ See, the OECD in the BEPS report (*Public Discussion Draft, BEPS Action 14: Make Dispute Resolution Mechanisms More Effective*, 2014) p. 1

⁸⁵ The Ernst & Young 2010 *Global Transfer Pricing Survey Addressing the Challenges of Globalization*, December 2010, p 3.

⁸⁶ *ibid*, P. 12

⁸⁷ Ernst & Young 2013 *Global Transfer Pricing Survey* (n. 29), p 25.

⁸⁸ *ibid*

CHAPTER 2

2 KENYA'S TRANSFER PRICING DISPUTE RESOLUTION FRAMEWORK

2.1 Introduction

For the purposes of protecting its tax base, Kenya, like the rest of the world has enacted a transfer pricing legislation, which legislation also provides for the various mechanisms through which disputes arising from a TP adjustment under the legislation may be resolved. Given the international nature of TP issues, the various income tax treaties to which Kenya is a party equally provides for mechanisms for resolving such disputes. This chapter commences by first outlining the legal basis of TP in Kenya and then proceeds to look at the various TP dispute resolution mechanisms available in Kenya and the experience so far. An assessment of these mechanisms is also undertaken.

2.2 Transfer Pricing: The Legal Authority

The statutory power to undertake a TP adjustment in a related party transaction is vested on the tax authority vide Section 18(3) of the ITA. For the purposes of the provision, and with the specific reference to companies, parties are related where one either (a) participates directly or indirectly in the management, control or capital of the business of the other, or (b) a third person participates directly or indirectly in the management, control or capital of the business of both of them.

This provision which is broadly based on the OECD TP Guidelines also permits under Section 18(8) of the ITA for the issuance of guidelines for the better operation of Section 18(3). It is under this section that the Minister,⁸⁹ in response to the *Unilever* decision issued the Income Tax (Transfer Pricing) Rules, 2006 ('TP Rules) which became effective on 1st July 2006. The rules in their current form provides for among others, the types of transactions covered,⁹⁰ methods of determining ALP,⁹¹ documentation and the general obligations of a taxpayer including the power of the Commissioner to call for documents.⁹² There is no specific requirement for contemporaneous documentation neither is there a specific penalty for non-compliance with the TP Rules. Under rules 10 and 12, the general provisions of the ITA relating to fraud, failure to furnish returns, penalties and interest for late payment of tax are made applicable to TP issues as well.

2.3 The Dispute Resolution Mechanisms

There are no special dispute resolution mechanisms under the ITA for transfer pricing cases. TP disputes are to be handled the same way as any other dispute arising from the application of the other provisions of the ITA. Depending on their nature, disputes arising under the ITA are first to be filed either with the 'Local Committee' (LC) or the 'Tribunal', (which are quasi-judicial bodies), with the right of appeal to the High Court and finally to the Court of Appeal.⁹³

⁸⁹ Following the promulgation of the Constitution of Kenya 2010, the designation has since changed to the Cabinet Secretary. The two terms will however be used interchangeably in this study.

⁹⁰ Income (Tax Transfer Pricing) Rules, Rule 6

⁹¹ Income (Tax Transfer Pricing) Rules, Rule 7

⁹² Income (Tax Transfer Pricing) Rules, Rules 8-10

⁹³ See, ITA, Section 87 and 91A respectively

Following the promulgation of a new constitution in Kenya, there currently exist a Supreme Court but access to the court from the Court of Appeal is generally restricted to constitutional issues.⁹⁴

2.3.1 The Local Committee/Tribunal

Until 12th April 2015, under section 86(1) of the ITA, the Tribunal was to hear appeals concerning (general) anti-avoidance provisions,⁹⁵ while the Local Committee was to hear all the other disputes arising under the ITA, including transfer pricing disputes. However, with effect from 13th April 2015, the Tax Appeals Tribunal Act (TATA),⁹⁶ which establishes a single Tax Appeals Tribunal (TAT) to hear all tax matters, whether direct or indirect taxes, became operational.⁹⁷ For the purposes of this research however, more reliance will be made on the pre-2015 establishment since most of the disputes covered in the study were handled under the prior arrangement and at the LC in particular. To the extent that it may be relevant, reference will also be made to the TATA, especially where its provisions departs from the earlier position.

Despite the ITA providing for a hierarchy of appeal bodies in tax matters, in practice, many taxpayers however still prefer to file their disputes directly to the courts, apparently due to the fact that the Kenyan Constitution confers on the High Court the ‘unlimited original jurisdiction in all civil and criminal matters’.⁹⁸ Given the supremacy of the Constitution,⁹⁹ the courts have generally directly admitted tax disputes, with a majority of these cases seeking the court’s prerogative orders under its judicial review powers. In *Keroche Industries v Kenya Revenue Authority & 5 Others*,¹⁰⁰ the KRA had raised an objection to the taxpayer’s direct access to the High Court but the court disagreed stating that:

The respondents’ argument that the applicant came to court prematurely without exhausting the internal tax objection process as regards each category of tax, is a serious misdirection [...] the issues raised were greater than any of the internal tribunals could handle. The task before the court is not, and has not been that of counting the shillings, it has been one of adjudicating on illegality, the doctrine of ultra vires, irrationality, procedural impropriety, Wednesbury unreasonableness (*sic*), oppression, malice, bias, discrimination and abuse of power.¹⁰¹

Further, according to a study commissioned by the EU, in Kenya, direct access to courts is generally preferred by taxpayers due to higher chances of obtaining from the courts, an immediate temporary injunctive relief ‘where the KRA is about to freeze taxpayers assets, including back accounts.’¹⁰² It is perhaps due to the recognition of the supremacy of the Constitution that the TATA as well does not contain any provision compelling taxpayers to first file their disputes at the TAT before proceeding to the High Court.

⁹⁴ See, Constitution of Kenya, 2010, Art. 163(4)

⁹⁵ The disputes are those arising under Sections 23 and 24 of the ITA. Section 23 is the country’s general anti-avoidance rule (GAAR) while section 24 deals with avoidance of tax arising from non-distribution of dividends.

⁹⁶ Tax Appeals Tribunal Act, 2013

⁹⁷ Legal Notice No. 32 of 20th March 2015

⁹⁸ See, Constitution of Kenya, 2010, Art. 165

⁹⁹ See, Constitution of Kenya, 2010, Art. 2

¹⁰⁰ *Keroche Industries Limited v Kenya Revenue Authority & 5 Others* [2007] eKLR, available at <<http://kenyalaw.org/caselaw/cases/view/39144>> accessed on April 12, 2015

¹⁰¹ *ibid*, p. 34

¹⁰² EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p.16,

However, the situation has been quite different when one looks at the TP disputes so far filed against the KRA. As of January 2015, in all the TP disputes that had been filed against KRA, an appeal had first been filed in each case with the LC before proceeding to the High Court. A possible explanation for this could be that these disputes involved MNEs who may be generally keen to comply with the legal provisions of the countries in which they operate and could be more concerned about obtaining a substantive resolution of the disputes as opposed to some temporary injunctive reliefs, which may only serve to increase the uncertainties involved.

Because they are generally deemed to be specialised, tribunals are normally expected to fast, efficient and expertly deal with the disputes for which they were created. However this is not always the case. The LC for example has been found to be suffering from a number of shortcomings which ranges from the lack of requisite tax and transfer pricing expertise,¹⁰³ to failure by the LC to issue a reasoned opinion of their findings. In the *Unilever* case for instance, Visram J. expressed his frustration for lack of a reasoned decision from the Local Committee when he stated that, **[u]nfortunately I do not have the benefit of the reasoning of the Local Committee and I am bound therefore to consider this appeal in terms of arguments advanced before me....**¹⁰⁴

It is perhaps due to these kinds of frustrations that led to an amendment of the ITA in 2012 to provide for academic qualifications for appointment to the Local Committee. The amendment however still fell short of expressly requiring the Local Committee to issue a reasoned decision.¹⁰⁵ The TATA now expands the 2012 amendments and adds that the Chairman to the Tribunal must hold qualifications equivalent to that of a High Court Judge.¹⁰⁶ It also requires that the Tribunal issues a reasoned decision.¹⁰⁷ The power of the Tribunal to engage an expert witness under Section 23 of TATA is likely to be one of its greatest successes. It is expected that this will help to enhance the Tribunal's capacity to make a finding which is well informed.

2.3.2 The Courts

All appeals from the decisions of the Local Committee lies with the High Court. However, as with the LC, the Court also lacks specialist knowledge in tax matters generally, and Transfer pricing issues specifically.¹⁰⁸ Related to this also is the fact that currently there exists no special tax bench within the Kenyan courts system that is exclusively dedicated to tax matters. The courts themselves have noted the need for such a bench and have remarked that:

The court avails itself of this opportunity to call for the establishment of a specialised Tax Division of the High Court which may give expeditious hearing of tax disputes in the interests, on the one hand, of a quick determination of the tax liability for the tax payers'

¹⁰³ EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p. 15

¹⁰⁴ *Unilever*, (n 1) p. 12

¹⁰⁵ Finance Act, No. 57 of 2012, Section 20; the qualifications include, A degree in taxation, finance or law, with five years' experience in the relevant filed.

¹⁰⁶ Section 4, Tax Appeals Tribunal Act, 2013

¹⁰⁷ See, Tax Appeals Tribunal Act, 2013, section 29(4)

¹⁰⁸ See for example, EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p. 15

benefit and, on the other hand, in the interests of the Public at large who eventually benefit for the proceeds of taxation.¹⁰⁹

The situation is made worse by the general huge case backlog currently plaguing the Kenyan courts system.¹¹⁰ As of October 2013, the KRA reported that as a result of this backlog, approximately Sh34.5 billion (USD 370,813,245) in taxes were being held up in the courts, with some cases dating as far back as 10 years.¹¹¹

The adversarial nature of Kenya's dispute resolution system is another challenge. Generally, the parties' main focus is to win their case, even on procedural technicalities, at the expense of having the dispute resolved in a principled and substantive manner.¹¹² This may have the effect of leaving any underlying double taxation unrelieved.

2.3.3 Litigation – The Experience so Far

2.3.3.1 The Unilever Case

Unilever Kenya Limited (UKL) and Unilever Uganda Limited (UGL), resident for tax purposes in Kenya and Uganda respectively are two subsidiaries of Unilever Plc, a company resident in the United Kingdom. UKL and UGL are therefore related parties within the meaning Section 18(6) (b) of the Kenyan ITA since a third person, Unilever Plc, 'participates directly or indirectly in the management, control or capital of the business of both'.

By a contract dated 28th August 1995, UKL, a manufacturer, agreed to produce various household goods on behalf of UGL, a distributor, for their Uganda market. An audit by the KRA on UKL for the 1995 and 1996 tax periods revealed (according to KRA) that the prices that were charged by UKL for the goods produced under the contract were not at arm's length. That UKL had sold the goods to UGL at prices which were much lower than their comparable sales, both in the domestic market (Kenya) and in its exports to unrelated parties. An adjustment under Section 18(3) of the ITA was consequently made by the KRA.

The adjustment was contested by UKL which first proceeded under Section 86 (1) (b) of the ITA and filed an appeal with the LC. On 17th September 2003, the LC decided the matter in favour of the KRA. UKL consequently appealed against this decision to the High Court on points of law and argued, among others, that Section 18(3) of the ITA as it then stood was ambiguous to the extent that it did not provide guidance on how to determine an arm's length price. Further, it was UKL's argument that in the absence such guidance, it was open for a taxpayer to resort, as they did, to the international best practices, in this case, the OECD TP Guidelines for guidance. The KRA on the other hand contended, among others, that Section 18(3) of the ITA as it then stood was clear on the subject and therefore the question of looking elsewhere for guidance could not even arise in the first place. Additionally, the KRA argued that the OECD TP Guidelines, on

¹⁰⁹ *Republic v Kenya Revenue Authority Ex-Parte Abdalla Brek Said T/A Al Amry Distributors & 4 others* [2015] eKLR, p. 3, available at < <http://kenyalaw.org/caselaw/cases/view/105263/>> (accessed on 12th April 2015)

¹¹⁰ *ibid*; See also, Law Society of Kenya, *Lawyers Concerned Over Case Backlog*, available at, <http://www.lsk.or.ke/index.php/component/content/article/1-latest-news/420-lawyers-concerned-over-case-backlog>, (accessed on April 12, 2015)

¹¹¹ *Remarks by the KRA's Chairman, Board of Directors on 22nd October 2013, at the Launch of 2013 Taxpayer's Week*, pg. 3, available at, <http://www.revenue.go.ke/index.php/notices/speeches/844-board-24102013>, (accessed on April 12, 2015)

¹¹² EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, para. 2.3.6.3

which the UKL sought to rely, did not form part of the Kenyan laws, and consequently needed to be disregarded.

In finding for UKL, the High Court found that the subject provision (Section 18(3)) was ambiguous and that in the absence of guidelines in the Kenyan law on how to determine an arm's length price, UKL was in law entitled to rely on the OECD TP Guidelines (UKL had in fact relied on the Cost Plus Method) in establishing the transfer price for its inter-company transactions. The Court stated that:

'I have no doubt in my mind that the OECD principles on income and on capital and the relevant guidelines such as "Transfer Pricing" principles, [.....] are not just here for relaxed reading. These have been evolved in other jurisdictions after considerable debate and taking into account appropriate factors to arrive at results that are equitable for 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 acceptable principles of business as long as these do not conflict with our own laws. To do so would be highly short-sighted.'¹¹³

What is not clear from the *Unilever* decision is whether the judge would have reached the same conclusion on the applicability of the OECD TP Guidelines in Kenya if it was the KRA which had sought to rely on the OECD principles to enforce taxation of MNEs transactions in situations where the provisions of the Kenyan ITA were unclear. In the author's opinion, the finding would have been the exact opposite. This view is supported by the current literalistic approach employed by the Kenyan courts in interpretation tax statutes. This approach, which is based on Lord Russell's dictum in the *Duke of Westminster*,¹¹⁴ a United Kingdom (UK) case,¹¹⁵ stipulates that a subject is not to be taxed according to what the court thinks to be the substance a transaction, but only on clear words of a statute. This approach has been applied by the High Court in many cases including the *Keroche Industries* case,¹¹⁶ and later confirmed by the Court of Appeal in the *Stanbic Bank Limited v Kenya Revenue Authority*,¹¹⁷ where the Court stated that 'tax laws are to be construed strictly' and even proceeded to issue a direction to the lower courts that 'the issue of adopting a purposeful approach as regard tax laws and statutes should never ever arise' in Kenya.¹¹⁸

Despite the tremendous contribution of the *Unilever* decision to the Kenyan tax arena, particularly relating to the development of transfer pricing as a concept, questions are still being asked as to whether there existed any sound legal foundations for the court, not only to recognize, but also to proceed and apply the OECD TP Guidelines in Kenya, in resolving the

¹¹³ *Unilever* (n.1), p.13

¹¹⁴ *IRC v. Duke of Westminster*, [1936] A.C. 1, at p. 19

¹¹⁵ Decisions from the commonwealth countries, though not binding, are of persuasive authority in Kenya. See, the Kenyan case, *C.A. Rashid Moledine v. Home Ginnors* (1967) E.A. at 655

¹¹⁶ *Keroche Industries*, (n.100)

¹¹⁷ *Stanbic Bank Kenya Limited v. Kenya Revenue Authority* (2009)eKLR, p. 10, available at <http://kenyalaw.org/caselaw/cases/view/61612/> (accessed on 11th April 2015)

¹¹⁸ *ibid*, Nyamu J.; Kenya law is built on the doctrine of *stare decisis* where the decision of a higher Court binds all the lower courts.

subject dispute notwithstanding that the country is not a member of the OECD and was not itself involved in the drafting of the guidelines.¹¹⁹

2.3.3.2 The Post Unilever Experience

In his obiter dictum in the *Unilever* case, Visram J. also urged the KRA to take initiatives towards providing legislative guidance on transfer pricing issues, including APAs.¹²⁰ The KRA took this advice and embarked on a journey that has largely defined the current transfer pricing regime in Kenya. However, contrary to the recommendation, no much progress has been made in the area of APAs.

The first reaction by the KRA was to drop the *Sara Lee Household & Body Care Ltd. v Commissioner of Income Tax*,¹²¹ another TP dispute which was then pending hearing in the High Court. Other similar disputes were also dropped without the deficiency notices being realised.¹²² The second reaction by KRA was to pursue the enactment of the transfer pricing guidelines, which guidelines were issued in the form of the Income Tax (Transfer Pricing) Rules 2006, which rules were to be effective 1st from July 2006. Thirdly, the KRA established a transfer pricing unit within the LTO where most MNEs belong. The KRA also embarked on various capacity building and development initiatives including training staff and acquisition of a database for the purposes of testing arm's length nature of MNEs transactions.¹²³

With these initiatives in place, the KRA from 2009 embarked on what may be referred as the second wave of TP audits. These audits have also resulted into a number of disputes, some of which are currently pending before the High Court. As of April 30, 2015, the following transfer pricing cases were pending in the High Court;

i. *Karuturi Limited (2013)*¹²⁴

The taxpayer (Karuturi), a Kenyan company in the business of growing and exporting rose flowers entered into an agreement with Flower Express (FE), a related party, tax resident in Dubai, under which Karuturi would sell to FE roses on a free-on-board (Kenya) terms. However, before the roses could leave Kenya, they would be resold by FE to third parties at substantially higher prices. The third parties would then export the flowers to markets controlled by FE, especially in Europe. A TP adjustment on the sale between Karuturi and FE was made by the KRA and taxes of approximately 960 million (USD 10,347,830) demanded, hence the dispute.

It is interesting to note that while the dispute is still pending in court, newspaper reports indicate that Karuturi is currently under financial distress and may have been put on liquidation.¹²⁵ The liquidation process, if it proceeds, would in essence mean that the KRA's chances of recovering

¹¹⁹ See for example, Bosire Nyamori (n. 14)

¹²⁰ *Unilever* (n.1) p.13

¹²¹ *Sara Lee Household & Body Care Limited v Commissioner of Income Tax*, HCITA, 543 OF 2003

¹²² Patrick Chege, (n 13) and (n.37),

¹²³ EU Commission (2011): (n.31), Appendix D: Country Study-Kenya, p. 18

¹²⁴ *Karuturi Limited v Commissioner of Domestic Taxes*, Nairobi HCITA No. 7 of 2013

¹²⁵ George Omodi, 'CfC Bank Puts Naivasha flower grower Karuturi up for sale', *Business Daily*, (Nairobi, January 26, 2015) <<http://www.businessdailyafrica.com/Corporate-News/CfC-Bank-puts-Naivasha-flower-grower-Karuturi-up-for-sale/-/539550/2603130/-/31qfx0/-/index.html>> accessed on April 10, 2015

the taxes would be significantly reduced. Under the Kenyan laws,¹²⁶ in winding up proceedings, tax claims and other levies owed to the government ranks secondary to secured creditors and can only be paid after the secured creditors' claims have been fully satisfied.¹²⁷ And even then, taxes owed (and other government levies) are only treated as preference (alongside other preference creditors with which they rank *pari passu*) for up to one year's tax assessment.¹²⁸ The balance if any, ranks equal to the unsecured creditors and may only be paid where the assets are sufficient to repay all the debts,¹²⁹ which is rarely the case. APAs, given their ability to resolve tax disputes *ex ante*, may be useful in helping a tax administration to avoid situations like this by ensuring that taxes are collected as and when they are due.

ii. *Ericsson Kenya Limited (2013)*¹³⁰

Ericsson Kenya Limited ('EKL') is a wholly owned subsidiary of Ericsson Telefonaktiebolaget LM (Sweden) which is also wholly owned by Ericsson AB-Sweden ('EAB'). EKL is therefore indirectly related to EAB within the meaning of Section 18(6) of the ITA as read together with Rule 2 of the TP Rules, 2006.

In 2008 EKL and EAB entered into tripartite contracts with their common Kenyan clients via a Master Services Agreement Build Operate and Transfer, and Equipment Supply Contract and Implementation Services Contract, both relating to the sale of hardware, software and services. Under these contracts, EAB was to supply the equipment (hardware and software) while EKL was to provide local installation, support and maintenance services.

According to the KRA, a tax audit for the 2007-2009 years of income revealed that EKL had made substantial losses under the contract. It is in fact the parties' common ground that the losses were as a result of extra-ordinary costs incurred by EKL under the contract. The point of departure however is whether the incurring of these costs by EKL is to be attributed to the special relationship between EKL and EAB (so that a transfer pricing adjustment can be done) or whether the subject costs were as a result of factors unrelated to the entities' association. It is EKL's position that Section 18(3) of the ITA does not apply in this situation since the losses incurred were occasioned by factors unrelated to the relationship between EKL and EAB. The KRA thinks otherwise.

Apart from the above projects, EKL also offered various services on behalf of EAB to their other related entities within the East African region, remuneration for which EKL benchmarked at 5% Full Cost Mark Up ('FCMU'). According to KRA, the remuneration for these services was not appropriately benchmarked, and therefore an upward adjustment was made. KRA is of the view that a remuneration of 12% FCMU would be appropriate. It is important at this point to disclose that the author is personally involved in this matter and consequently, only general discussions on the case will be made without giving an opinion, one way or the other, on the merits of the case. See paragraph 2.3.3.3 below for more discussions on the case.

¹²⁶ Companies Act, Cap. 486 Laws of Kenya

¹²⁷ *ibid*, section 311 (1)

¹²⁸ *ibid*, section 311 (5) (a)

¹²⁹ *ibid*

¹³⁰ *Ericsson Kenya Ltd. of Domestic Taxes*, Nairobi HCITA No. 8 of 2013

iii. *Bamburi Cement Limited (2014)*¹³¹

Bamburi Cement Limited ('BCL'), a cement manufacturer, is a company incorporated in Kenya and is part of Lafarge, a public limited company incorporated in France which owns 58.6% of BCL. Lafarge and BCL entered into a five year Trademark License and a General Assistance Agreement under which BCL would benefit from Lafarge's manufacturing knowhow, trademark and logo and also from other various services from Lafarge. The remuneration for the entire agreement was bundled at an aggregate annual fee of 2% of the BCL's consolidated annual net turnover.

The dispute arose as a result of a tax audit by the KRA covering 2008-2012 years of income. Regarding provision of the 'various services' by Lafarge, the main question for determination is whether the costs for those services should be allowed against BCL's income in the absence of proof of actual provision of those services. A related question also is whether the remuneration for the 'various services', which ranges from technical know-how, human resource to financial and commercial matters, ought to have been bundled together and payment made in lump sum without BCL specifically assigning each payment to a particular service. The KRA holds the view that the costs could only be allowable if BCL proved that the services were in fact rendered, and that each payment is linked to a corresponding service offered by Lafarge. According to the KRA, the mere existence of the service centers is not by itself a proof that the services were actually rendered to BCL.

Another question for determination is whether the Lafarge's trademark and logo ('L-Lafarge') should be remunerated without proof of its relevance and value addition to BCL. The KRA has taken the position that having conducted a detailed analysis and tests in relation to the trademark and logo, no clear and identifiable benefit or value addition to BCL could be established, hence any payments associated with the logo was disallowed.

Running through all the above issues is also the question of whether BCL was under paragraph 9 of the TP Rules, 2006 obliged to maintain contemporaneously, documentation in respect of these transactions. The KRA contends that BCL did not only fail to maintain the requisite documentation at the time the transfer pricing was established, but that BCL also failed to produce such documents as and when required by the Commissioner under the TP Rules, 2006. The case is also pending hearing and given the author's involvement in the matter, discussion on the case will equally be restricted. See paragraph 2.3.3.3 below for more discussions on the case.

2.3.3.3 A General Assessment of the Cases

An assessment of the above cases reveals a number of issues. First, as had already been pointed earlier, it is apparent that all these cases were commenced at the LC level before an appeal was made to the High Court in each case. It can therefore be safely concluded that currently, the preferred appellate procedure in TP disputes in Kenya follows the process established under the Kenyan ITA. This, in the author's opinion is a positive result especially taking into account that as opposed to courts, tribunals are generally expected to be more specialised in tax and transfer pricing matters so as to competently resolve such disputes. It is against this background that it is recommended that qualifications for appointment to the Tribunal established under the TATA

¹³¹ *Bamburi Cement Ltd v Commissioner of Domestic Taxes*, Nairobi HCTA No. 11 of 2014

should, in addition to the qualifications enumerated under Section 4(b) of the Act, also explicitly mention tax as one of the areas of specialization. It is noteworthy that a degree in tax was one of the requirements in the 2012 amendment to the ITA, but has been curiously omitted under the TATA.

Second, a look at the sequence of the cases reveals a progression in complexity of the TP issues involved. The *Unilever* case which was the first TP dispute in Kenya involved a simple issue regarding the methodology to be used in determining the arm's length price. Subsequent cases now involve more complex issues such as comparability analysis (*Ericsson Kenya Limited*) and those concerning intangibles and the concept of value addition (*Bamburi Cement Limited*). A possible explanation for this progression in complexity of the TP issues involved may be the fact that the initiatives so far undertaken by the KRA in the area of transfer pricing has helped it to developed requisite capacity to enable its TP team flag out some of the technical TP manipulations which in the past could go unnoticed. In the author's opinion, this development is likely to make TP issues become even more critical, both to the taxpayers and to the KRA, especially in view of the fact that there is usually no single 'right' answer in transfer pricing disputes and that establishing the arm's length price is not a price science and is quite subjective.¹³²

Third, the duration taken to finally have the TP disputes resolved, thus removing the uncertainties, is quite long in almost all the cases. The *Unilever* case took approximately 10 years to be resolved. The dispute involved tax issues dating as far back as 1995 but was only resolved in October 2005 when the judgment was delivered. *Ericsson Kenya Limited* and *Bamburi Cement Limited* which are still pending in the High Court involve tax issues for 2007-2009 and 2008-2009 years of income respectively. For both cases, it is approximately eight years and the uncertainties, for both the taxpayer and the tax administration still persist. This is even worse in the *Karuturi Limited* case where the company has reportedly been put under liquidation.¹³³

Finally, in all the cases, the audit periods covered are only for limited tax period. Under Section 56(3) of the ITA, the KRA is only authorized to carry tax audits (absent any fraud or willful neglect on the part of the taxpayer) going back not more than seven years after the relevant year of income. In view of the fact that TP issues are not generally considered 'fraudulent' or 'willful neglect', then there may be instances where there are genuine TP adjustments that ought to have been made by the KRA but for the time limitation. As will be seen later in Chapters 3 and 4 below, these are some of the issues that the adoption of an APA by a tax administration may help to ameliorate.

2.4 The Article 25 Procedures (MAP, Arbitration and APA)

The authority to conclude a Double Tax Agreement between the Government of Kenya and a foreign jurisdiction is vested on the Minister of Finance by Section 41 of the ITA. The provision also declares that such an agreement would supersede the other provisions of the ITA or any

¹³² See for example, OECD (2012), 'Transfer pricing and developing countries', in *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing, p. 75; see also, Paul Wilmshurst, 'UK Transfer Pricing and the Tax Avoidance Debate' (2013), February-March *The Tax Executive*, p. 38, available at, < <http://www.crai.com/sites/default/files/publications/UK-Transfer-Pricing-and-the-Tax-Avoidance-Debate.pdf> > accessed on May 22, 2015

¹³³ See, George Omondi, (n.125)

other written law of the country in relation to income tax. These treaties are however subject to the Constitution of Kenya 2010, which recognizes them as part of the Kenyan law,¹³⁴ but also declares its superiority over all Kenyan laws.¹³⁵

Kenya's income tax treaty network is not very extensive, with only nine treaties currently operational.¹³⁶ All the treaties have provisions the equivalent of the Article 25 of the OECD Model Tax Convention. However, only two of these treaties (with India and with France) have a provision the equivalent of Article 9(2) of the OECD Model Tax Convention regarding a corresponding adjustment. None of the treaties have a provision for arbitration.¹³⁷

Currently, there are no records of TP cases that have been resolved under the treaties, either by way of a corresponding adjustment under Article (Article 9(2)) or pursuant to the mutual agreement procedure (Article 25). In the circumstances, it may be concluded that in the context of Kenya, income tax treaties remain untested in resolving transfer pricing disputes. It is therefore against this background, and in view of the reported success of APAs in other jurisdictions that this research will now assess the APA programme with a view of exploring its applicability to the Kenyan tax system. It is however important to note that for treaty based dispute resolution mechanisms (including bilateral and multilateral APAs) to be more effective, it is necessary for a country to develop an extensive treaty network, especially with its major trading partners. In this regard, it is noteworthy that Kenya is currently working on the process of improving its network.¹³⁸ It is therefore hoped that this exercise will help to improve the effectiveness of the treaty based mechanisms in resolving TP disputes as well.

¹³⁴ Article 2 (6), Constitution of Kenya, 2010

¹³⁵ Article 2(4), Constitution of Kenya, 2010

¹³⁶ The Countries are, Zambia, Norway, Denmark, Sweden, United Kingdom, Germany, Canada, India and France; see the KRA website, available at <<http://www.revenue.go.ke/ito/ltodta.html>> accessed on May 22, 2015. The Treaty with France is listed in the website as still under negotiations, however, the same has been effective since January 1, 2011 (see the IBFD website)

¹³⁷ *ibid*

¹³⁸ See, the KRA website, *ibid* (n. 136)

CHAPTER 3

3 ADVANCE PRICING AGREEMENTS – OECD RECOMMENDATIONS AND THE INTERNATIONAL EXPERIENCE SO FAR

3.1 Introduction

Transfer pricing disputes do not generally have a single ‘right’ answer and consequently the most acceptable outcomes in such cases are usually achieved through negotiations between the parties.¹³⁹ The uncertainties involved in such disputes and the need for compromises during the negotiations requires the existence of a framework that encourages a principled approach to the negotiations so as to promote transparency and consistency.¹⁴⁰ The ability of APAs to meet these features has seen the programme become popular in resolving TP disputes. According to a 2013 survey,¹⁴¹ the level of satisfaction with APAs as a process of managing these disputes was found to be quite high, with 79% of the respondents recording their satisfaction.¹⁴² This trend has also been confirmed by the OECD which has stated that APAs have currently become more popular and effective in resolving transfer pricing disputes. According to the OECD, a significant number of its member countries have adopted APAs and that for those countries, they are so far satisfied, and that owing to this success, the use of APAs is projected to expand.¹⁴³

The above observations were made by the OECD in 1995. This chapter seeks to highlight the concept APAs and also to assess the extent, if any, to which its use has been embraced in a few selected countries. This will be done by first outlining the OECD recommendations on APAs, and then proceed to analyse how those recommendations have been implemented in practice by the US, an OECD member country with the longest experience with APAs. Experiences from China and India will also be considered as well to bring in the developing countries’ perspective.

3.2 The OECD Recommendations on APAs

Advance Pricing Agreement is an arrangement through which a taxpayer requests from one or more tax administration(s) a binding pricing settlement in respect of the taxpayer’s future transfer prices. Depending on the number of countries involved, APAs can either be unilateral, bilateral or multilateral.¹⁴⁴ In contrast to other transfer pricing dispute settlement and management mechanisms, APAs represent a cooperative approach where taxpayers and tax administrations jointly agree, prospectively (and in some cases retroactively) on an acceptable transfer pricing methodology to govern a particular transaction or groups of transactions (‘covered transactions’) for a fixed period of time.

¹³⁹ OECD (2012), ‘Transfer pricing and developing countries’, in *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing.

¹⁴⁰ *ibid*, page 75

¹⁴¹ Ernst & Young, *2013 Global Transfer Pricing Survey* (n. 29)

¹⁴² *ibid*, p. 17

¹⁴³ OECD TP Guidelines, para 4.159

¹⁴⁴ See, OECD TP Guidelines, Glossary

According to the OECD TP Guidelines, APAs are intended not to substitute the traditional transfer pricing dispute resolution mechanisms, but to supplement them.¹⁴⁵ The important role of APAs in managing transfer pricing disputes is also underscored by the UN manual on transfer pricing which, apart from acknowledging the OECD position, also points out that APAs provide the most efficient method of addressing TP disputes by preventing them before they arise.¹⁴⁶

APAs are different from the traditional private rulings. While a private ruling would typically concern a legal point and would cover only a specific transaction, APAs usually covers a taxpayer's several (or even all) international transactions on a continuous basis.¹⁴⁷ Additionally, while the facts of a transaction for a private ruling are normally not in dispute, the facts that underlie an APA request are very germane and would ordinarily be highly scrutinised.¹⁴⁸

The OECD TP Guidelines define an APA as 'arrangements between a taxpayer and a tax authority that determine in advance how intra-group 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'.¹⁴⁹ Ordinarily, an APA is not intended to settle specific transfer prices or profit margins for inter-company transactions, but only to agree on the methodology for determining those prices or profit margins.¹⁵⁰ However, in certain cases, it may be possible to agree on a specific price or profit margins. This may be the case for example where an APA concerns a one-off transaction.¹⁵¹ How specific an APA can be, therefore depends on the reliability of the predictions and the critical assumption(s) that underlie those predictions.¹⁵² To enhance APAs' reliability, the use of comparables and adjustment to such comparables or profit ranges is recommended.¹⁵³

Apart from being used as a mechanism for establishing the methodology for establishing the transfer prices or profit margins, APAs may also be used in resolving income attribution and allocations issues arising under Article 7 of the OECD Model Tax Convention.¹⁵⁴

3.2.1 Types of APAs

There are three different types of APAs, namely unilateral, bilateral or multilateral APAs. Unilateral APA refers to an agreement between the taxpayer and a single tax administration. The power to enter into this type of agreement is normally drawn from the country's domestic law. It is therefore not an option where a country's national laws do not allow such an agreement.¹⁵⁵

¹⁴⁵ OECD, TP Guidelines, para 4.123

¹⁴⁶ UN, *Practical Manual on Transfer Pricing for Developing Countries, 2013*, para 9.1.2.1

¹⁴⁷ OECD, TP Guidelines, para 4.132

¹⁴⁸ *ibid*

¹⁴⁹ OECD TP Guidelines para 4.123

¹⁵⁰ The use of APAs to agree on a specific future prices or profit margins is particularly discouraged by the European Union; (see Jérôme Monsenego, (n. 38), p 139, footnote 8); see also, the OECD TP Guidelines, para 4.127

¹⁵¹ See, Jérôme Monsenego, (n.38), p 139 generally

¹⁵² OECD TP Guidelines, para 4.125

¹⁵³ OECD TP Guidelines, para 4.127

¹⁵⁴ OECD (2010), "Annex to Chapter IV. Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure ("MAP APAs")", in OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, OECD Publishing, Paris. ('OECD TP Guidelines, Annex to Chapter IV'), para 35

¹⁵⁵ See OECD TP Guidelines, para 4.140-1 (See also, UN, *Practical Manual on Transfer Pricing for Developing Countries 2013*, para 9.6.1.5 which singles out particularly the problems faced by civil law countries in this respect.

While it may be relatively cheaper in terms of resources and time to conclude a unilateral APA compared to bilateral or multilateral APAs, its main drawback is its inability to relieve double taxation that may occur to an entity as a result of its dealings with associated enterprises in other jurisdictions. For this reason, the OECD Guidelines recommends the use of bilateral or multilateral APAs.¹⁵⁶ According to Monsenego (2013), a unilateral APA may even increase a MNE's exposure to audit and more stringent conditions in the other jurisdictions not involved in the APA.¹⁵⁷

Despite these shortcomings, unilateral APAs may still be very useful especially in cases where, for example, the governments of the countries involved in the covered transaction do not have a tax treaty or where a cost-benefit analysis would still supports the idea of a unilateral APA.¹⁵⁸

Bilateral APAs on the other hand refers to agreements entered into between a taxpayer and two countries in which the different entities of the taxpayer are tax resident. This is generally done through the mutual agreement procedure (Article 25 OECD Model Tax Convention) which provides a framework for parties to consult together for the purposes resolving by mutual agreement 'any difficulties or doubts arising from the interpretation or application of the Convention' including for purposes of eliminating double taxation in cases not provided under the treaty.¹⁵⁹ Additionally, the countries' domestic rules in most cases also provide more elaborate rules on how the bilateral APAs may be managed, including how to monitor their application. The OECD Guidelines also cite 'executive power conferred on the heads of tax authorities, as another possible legal basis through which a country may negotiate bilateral or multilateral APAs.¹⁶⁰ However, in the author's opinion, in countries such as Kenya where the country's constitution places a limit on the extent to which public officers may exercise their powers, especially in relation to taxation, this would only extend to procedural aspects as opposed to substantive taxation rules.¹⁶¹

It is important to note that the existence of domestic rules is not a prerequisite for a country's engagement bilateral APAs.¹⁶² The MAP process may still be used to negotiate APAs even where the domestic laws of a country do not permit a tax administration to enter into a binding agreement with taxpayers.¹⁶³ The power to negotiate APAs in such cases will normally be drawn from the treaty itself which in most cases override national laws.¹⁶⁴ The main advantage of a bilateral APA is its ability to bind more than one jurisdiction hence securing more certainty as compared to unilateral APAs.

¹⁵⁶ OECD TP Guidelines para 4.129-30

¹⁵⁷ Jérôme Monsenego, p. 140, foot note 12.

¹⁵⁸ See, Mark Bronson et al, 'Overview/Best Practices' in Duff & Phelps (eds), *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International 2013), p. 62

¹⁵⁹ OECD TP Guidelines, para 4.139; See also, OECD Model Tax Convention; see also Commentary to Article 25, para 50

¹⁶⁰ This refers to the tax administration's power to issue administrative and procedural guidelines, especially where the treaty provisions are not appropriate or where the treaty is not applicable (see OECD TP Guidelines, para 4.139).

¹⁶¹ See Article 209, Constitution of Kenya, 2010

¹⁶² See Jérôme Monsenego (n 30), p. 140-1

¹⁶³ OECD TP Guidelines para 4.130

¹⁶⁴ The principle of '*pacta sunt servanda*' in international law enjoins every State party to a treaty to act in good faith and not to invoke internal law as a justification for failure to perform obligation under a treaty (see Arts. 26 and 27 *Vienna Convention on the Law of Treaties*)

Multilateral APAs on the other hand are agreements made with more than two tax jurisdictions.¹⁶⁵ Under this arrangement, a taxpayer will normally approach each of the subject jurisdictions with an overall proposal, which will then be considered by the participating jurisdictions at a multilateral forum.¹⁶⁶ Although a multilateral APA may provide more certainty to a taxpayer than the other two types of APAs, it suffers from a number of shortcomings, key among them the concern that tax treaties are typically bilateral and are therefore not designed for a multilateral process and consequently, there may be some difficulties in finding a mechanism, not only to negotiate, but also to implement these kinds of agreements.¹⁶⁷ There is also the problem of exchange of information and the attendant confidentiality concerns, especially where there is no exchange of information articles in the respective countries' treaties.¹⁶⁸ Despite these challenges, the OECD has noted that multilateral APAs have 'become the norm' in the global trading field.¹⁶⁹ In fact, the OECD encourages the use of bilateral and multilateral APAs and states that '[w]herever possible, an APA should be concluded on a bilateral or multilateral basis'.¹⁷⁰

3.2.2 The APA Lifecycle

The negotiation of bilateral and multilateral APAs and the subsequent agreement is basically a matter between the competent authorities of the countries involved. Unilateral APAs on the other hand is negotiated directly by the MNE concerned with the country in which it is tax resident. However, in both cases, it is always the taxpayer who commences the process by filing a request for an APA. According to the OECD, the following process is recommended:

i. Pre-Filing Conference

Prior to making a formal request, a preliminary meeting between the taxpayer and the tax administrations should be held to discuss the suitability of the proposed APA and also to share and understand each other's expectations and objectives.¹⁷¹ Other issues that are to be considered should include the nature of the proposed transaction, the methodology and an economic analysis of the chosen transfer pricing method and the critical assumptions, if any, that underlie the transaction in general and the chosen methodology in particular.¹⁷² The taxpayer normally has the option of attending the meeting on an anonymous or named basis, but must nevertheless provide sufficient information for the purposes of making the meeting productive. The information provided however remains confidential.¹⁷³ One of the key concerns at this stage is how to balance confidentiality requirements against the need for clarity and sufficiency of information to be provided. In the author's view, maintaining confidentiality while at the same time disclosing requisite information to enable the tax authority to sufficiently understand the proposed transaction may be quite tricky.

¹⁶⁵ OECD TP Guidelines, Glossary

¹⁶⁶ See, OECD TP Guidelines, Annex to Chapter IV, para 21

¹⁶⁷ To overcome the challenge, it is recommended that countries conclude a series of bilateral APAs, which are then exchanged between all the jurisdictions concerned (See, OECD TP Guidelines, Annex to Chapter IV, para 21).

¹⁶⁸ The exchange of information problem in a multilateral setting may be overcome by asking the taxpayer himself to assume responsibility for providing information to the countries involved (OECD TP Guidelines, Annex to Chapter IV, para 25).

¹⁶⁹ OECD TP Guidelines, Annex to Chapter IV, para 27

¹⁷⁰ OECD TP Guidelines, para 4.162; See also, OECD TP Guidelines, Annex to Chapter IV, para. 5

¹⁷¹ OECD TP Guidelines, Annex to Chapter IV, para 29-33

¹⁷² *ibid*

¹⁷³ OECD TP Guidelines, Annex to Chapter IV, para 32

ii. *Formal Request*

This refers to the lodgment by the taxpayer of a detailed proposal providing sufficient information and documentation about the proposed transactions, providing details of among others, the chosen TP method and the information necessary to support the proposed methodology.¹⁷⁴ Other key information to be availed at this point includes the details about the comparable pricing information¹⁷⁵, critical assumptions on which the proposed methodology is based,¹⁷⁶ how to deal with any unexpected results¹⁷⁷ and the proposed duration of the APA.¹⁷⁸

iii. *Review and Acceptance: Legal Effect and possible ‘Rollback’*

After receipt of the proposal, the tax administrations should first undertake a ‘fact finding, review and evaluation’ of the proposal to verify the accuracy of the information provided by the taxpayer before commencing the substantive mutual discussions on the proposal.¹⁷⁹ Once an agreement is reached, the parties are to prepare a draft mutual agreement which should thereafter be passed over to the taxpayer for his consent.¹⁸⁰ To give effect to the APA as between the taxpayer and the tax administration in which it is tax resident, the agreement will then have to be recognised under the applicable domestic legislation.¹⁸¹ Once so recognised, the terms and conditions of the APA becomes binding on both the taxpayer and the tax administration in relation to the covered transactions, subject to any changes in the law or the facts that underlie the agreement.¹⁸² Further, subject to the applicable treaty and domestic law requirements, the tax administrations, may either with the concurrence of the taxpayer, or on its own motion, apply the agreed methodology retrospectively (rollback) to resolve past years’ audit issues.¹⁸³

iv. *Monitoring: Compliance Report and Audit (Revocation, Cancellation, Revision)*

Once in place, the tax administration is to monitor taxpayer compliance with the terms and conditions of the APA. As a condition of the agreement, the taxpayer will normally be required, over and above its annual tax return, to file an annual report outlining its actual operations, with the details of the extent to which it has complied with the APA, including information as to whether the critical assumptions still hold.¹⁸⁴ Further, the tax administration may also still carry out an audit of the taxpayer’s operations, but such audits will only be limited to verifying the taxpayer’s compliance with the terms and conditions of the APA and also to determine whether the underlying assumptions are still relevant.¹⁸⁵ Where non-compliance is established or where the critical assumptions are no longer valid, depending on the nature of non-compliance and

¹⁷⁴ OECD TP Guidelines, Annex to Chapter IV, para 41-2; However, irrespective of the methodology chosen, the arm’s length principle must always be complied with. (see OECD TP Guidelines, para 2.10)

¹⁷⁵ Should include information on the availability and use of comparables and what adjustments, if any, have been made to account for any material differences (see, OECD TP Guidelines, Annex to Chapter IV, para 40)

¹⁷⁶ OECD TP Guidelines, Annex to Chapter IV, para 43-6; For more discussion on critical assumptions, see Daniele de Carolis, ‘Critical Assumptions in Advance Pricing Agreements: A Comparison between the OECD Guidelines and the American Tax System, Vol. 41, Issue 12 *Intertax*, (Kluwer Law International 2013)

¹⁷⁷ OECD TP Guidelines, Annex to Chapter IV, para. 47-50

¹⁷⁸ OECD TP Guidelines, Annex to Chapter IV, para. 51

¹⁷⁹ OECD TP Guidelines, Annex to Chapter IV paras 54-64

¹⁸⁰ See, OECD TP Guidelines, Annex to Chapter IV paras 65

¹⁸¹ This is to be able to give the agreement a legal effect as between the taxpayer and the tax administration in which it is tax resident (see, OECD TP Guidelines, Annex to Chapter IV paras 67-8, 70)

¹⁸² *ibid*

¹⁸³ OECD TP Guidelines, Annex to Chapter IV paras 69

¹⁸⁴ OECD TP Guidelines, Annex to Chapter IV paras 72

¹⁸⁵ OECD TP Guidelines, Annex to Chapter IV paras 73

subject to the terms of the APA and the relevant domestic legal provisions, the agreement may be revised¹⁸⁶, cancelled¹⁸⁷ or revoked.¹⁸⁸

v. *Renewal*

An APA may be renewed by the consent of all the parties to it, and subject to any adaptations as may be necessary, the renewal process is to follow the same procedures as the initial APA request.¹⁸⁹

3.3 APA in Practice – A Survey of Selected Jurisdictions

3.3.1 Introduction

Japan was the first country to introduce APA in 1987. This was only one year after the country had enacted its transfer pricing legislation. According to the Japan National Tax Agency, APAs were intended to aid in the enforcement of transfer pricing regulations and at the same time guarantee predictability to MNEs regarding the tax treatment of their inter-company dealings by ensuring ‘administrative confirmation on the most rational method of calculating the arm’s length price.’¹⁹⁰

After Japan, APA was subsequently adopted in the United States by the Internal Revenue Service (IRS) which introduced the programme in 1991 through Procedure 91-22. In the US, the programme came about as a result of a push by taxpayers who felt that the other alternative transfer pricing compliance and resolution mechanisms were not only too adversarial, but were also unproductive.¹⁹¹ Other countries that also introduced the programme prior to the 1995 OECD TP Guidelines include Canada (1994), New Zealand (1994), Australia (1995) and Mexico (1995). Subsequent to the 1995 OECD TP Guidelines which promoted APAs, several other countries including, South Korea (1996), China (1998), the UK (1999), France (1999), Netherlands (1999) and Germany (2000) also embraced the programme.¹⁹² According to the Deloitte 2015 Global Transfer Pricing Survey, over 50 of the 67 countries covered had some form of APA provision in their tax legislation as of 31st December 2014.¹⁹³

¹⁸⁶ Revision would be done to reflect the any changes to the conditions that underlie the agreement. The revised APA should state its effective date and any transitional arrangements, if any (See OECD TP Guidelines, Annex to Chapter IV, paras 83-5).

¹⁸⁷ The effective date of the cancellation may either be from a specific date or for a particular tax year or accounting period (see OECD TP Guidelines, Annex to Chapter IV, para, 79)

¹⁸⁸ Revocation has a retroactive effect and operates as if the APA did not exist in the first place. It is the most drastic action and it is therefore recommended that it should only be resorted to in exceptional circumstances. See Paras OECD TP Guidelines, Annex to Chapter IV, paras, 77-8)

¹⁸⁹ Where there have not been any material changes to the facts, the level of the information required may be significantly reduced (see, OECD TP Guidelines, Annex to Chapter IV para 87).

¹⁹⁰ NTA, *APA Program Report 2009* (November 2010), p3

¹⁹¹ Michelle Markham (n.20), p.23-4

¹⁹² NTA, *APA Program Report 2009* (November 2010), p3

¹⁹³ Deloitte, *The 2015 Global Transfer Pricing Country Guide* Available at <<http://www2.deloitte.com/.../dttl-tax-global-transfer-pricing-guide-2014.pdf>> (accessed in April 1, 2015); *The countries include, Australia, Austria, Belgium, Canada, Chile, China, Columbia, Costa Rica, Czech Republic, Denmark, Dominican Republic, Finland*, France, Germany, Greece, Guatemala, Hong Kong, Hungary, India, Indonesia, Ireland*, Israel, Italy, Japan, Kazakhstan, Korea, Latvia, Lithuania, Luxembourg*, Malaysia, Mexico, Netherlands, New Zealand, Norway*, Peru, Philippines, Poland, Portugal, Romania, Russia, Singapore, Slovakia, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, Ukraine, United Kingdom, United States, Uruguay, Venezuela and Vietnam. The countries with asterisks, though not having a formal APA legislation, have some form of Advance Pricing Agreement. In Norway,*

The countries however follow different approaches in implementing and administering the APA programme. Some Jurisdictions like China impose a monetary threshold for a transaction to qualify into the programme,¹⁹⁴ while others like the United Kingdom consider the degree of complexity of the transfer pricing issues involved in the proposed transaction as the criteria.¹⁹⁵

The Deloitte survey also reveals that countries such as the United States, Austria, Greece, and Germany charge application fee for taxpayers to access the programme while others like Australia, France and New Zealand imposes no application fee. Others like Canada for example, does not levy any application fee but requires the taxpayer to reimburse the tax administration the ‘out-of-pocket’ expenses incurred in the APA negotiations.¹⁹⁶

Some countries such as Canada, China, Japan and the US periodically publicise their APA programme reports in their websites. India introduced APAs in 2012 and since then has also been issuing press releases on the performance of their programme.¹⁹⁷

3.3.2 China

The Chinese APA was introduced in 1998, when the same was included as ‘one of the other reasonable methods’ that can be used to determine the arm’s length price in a related party transaction.¹⁹⁸ The country offers unilateral, bilateral and multilateral APAs. For a transaction to be admitted to the programme there is a requirement that the subject transaction must be over CYN 40 million. Currently, APAs are regarded as the most effective way of resolving TP disputes in China.¹⁹⁹

According to the country’s 2013 APA Report,²⁰⁰ China had from 2005 to 2013 executed a cumulative total of 104, 67 APAs comprising of 67 unilateral and 37 bilateral APAs. In 2013 alone, a total of 19 APAs were signed, 11 being unilateral and the rest being bilateral APAs. No multilateral APA has been executed by the country so far.²⁰¹ The completion time has generally been less than two years. 63 percent of the APAs that we signed in 2013 were completed within one year. Transactional Net Margin Method (TNMM) was the dominant transfer pricing method and was used in 85 percent of the cases. The programme has a rollback option which has been used to resolve outstanding transfer disputes dating as far back as 10 years.²⁰² A request for renewal of an APA must be filed 90 days prior to its expiration.

APAs are currently available only for natural gas and there is also an ongoing pilot scheme for the roll out of formal APAs for other sectors.

¹⁹⁴ To qualify, the transaction involved should be over RMB 40 Million (see See, SAT, *China Advance Pricing Arrangement: Annual Report*, Available at <<http://www.chinatax.gov.cn/2013/n2925/n2957/c1371176/part/1371191.pdf>> accessed on April 27, 2015

¹⁹⁵ See HMRC, *Policy Paper: Statement of Practice 2(2010)* (HMRC 2013), available at <<https://www.gov.uk/government/publications/statement-of-practice-2-2010/statement-of-practice-2-2010>> accessed on April 27, 2015

¹⁹⁶ See, Deloitte, *The 2015 Global Transfer Pricing Country Guide* (n. 193)

¹⁹⁷ See for example CBDT Press Release (March 31, 2014), available at,

<http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/2/Press_Release.pdf>, accessed on April 30, 2015

¹⁹⁸ SAT, *Advance Pricing Arrangement Annual Report 2013*, p. 5

¹⁹⁹ Jinyan Li, ‘Transfer pricing disputes in China’ in Eduardo Baistrocchi & Ian Roxan, *Resolving Transfer Pricing Disputes: A global Analysis* (Cambridge University Press 2012) p.665

²⁰⁰ SAT, *Advance Pricing Arrangement Annual Report 2013*

²⁰¹ *ibid*, p. 21

²⁰² *ibid*, p. 17

The uniqueness of the Chinese APA is the availability of a multi-stage dispute resolution mechanism for the programme. Under Article 63 of the Implementing Measures, where, during the implementation of the APA, there occurs any disagreements between the tax authority and the taxpayer, the parties are first encouraged to resolve the same through negotiations and where those negotiations fail, the case may be taken to a higher level within the tax administration and finally, for bilateral and multilateral APAs to the State Administration of Taxation. It is only where the disagreement still persists that the APA may be terminated.²⁰³

3.3.3 India

The APA programme was introduced in India with effect from July 1, 2012 vide the Finance Act, 2012. Detailed rules implementing the programme were introduced by the Central Board of Direct Taxes (CBDT) vide the official gazette of August 31, 2012. Since its introduction, the Indian APA has been highly embraced by taxpayers, with some practitioners remarking that it has provided a ‘welcome opportunity’ to prevent transfer pricing controversies and thus eliminate uncertainties associated with future litigation.²⁰⁴ According to CBDT press release,²⁰⁵ 146 applications were received in the first year (period ending March 31, 2013). As an indication of what could be seen as the programme’s wide acceptance by the Indian MNEs, the number of APA applications increased in the second application period (period ending March 31, 2014), to over 235 applications, representing an increase of over 70 percent.²⁰⁶

Whereas the Indian APA programme offers unilateral, bilateral and multilateral options, most of the agreements that have so far been signed are unilateral in nature. Of the applications received in the second application period, approximately 88 percent of them were for unilateral APAs and most of which were completed within one year.²⁰⁷ The dominance of unilateral APAs over the other types of APAs has been speculated by some to be as a result of India’s stand on corresponding adjustment clause under its income tax treaties, which has prevented it from entering into bilateral and multilateral APAs with some of its major trading partners such as France and Germany, with whom India does not have an equivalent of Article 9(2) of the OECD Model Tax Convention.²⁰⁸ It is this author’s opinion that the dominance of unilateral APAs could also be attributable to the fact that India, like all other countries at their early stages with the programme are still be down in the learning curve and hence may be more guarded when it comes to bilateral or multilateral APA requests.

Effective October 1, 2014, India introduced a rollback option for the programme and taxpayers will from then be able to apply the APA agreement for a period of four years preceding the first

²⁰³ SAT, *China Advance Pricing Arrangement: Annual Report*, p. 19; see also Jinyan Ali, ‘Transfer Pricing disputes in China’ in Eduardo Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis*, (Cambridge University Press 2012)

²⁰⁴ See Vijay Iyer, ‘Advance Pricing Agreements-Addressing the Taxpayers Needs’ in *EY India Tax Insights* (2014) April-June, p. 2

²⁰⁵ CBDT Press Release (March 31, 2014), available at,

http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/2/Press_Release.pdf, accessed on April 30, 2015

²⁰⁶ Ernst & Young, *India Advance Pricing Agreements: Providing Transfer Pricing Certainty* (EY, 2014), p.3, available at [http://www.ey.com/Publication/vwLUAssets/EY-India-Advance-Pricing-Agreements/\\$FILE/EY-India-Advance-Pricing-Agreements-providing-transfer-pricing-certainty.pdf](http://www.ey.com/Publication/vwLUAssets/EY-India-Advance-Pricing-Agreements/$FILE/EY-India-Advance-Pricing-Agreements-providing-transfer-pricing-certainty.pdf).> accessed on April 30, 2015

²⁰⁷ *ibid*

²⁰⁸ Vijay Iyer (n 204), p. 4

year in which the APA was applicable.²⁰⁹ The term of APAs is fixed to not more than five years with an option for renewal.²¹⁰ One major drawback of the Indian APA is its lack of a confidentiality clause, which essentially means that information obtained under the APA process may be used by the tax administration against the taxpayer in future audit or litigation.²¹¹ This may be even worse where the APA negotiations fail.

3.3.4 The US

The United States' Internal Revenue Service (IRS) introduced the APA programme in 1991 vide Revenue Procedure 91-22,²¹² and the country has since executed more than 1,400 APAs.²¹³ Effective 27th February 2012, the APA programme was merged with the MAP programme and consequently renamed as Advance Pricing and Mutual Agreement Programme. According to the IRS, this merger has increased the programme's efficiency by eliminating the 'two "handoffs"' that existed under the prior system where the APA team could only develop the IRS position but was not responsible for the APA discussions with the treaty partners. The reverse was also the case with the office of the US Competent Authority.²¹⁴

According to the IRS 2014 APA report,²¹⁵ 101 APAs were executed in 2014, with over 80 percent of them being bilateral and the balance being unilateral.²¹⁶ Although this was a slight reduction from 2013 and 2012 figures which stood at 145 and 140 respectively,²¹⁷ it still reflected a significant increase in the number of APAs concluded prior to the 2012 merger which, as seen above, the IRS has credited with the greater processing efficiencies. The efficiencies brought about by the 2012 merger even becomes clearer when one contrasts the current statistics with the 2011 report where only 43 APAs were reported to have been finalized.²¹⁸ The average processing time during the 2014 period was 38.5 months, which, though representing approximately six months decrease from the 2013 figures, still exhibited some improvement from the 2011 rate which stood at 40.7 months.²¹⁹

Regarding the term of the APAs, although Rev. Proc. 2006-9 prescribes a term limit as five years, the actual term is in practice determined on a case-by-case basis. The 2014 statistics indicate that more than 40 percent of the APAs concluded were actually for a term of more than five years, 10 percent of which had a term of ten years or longer despite the fact that the initial applications in most of those cases were for a term of five years. According to the IRS, the longer terms were granted 'to ensure reasonable amount of prospectivity in the APA term.'²²⁰ Practitioners have also observed that the longer period is normally applicable where either an

²⁰⁹ Introduced vide, Finance (No. 2) Act 2014

²¹⁰ See, Indian ITA, Section 92CC

²¹¹ See, Anurag S. & Shreya G., 'India: Advance Pricing Agreements' (2014) January/February *Asia-Pacific Tax Bulletin*, pp. 33-43

²¹² IRS Rev. Proc. 91-22, 1991-1, C.B. 526

²¹³ IRS, Announcement 2015-11, *Announcement and Report Concerning Advance Pricing Agreements*, p.4

²¹⁴ IRS Announcement, 2014-14, *Announcement and Report Concerning Advance Pricing Agreements*, p.3-4

²¹⁵ IRS, Announcement 2015-11, *Announcement and Report Concerning Advance Pricing Agreements*

²¹⁶ *ibid*

²¹⁷ *ibid*

²¹⁸ IRS Announcement 2011-22, *Announcement and Report Concerning Advance Pricing Agreements*

²¹⁹ *ibid*, (n. 213), (n. 214) and (n. 215)

²²⁰ IRS, Announcement 2015-11, *Announcement and Report Concerning Advance Pricing Agreements*, p. 15

application took too long to complete or where additional years are required to address some difficult issues.²²¹

The report also reveals that most (over 80 percent) of the APAs completed in 2014 were bilateral with the rest being unilateral. On the type of transactions covered, 36 percent involved sale of tangible goods while 40 percent involved services. The predominant transfer pricing methodology was the profit methods with Comparable Profits Methods being used in 78 percent of the cases.

The US APA has a provision for renewal, rollback and also for confidentiality of the information received in the process of negotiating an APA.²²² The country charges a user fee for the programme, with the current fees ranging between USD 10,000 to 50,000 depending on the nature of the request and the size of taxpayer involved.²²³

An analysis of the countries' APA reports reveals that the US has the highest proportion of bilateral APAs over unilateral APAs, followed by China and India respectively. Conversely, India has the highest proportion of unilateral APAs compared to its bilateral APAs. While it is acknowledged that this trend could be partly attributable to the fact that the US may be having a more elaborate treaty network,²²⁴ there is also the possibility that it could as well be attributable to the stage at which the respective countries are with the implementation of the APA programme. Early implementers like the US (1991) now appears to have gained more experience, hence more confidence to engage in bilateral APAs and even multilateral APAs. India on the other extreme, still being less experienced with the programme, appears to be more guarded, choosing instead to initially focus on unilateral APAs as they build the requisite experience and confidence to be able to engage in bilateral or even multilateral negotiations. It is submitted that this would be the correct approach for a country intending to introduce the programme for the first time. In fact, even for the US, its first APA report which published in 2000, approximately 10 years after its first implementation of the programme, indicates that unilateral APAs then constituted almost 50 percent of the total applications,²²⁵ compared to the current 20 percent.²²⁶

3.4 Advantages of APAs

From the above survey, it is apparent that APAs have helped to resolve a significant number of TP issues, with some countries such as the US executing as high as 145 APAs in a single year. The experiences from China and India similarly reveal a considerable reliance by MNEs on the programme. It is evident that APA has been used in these cases to minimise risk of transfer pricing adjustment, thus ensuring certainty in business decisions and in tax treatment of inter-company transactions. The OECD TP Guidelines also cites this as the programme's main

²²¹ See for example, Darrin Litsky, '2014 U.S. APA Report Shows Program Holding Steady' (2015), *Deloitte Global Transfer Pricing*, April, 10, p.2, available at <https://www.google.co.ke/?gws_rd=ssl#q=Deloitte%2C+%E2%80%982014+U.S.+APA+Report+Shows+Program+Holding+Steady%E2%80%99> accessed on April 30, 2015

²²² Internal Revenue Code (1986), Section 6103 (b), Paragraph 2 (C)

²²³ Rev. Proc. 2006-9, Section 4

²²⁴ As of May 11, 2015, the US had in place, income tax treaties with a total of 78 countries (see, <http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z> accessed on May 11, 2015)

²²⁵ IRS, Announcement 2000-35, *Announcement and Report Concerning Advance Pricing Agreements*, p. 8

²²⁶ IRS, Announcement 2015-11, *Announcement and Report Concerning Advance Pricing Agreements*

advantage.²²⁷ The certainty thus offered, has the effect of preventing expensive and often time consuming audits and litigation.²²⁸ Additionally, due to the cooperation involved and the non-adversarial nature of the negotiation process, there is the likelihood of an enhanced, and free flow of information between the tax administration and the taxpayer,²²⁹ which, apart from facilitating the negotiations, also serves to place the revenue authority in a position to gain a useful insight into the operations of the MNE involved. This insight is particularly crucial since it enables the tax authority to understand a taxpayer's operational structures including, the functions, assets and risks; factors which are key ingredients for the determination of the correct arm's length price or profit margin.²³⁰ The APA process, especially bilateral and multilateral negotiations may also be useful in enhancing understanding and cooperation between the treaty partners. However, to be able to get increased benefits offered by the APA programme, it is imperative that a country expands its treaty network, especially with its major trading partners.

3.5 Disadvantages of APAs

Despite the fact that APAs significantly reduces uncertainties associated with the determination of the arm's length price in inter-company transactions, the programme is not itself a silver bullet when it comes to TP issues, which are inherently difficult. The programme's adoption cannot in therefore magically make these difficult TP issues go away.²³¹ Additionally, due to the difference in their interests, negotiations between a taxpayer and a tax administration may still be quite contentious, especially where difficult TP issues like high value intangibles are involved.²³² Further, the time and costs involved both for the tax administration and the taxpayer, especially at the initial stages of the programme's implementation, is one of the biggest drawbacks of the programme.²³³ Other shortcomings of the programme include the fact that the process may be shunned by some taxpayers who may view it as amounting self-reporting of their sensitive tax planning information to a tax authority, with the consequence that such information may even be used against them, especially where the APA negotiations fail.²³⁴ There is also the possibility that most of the companies that would be interested in the APA process are large companies with good compliance history. Therefore committing resources to process an APA application from such taxpayers instead directing the resources towards investigating less complaint taxpayers may be seen as non-optimal use of resources since the risk of loss of tax revenue is always higher in the latter case.²³⁵

Apart from the operational and administrative issues, there are also a number of legal strictures that the APA programme is expected to comply with. The programme must not only exist harmoniously with the other provisions of a country's tax system, but must also be compatible with the country's other legal and constitutional provisions. Chapter 4 below discusses, from Kenya's perspective, some of the legal considerations that are crucial for the successful implementation and management of the APA programme.

²²⁷ OECD TP Guidelines, para 4.143

²²⁸ *ibid*, para 4.145

²²⁹ *ibid*, para 4.144

²³⁰ See OECD TP Guidelines, para 1.20

²³¹ Annet W. Ogotu, 'Resolving Transfer-pricing Disputes: Are Advance Pricing Agreements' the Way Forward for South Africa.' *S. Afr. Mercantile LJ* 18 (2006): 460.

²³² *ibid*

²³³ Michelle Markam, 'The Advantages and Disadvantages of Using an Advance Pricing Agreement: Lessons for the UK from the US and Australian Experience', *Intertax*, 2005 Issue 5, Volume 33, pp. 219-28

²³⁴ *ibid*

²³⁵ *ibid*

CHAPTER 4

4 ADVANCE PRICING AGREEMENTS – LEGAL CONSIDERATIONS

4.1 Introduction

The implementation of the APA programme brings to the fore a number of legal and administrative issues. While the author acknowledges that administrative considerations such as the availability of adequately trained staff to run the programme are crucial, such considerations however fall outside the scope of this research and will not therefore be covered. This chapter is only be devoted to the examination of the legal considerations that are likely to arise, either at the implementation stage, or in the course of running the APA programme. For the purposes of this research, some of the issues that will be discussed include; the legal basis of APAs, confidentiality versus transparency issues, the binding nature of APAs and the equality and equity issues. The issues will be analysed from the perspective of the Kenyan legal and constitutional system while drawing where relevant, from the experiences in China, India and the US.

4.2 The Legal basis of APAs

While unilateral APAs will normally be entered into on the basis of the existence of such powers in the domestic law, bilateral or multilateral APAs can only be entered into through the mutual agreement procedure.²³⁶ Despite the fact that APAs are not expressly mentioned under the mutual procedure article (Art. 25 OECD Model Tax Convention), Paragraph 3 of the Article provides a framework for the contracting parties to consult together for the purposes resolving, by mutual agreement, ‘any difficulties or doubts arising from the interpretation or application of the Convention,’ including for purposes of eliminating double taxation in cases not provided under the treaty.²³⁷ The OECD TP Guidelines clarifies that since bilateral APAs have as their main aim the elimination of double taxation which arise as a result of transfer pricing cases where there are normally ‘doubts and difficulties’ as to the application of the treaty, it can therefore be said to be properly falling under Article 25.²³⁸ The exchange of information articles (for example those based on Article 26 OECD Model Tax Convention) are equally relevant since the participating jurisdictions needs to share information regarding the taxpayer’s operations in their respective jurisdictions.

China,²³⁹ India²⁴⁰ and the US²⁴¹ have all incorporated in most of their income tax treaties a provision for a corresponding adjustment. Also included in these treaties is a provision for the mutual agreement procedure, enabling treaty partners to consult with a view resolving any disputes that may arise under the treaties. It is noteworthy that both China and India under their respective policies on income tax treaties holds the view that in the absence of a provision equivalent to Article 9(2) OECD Model Tax Convention in any of their treaties precludes the

²³⁶ A provision the equivalent of Art. 25 of the OECD Model Tax Convention

²³⁷ See, OECD TP Guidelines, para 4.139; See also paragraph 50 of the Commentary to Art. 25

²³⁸ *ibid*

²³⁹ See for example, Article 8(2) and Article 24 (3) of the China-USA income tax treaty

²⁴⁰ See for example Article 10(2) and Article 27 (3) of the India-Kenya income tax treaty

²⁴¹ See for instance, the US-China income tax treaty (n. 239)

question of a corresponding adjustment from becoming the subject of negotiations under the mutual agreement article.²⁴²

In the context of Kenya, only two²⁴³ of the country's nine income tax treaties currently in force have a provision for a corresponding adjustment. All the nine treaties nevertheless have a provision for the mutual agreement procedure, including a provision equivalent of Article 25(3) of the OECD Model Tax Convention. Kenya however does not have any particular treaty policy, similar to Indian or Chinese positions precluding double taxation issues arising under Article 9 form being the subject of MAP where paragraph 2 of the Article is not included in a treaty.

According to the OECD, the MAP process is particularly appropriate for negotiating bilateral or multilateral APAs, especially where the domestic laws of a country do not permit tax administrations to enter into a binding agreement on tax issues.²⁴⁴ The power to negotiate APAs in such cases will therefore be drawn from the treaty itself, which in most cases override national laws.²⁴⁵ It can therefore be safely concluded that even in the absence of a specific APA legislation, Article 25 (3) in the Kenyan income tax treaties, when read together with section 41 of the ITA,²⁴⁶ would form the legal basis in Kenya for bilateral and multilateral APAs. Unilateral APAs would however still require a specific legislation authorising such agreements. As seen in Chapter 3 above, all the three countries under study have enacted a specific domestic legislation on APAs to supplement their respective mutual agreement procedure article.

The need for a domestic legislation is necessitated by the fact that as opposed to unilateral APAs, bilateral or multilateral APAs are ordinarily between the competent authorities of the participating countries, there is therefore the need for a legal procedure to make the agreement binding by creating a legal nexus between the subject taxpayer and the tax authority of the country in which the entity is tax resident. China²⁴⁷, India²⁴⁸ and the USA²⁴⁹ have all enacted a domestic legislation anchoring APAs in the respective countries' legal system. Such domestic legislations also provide for other supplementary issues such as documentation, filing and monitoring which are pertinent to the smooth running of the programme. However since bilateral or multilateral APAs involves other jurisdictions, the supplementary issues as provided under such domestic legislation must not be consistent with the APA itself.²⁵⁰

The APA (agreement) itself must therefore comply with the domestic legislation and any representation made under the agreement which is not statutorily backed becomes void. APAs are subject to the law and therefore any change of law in a country renders ineffective, any portion of the agreement which is not in conformity with the new legal position.²⁵¹ In the context

²⁴² See, OECD Model Tax Convention, *Non-OECD Economies' Positions on the OECD Model Tax Convention, Positions on Article 25 (Mutual Agreement Procedure) and Its Commentary*, para 5

²⁴³ Income tax treaties with France and with India

²⁴⁴ OECD TP Guidelines para 4.130

²⁴⁵ See for example, section 41 of the Kenyan ITA which expressly provides that such arrangements supersede the other provisions of the ITA.

²⁴⁶ Section 41 of the Kenyan ITA is the provision authorising the Minister to sign income tax treaties.

²⁴⁷ See, Implementation Rules on Advance Pricing Arrangements, Guo Shui Fa (2004) No. 118; See, SAT, *China Advance Pricing Arrangement: Annual Report*, available at <<http://www.chinatax.gov.cn/2013/n2925/n2957/c1371176/part/1371191.pdf>> accessed on April 27, 2015

²⁴⁸ Indian ITA, Section 92CC and Section 92CD

²⁴⁹ Re. Proc. 2006-9

²⁵⁰ OECD TP Guidelines, Annex to Chapter IV, para 67-8

²⁵¹ OECD TP Guidelines, Annex to Chapter IV, para 79

of Kenya, the primacy of statutory provisions over any representations or agreements by a public officer was confirmed in the *Shake Distributors* case,²⁵² where the court stated that a public body cannot make a promise which is inconsistent with the express letter of the law.²⁵³ Additionally, in Kenya, such agreements (APAs), apart from complying with the statutory provisions, would also be expected to be consistent with the country's Constitution, particularly Article 210 thereof which prohibits any levy, waiver or variation of any taxes except as by statute provided.

4.3 Confidentiality-Transparency Conundrum

In the course of negotiating APAs, MNEs are usually required to disclose, in good faith, all the information relevant to the proposed transactions so as to fully benefit from the guarantees presented by the programme.²⁵⁴ The information so provided may include sensitive commercial and proprietary information and there is therefore the need for a mechanism to ensure that such information is protected by the tax administration so as to guarantee the integrity of the process.²⁵⁵ Those who oppose disclosure cite taxpayer privacy and confidentiality rights.²⁵⁶ On the other hand, there is the equally forceful argument in favour of the need for disclosure of such information, with the proponents for disclosure putting forward as their main justification the need for public oversight and the need to eliminate the possibility and or perception of 'secrete deals'.²⁵⁷

Both the US²⁵⁸ and China²⁵⁹ APA programmes have confidentiality provisions exclusively directed towards the information obtained during the APA process. India on the other hand lacks such a provision but has a general confidentiality clause under Section 138 of the Indian ITA, 1961 which leaves it to the discretion of the Commissioner to decide whether or not to disclose taxpayer information. The Commissioner is to release such information where in his opinion there exists sufficient public interest to warrant disclosure. The Commissioner's decision on the question is declared final and not subject to question in any court of law.²⁶⁰ Practitioners have commented that because of this, the Indian APA programme lacks a 'firewall provision' and therefore information provided under the programme can be used by the tax administration against the taxpayer in other subsequent processes such as audit and litigation,²⁶¹ especially where either the APA talks collapse, or where for some reason the taxpayer withdraws from the negotiations.

In the US, Section 6103 of the tax code declares all taxpayer return information confidential. Section 6110 of the same code on the other hand requires disclosure of all IRS 'written

²⁵² *R.v KRA ex parte Shake Distributors Ltd*, available at < <http://kenyalaw.org/caselaw/cases/view/85683> > accessed on April 27, 2015

²⁵³ *ibid*, p. 6

²⁵⁴ See for example sub-section 7, Section 9CC of the Indian Income Tax Act which provides that an APA may be declared void ab initio if it was secured by fraud or misrepresentation of facts.

²⁵⁵ OECD TP Guidelines, para 4.156-7; See also Annex on Chapter IV, para 57

²⁵⁶ Michelle Markham (n 20), p.44-5

²⁵⁷ John L. Abramic, 'Advance Pricing Agreements: Confidential Return Information or Written Determinations Subject to Release' in *Chicago-Kent Law Review*, Vol. 76, p1845-6

²⁵⁸ See, Internal Revenue Code (1986), Section 6103 (b), Paragraph 2 (C).

²⁵⁹ See, China Advance Pricing Agreement Annual Report 2013, State Administration of Taxation People's Republic of China, p.36

²⁶⁰ Section 138(1)(b)

²⁶¹ See, Ernest & Young, *India Tax Insights, Advance Pricing Agreement in India-Addressing Taxpayers Needs* (April-June 2014), available at, < <http://www.ey.com/IN/en/Services/Tax/EY-india-tax-insights-april-june-2014-advance-pricing-agreement-in-india-addressing-the-taxpayers-needs-vijay-iyer> > accessed on April 22, 2015

determinations.’ Additionally, Section 552 of the US Freedom of Information Act (‘FOIA’), subject to a few exceptions, imposes a duty on government institutions to publish and make available all information held by them. This tension of the laws led to a suit in 1996 regarding APAs by the US Bureau of National Affairs (‘BNA’) against IRS, the ‘*BNA Case*’.

4.3.1 The *BNA Case*²⁶²

This case was filed in 1998 against IRS under Section 6110 of the tax code and the FOIA seeking disclosure of information regarding all APAs executed by IRS. It was BNA’s argument that APAs contained declarations by IRS of the policy and legal interpretations of tax laws and were therefore ‘written determinations’ which ought to be published for the benefit of taxpayers generally. While objecting to publication, IRS took the position that APAs contain sensitive taxpayer information which is protected both under the FOIA exceptions, and under Section 6103 of the of the tax code. The suit was however compromised when IRS ultimately agreed with BNA’s claim that APAs were in fact ‘written determinations’ and therefore subject to Section 6110 disclosures. IRS nevertheless still maintained that the disclosure was to be subject to the redaction of any identifying or protected taxpayer information.²⁶³

However, following confidentiality concerns raised by among others, the country’s treaty partners who felt that any disclosures would effectively (but without due consultation) alter the terms and conditions of the earlier APAs,²⁶⁴ the US Congress amended both section 6103 and 6110 of the revenue code classifying APAs as confidential return information and thereby preventing disclosure under both the FOIA and the tax code.²⁶⁵ The amendment also, in a bid to strike a balance between confidentiality and transparency concerns, required the IRS to publish annual reports on APAs, containing mainly statistical information without disclosing any data that would lead to the identification of any taxpayer.²⁶⁶ It is under this legislation that the first US APA report was released in March 2000,²⁶⁷ a format which has generally been accepted by all the stakeholders.²⁶⁸

4.3.2 The *Njoya Case*²⁶⁹

In Kenya, the confidentiality of taxpayer information is protected under Section 125 of the ITA which declares as secrete, ‘all documents and information relating to the income of a person and all confidential instructions in respect of the administration of the Income Tax Department.’ Such information is not to be produced, even in court, except where needed for the carrying into effect the provisions of the ITA itself, or to assist in the prosecution of an offence committed under the Act.²⁷⁰ Section 125 also provides a few exceptions where such information may be revealed. The exceptions are limited to among others, for revenue or statistical purposes,²⁷¹ or

²⁶² Bureau of Nat’l Affairs, Inc. v. IRS, 24 F. Supp. 2d 90, 91 (D.D.C. 1998).
2012)p42-44

²⁶³ ibid

²⁶⁴ See, Michelle Markham (n. 20), pp. 42-5

²⁶⁵ Public Law No. 106-170

²⁶⁶ ibid, Section 521, the Ticket to Work and Work Incentives Improvement Act, 1999

²⁶⁷ IRS Announcement 2000-35 *Announcement and Report Concerning Advance Pricing Agreements* April 5, 2000

²⁶⁸ See, Michelle Markham (n. 20), p. 44

²⁶⁹ *Timothy Njoya v Attorney General & Another* [2014]eKLR, available at, <<http://kenyalaw.org/caselaw/cases/view/102921/>>, accessed on April 20, 2015.

²⁷⁰ ITA, Section 125 (2); This provision was confirmed in the *Timothy Njoya* case (ibid)

²⁷¹ ITA, Section 125(3)

the release of such information under the exchange of information articles of the income treaties.²⁷²

On the other hand, Article 35(1) of the Constitution,²⁷³ decrees the right of every Kenyan citizen to access information held by the state. Further, Article 2 of the Constitution provides for the supremacy of the Constitution and declares void, to the extent of the inconsistency, any law (including treaties to which Kenya is a party) not in harmony with the Constitution. On the other extreme, the right to privacy is also protected under Article 31 of the Constitution. To balance off, Article 24 of the Constitution prescribes the circumstances under which the rights granted under the constitution may be limited.

It is this confidentiality – transparency conundrum that was the subject of litigation in the *Njoya* case. The Petitioner having unsuccessfully sought from the KRA information regarding the payment of taxes relating to the Kenyan Members of Parliament, filed a constitutional petition in the High Court of Kenya, seeking a declaration that Section 125 of the ITA on which the KRA had relied on to deny his request unconstitutional and therefore void on the basis that violates Article 35(1) of the Constitution.

In dismissing the Petition, the Court found that Section 125 ITA provides a reasonable justification under Article 24 of the Constitution for the limitation of the right of access to information under Article 35(1).²⁷⁴ The Court quoting with approval the dictum in the *Re Brown Trustee's case*²⁷⁵ stated that:

Its (*sic*) important in the public interest that crime should be punished than that money should be recovered for revenue; but they are both things in the public interest, and if the Commissioners of Inland Revenue, speaking through the mouth of the Lord Advocate, represent to me that in their view it will embarrass them in the future collection of revenue to have documents of that kind recovered, I am afraid I must, at whatever hazard to private litigation, give effect to that objection....²⁷⁶

It is evident that both the Congress in the *BNA* case, and the Court in the *Njoya* case, sought to strike a balance between two legitimate but competing interests. While it was acknowledged that disclosure of tax information held by the public bodies is generally important, private interests were allowed to override public interest in both cases. In another Kenyan case, the *Nairobi Law Monthly*,²⁷⁷ the court was of the view that international standards relating to access to information require ‘maximum disclosure and limited exceptions’ and that the burden is on the person denying access to justify (based on ‘harm’ or ‘public interest’ considerations) his assertion for non-disclosure.²⁷⁸ Commercial interests and the integrity of the government decision making process are some of the reasons that were cited in that case as possible justifications for non-disclosure.²⁷⁹ The Court was of the view that in determining whether or not to uphold assertion for non-disclosure, the test should be that:

²⁷² ITA, Section 123 (3) and (4)

²⁷³ Constitution of Kenya, 2010

²⁷⁴ *Timothy Njoya* (n. 269) Para. 39

²⁷⁵ Tax Cases (1890-1898) Volume 3, 598

²⁷⁶ *Timothy Njoya* (n 269) para. 41

²⁷⁷ *Nairobi Law Monthly v KENGEN* (2013) eKLR, available at <<http://kenyalaw.org/caselaw/cases/view/88569/>> accessed on April 20, 2015

²⁷⁸ *ibid*, para 53

²⁷⁹ *Nairobi Law Monthly* (n. 277) para. 54

[t]he reasons for non-disclosure must relate to a legitimate aim; disclosure must be such as would threaten or cause substantial harm to the legitimate aim; and the harm to the legitimate aim must be greater than and override the public interest in disclosure of the information sought.²⁸⁰

The OECD recommendations on APAs upholds taxpayer information confidentiality and provides that such information are not only to be protected from third party disclosures, but are also not to be used by the tax administration in subsequent audits or litigation where either no agreement is reached, or where the taxpayer, for some other reason withdraws from the APA process.²⁸¹ This position is also confirmed by the UN TP Manual which observes that for APAs to be better embraced, it is desirable either to keep the APA and audit processes separate, or where for any reason that is not possible, then a limitation on the use of information provided during the APA process be imposed in the agreement itself.²⁸²

Whereas the Court decision in the *Njoya* case did not address the extent to which (if any) tax information may be shared, the US Congress' action in the *BNA* case seems to have struck the correct balance in the confidentiality-transparency puzzle. The publication of the annual APA reports serves to provide information which may be useful in providing some degree of guidance to all taxpayers, but also protects taxpayer private business information obtained in the course of negotiating the APAs.²⁸³ This has the effect of increasing public confidence in the fairness and transparency of the APA programme. In the opinion of the author, some level transparency may be achieved under the existing Section 125 (3) (b) of the ITA which authorizes disclosure of taxpayer information solely for revenue and statistical purposes. However, to guarantee certainty and uniformity in application, there may be need to introduce a special confidentiality-transparency balancing provision under the TP Rules like in the US situation.

4.4 Equity and Equality Issues

The APA programme by its very nature inevitably raises both equity and equality concerns. The principle of equity demands that taxpayers who are in the same economic circumstances, whether domestic owned or foreign controlled, should be accorded equivalent tax treatment, irrespective of whether one is under the APA programme or not. An APA should therefore not have the effect of granting unequal treatment to taxpayers in the same legal and factual situation. Equivalence in treatment should cover both access to the programme, and the overall tax treatment of a taxpayer's transactions.

First, to guarantee neutrality as to the tax treatment of transactions, the OECD recommends that APA negotiations and the final agreement must respect the arm's length principle,²⁸⁴ and that where the agreement goes beyond determining the methodology, then, abundant care must be taken to ensure that predictions as to the future transactions and the critical assumptions on which those predictions are based are reliable.²⁸⁵ To enhance reliability, taxpayers and tax

²⁸⁰ *ibid*

²⁸¹ OECD TP Manual, para 4.156-7; also see, OECD TP Manual, Annex to Chapter IV, paras 57 and 66(j)

²⁸² UN TP Manual, para 9.6.2.5

²⁸³ The Report is published under Section 521(b) of the US Ticket to Work and Work Incentives Improvement Act, 1999

²⁸⁴ OECD TP Guidelines for MAPA APAs, paras 10,22,38,40,41,43,47 & 49

²⁸⁵ OECD TP Guidelines, para 4.124-8

administrations are encouraged to ensure that the (critical) assumptions that underlie the APA agreement are (where possible) based on observable, reliable and independent data.²⁸⁶

Given the prospective nature of APAs, the ability of a transaction to reflect the arm's length price or profit margin (hence equivalence in treatment with other similar transactions) significantly depends on the reliability of the critical assumptions that underlie the agreement. It is therefore necessary to stipulate certain assumptions concerning legal, operational and economic conditions which are likely to affect the projected transactions and how those assumptions will impact the arm's length nature of the transactions. These assumptions are considered 'critical' where the actual conditions existing at the time of the transactions would deviate from those that were projected at the time of the agreement, to the extent that the ability of the methodology to reliably reflect the arm's length price is undermined. In such a case, the agreement would, depending on the extent of the departure, need to be revised or cancelled.²⁸⁷ Through this mechanism, the arm's length principle is protected thereby effectively ensuring equality in the treatment of transactions and taxpayers generally.

In the US, claims of unequal treatment of taxpayers' transactions under the APA programme became a point of litigation when GSK alleged that IRS had denied it an APA for its drug Zantac, whereas granting the same to its competitor, SmithKline Beecham Corp, in respect of Tagamet, a competing product. For this reason, GSK claimed from the IRS approximately USD 1.7 billion in refund as a result of the alleged unequal treatment.²⁸⁸ Even though the case was eventually settled amicably,²⁸⁹ it serves to demonstrate the significance of the need to grant taxpayers who are in similar circumstances equal treatment under the APA programme.

Secondly, to be deemed equitable, access to APAs, like any other tax programme should be made available to all taxpayers in similar circumstances. The OECD however acknowledges that the very nature of the APAs, especially in relation to the high cost of administering the programme, may limit its accessibility only to large taxpayers.²⁹⁰ To address the possible equity issues, it is recommended that tax administrations should consider adopting specific programmes tailored towards the small and medium enterprises.²⁹¹

While China places a monetary threshold for the access to its APA programme,²⁹² India and the US have no such restrictions. India²⁹³ and the US however charges user fee for the programme, with the US providing for different rates for large taxpayers and small businesses,²⁹⁴ China on the other hand has no such fee. Additionally the US has a simplified procedure for small

²⁸⁶ OECD TP Guidelines for MAP APAs, para 44

²⁸⁷ OECD TP Guidelines for MAP APAs, para 43; For more on critical assumptions, see Daniele de Carolis, 'Critical Assumptions in Advance Pricing Agreements: A Comparison between the OECD Guidelines and the American Tax System', Vol. 41, Issue 12 *Intertax*, (Kluwer Law International 2013)

²⁸⁸ *GlaxoSmithKline Holdings Americas Inc. v. Commissioner*, No. 5750-04; GSK discovered facts of the case when SmithKline Beecham Corp merged with Glaxo in January 2000.

²⁸⁹ GSK agreed to abandon the claim as part of the deal in *GlaxoSmithKline Holdings Americas Inc. v. Commissioner*, No. 5750-04 and 6959-05 where GSK agreed to pay IRS USD 3.4 billion in full and final settlement of the disputes.

²⁹⁰ OECD TP Guidelines, para 4.163

²⁹¹ *ibid*

²⁹² APAs are restricted for related party transactions exceeding RMB 40 million; see SAT, *China Advance Pricing Agreement: Annual Report*, 2013, p.8;

²⁹³ The fee depends on the value of the International Transaction to be covered, Rule 10I (5), ITR

²⁹⁴ Currently, original APA request costs USD 50,000 for large taxpayers and USD 22,500 for small taxpayers; See, IRC, Section 4

businesses.²⁹⁵ It is submitted that while placing a monetary threshold as a prerequisite for accessing the programme may seem plausible especially in a country with many MNEs, it is likely to be faulted for being restrictive, more so where such threshold is set too high and hence may be seen as inequitable in the circumstances. Charging of user fee on the other hand although may equally be questioned, appears to have been generally accepted as reasonable, especially where the fee is based on the value of the covered transaction like in the Indian situation. The UN TP Manual confirms that the charging of user fee for APAs has essentially been accepted by MNEs who regard the advantages to be derived under an APA as outweighing any inconvenience of paying such fees.²⁹⁶

In the Kenyan context, equity and equality are national values embodied under Article 10 (2) (b) of the Constitution and are binding on all public officers, tax officials included. Additionally, the Constitution declares that every person has a right to equal protection and equal benefit of the law,²⁹⁷ and that the burden of taxation is to be shared fairly.²⁹⁸ This essentially means that any considerations for APAs in Kenya must address equity and equality issues by ensuring that no taxpayer benefits from a more favourable tax treatment as a result of the programme. This can be achieved by having an APA the operation of which respects the arm's length principle and also one that is accessible to all taxpayers, irrespective of the size. To address equity issues, it may be necessary to consider a special APA programme specifically tailored for SMEs requiring a less elaborate procedure, reduced information requirements and charging of a reduced user fee as well.

4.5 The Binding Effect of APAs

Another legal question worthy consideration is the extent to which APAs, once executed, are to be binding both on the taxpayer and the tax administration. The OCED recommendations are that once registered, the terms and conditions of APAs becomes binding, both on the taxpayer and the tax administration in relation to the covered transactions, subject to any changes in the law or the facts that underlie the agreement.²⁹⁹ This position has been adopted by China³⁰⁰, India³⁰¹ and the US.³⁰² In all the three jurisdictions, the agreement may be declared void ab initio if it is established that the same had been entered by the taxpayer using fraudulent means or by misrepresentation of material facts, with the consequence that parties are to revert to their original positions as if the APA had not existed in the first place.³⁰³ On the other hand, where parties fail to meet the terms of the agreement or where there has been a change in the critical assumptions, the agreement will not remain binding and may either be cancelled, or where possible, be revised to reflect the changes.³⁰⁴

The power of a tax administration to revoke, cancel or even to propose revision of the agreement may be challenged by a taxpayer, both on its procedural and substantive aspects. Substantively, it may be argued on behalf of a taxpayer that the basis of a proposed revision, cancellation or

²⁹⁵ Taxpayer with a total gross income of USD 200 million or less; see, IRC, Section 8

²⁹⁶ UN TP Manual, para 9.6.2.14

²⁹⁷ The Constitution of Kenya, 2010, Article 27 (1)

²⁹⁸ The Constitution of Kenya, 2010, Article 201 (b) (i)

²⁹⁹ OECD TP Guidelines, para 4.135

³⁰⁰ SAT, *Advance Pricing Arrangement Annual Report 2013*) p. 4

³⁰¹ Sec. 92CC (5) & (6)

³⁰² Revenue Procedure 2006-9, section 11.01(4)

³⁰³ See, India, Sec. 92CC (7) ITA; US, Revenue Procedure 2006-9, 11.06

³⁰⁴ See for example the Indian ITA, Sec. 92CC

revocation of an APA by the tax administration does not warrant such an action and would therefore be a breach of the taxpayer's legitimate expectation. Regarding the procedural aspects, it may be argued that the procedural underpinnings concerning appropriate notifications, opportunity to be heard, among others had not been followed by a tax administration prior to the cancellation, revocation or proposal for revision. Related to the two issues also is whether a dispute arising under an APA in relation revocation, cancellation or revision of the agreement is to be determined by reference, exclusively, to the provisions of the agreement itself, or whether such a dispute may be resolved by resorting to the applicable revenue laws and procedures and the general administrative standards.

The binding nature of APAs, the nature of applicable law and the power of the tax administration to cancel the agreement was recently the subject of a preliminary ruling in the *Eaton v Commissioner* case,³⁰⁵ where the IRS terminated retrospectively its APA with *Eaton* on the basis that the company had failed to comply with the terms of the agreement and demanded a sum of USD 360 million in taxes owed and also raised USD 51 million in penalties. The issue for determination was whether an APA is a binding contract, governed by the general contract law principles, or whether it is an administrative determination, governed by applicable revenue procedures. According to *Eaton*, the Commissioner had always represented that APAs are 'binding contracts' and consequently, the general contract law principles were applicable in interpreting the agreement. The IRS on the other hand maintained that its power to cancel the APA was reserved in the agreement and that the Court can only intervene where it is demonstrated that there was abuse of discretion on the part of the tax administration.

In finding for the IRS, the Court found that an APA agreement is governed by the applicable revenue procedures and that the Court's jurisdiction is only limited to considering whether the Commissioner, in cancelling agreement had abused his discretion which is a factual question, and that the onus is on the taxpayer to prove that the decision was arbitrary and without any sound factual basis.³⁰⁶ The Court stated that:

Petitioner and respondent are bound to the terms upon which they agreed. The APAs at issue provide that the applicable revenue procedures shall govern their legal effect and administration. The applicable revenue procedures reserve to respondent discretion to cancel the APAs at issue in certain circumstances. We are unpersuaded that the description of APAs as contracts renders ineffective the explicit terms and conditions that petitioner and respondent agreed govern the APAs at issue.³⁰⁷

In Kenya, the right to fair administrative action is guaranteed under Article 47 of the Constitution which declares the right of every person to an 'expeditious, efficient, lawful, reasonable and procedurally fair' process. In the relation to APAs, this would mean that before any revision, cancellation, termination or revocation is done by the tax administration, the taxpayer must not only be notified in writing,³⁰⁸ but must also be given an opportunity to heard. The right to be heard was declared by the Kenyan High Court in *Total v Kenya Revenue Authority*,³⁰⁹ as a

³⁰⁵ 140 T.C. No. 18 (June 26, 2013), the case is still pending. 2013 T.C.M. (CCH) 59,575

³⁰⁶ *ibid*, p. 417-18

³⁰⁷ *ibid*, p. 418-19

³⁰⁸ The Constitution of Kenya, 2010, Article 47 (2)

³⁰⁹ *R. v Kenya Revenue Authority, Ex-Parte, Total Kenya Ltd* [2012]eKLR, available at <http://kenyalaw.org/caselaw/cases/view/79679> accessed on April 25, 2015

fundamental right which cannot be taken away irrespective of the hopelessness of one's case.³¹⁰ This therefore means that any failure on the part of the tax administration to comply with the procedural underpinnings as may be agreed under the APA itself and also as guaranteed under the Constitution would render such actions void.³¹¹ It is also important to note that the constitutional thresholds would generally prevail, especially in instances where the APA itself provides a taxpayer with less procedural guarantees.³¹²

Additionally, the binding nature of APAs may be tested from the perspective of the 'legitimate expectation' principle. A tax administration's proposal to revise, cancel or even revoke an APA may be opposed by a taxpayer on the basis that owing to the representations made by the tax administration, a taxpayer has in good faith relied on those representations to materially and significantly alter its financial and business position to the extent that it would be unfair for the tax authority to be allowed to renege on the agreement. This is particularly relevant where as a result of an APA; a taxpayer for example undertakes a massive investment, which may even involve heavy borrowing and other third party commitments.

In Kenya, while there are cases where it has been held that there can be no legitimate expectation contrary to express provisions of the law,³¹³ there are also cases where taxpayers' assertion of legitimate expectations has been upheld. One such case is the *Keroche Industries* case where the Court stated that:

One other reason why the Respondents conduct in changing the tariff and making its effect retroactive is illegal, is that it became penal and penal laws should not be retroactive. The applicant has in the circumstances of this case the right to protect its reliance on legitimate expectations [...]. The applicant in conducting its affairs is entitled to rely on certainty and regularity of law. The capriciousness, oppression and arbitrary application of the tariff retroactively is the antithesis of certainty and regularity of law. Having written to the Applicants' predecessor and having by conduct made the applicant rely on it as the applicant having relied on the representations in planning its affairs, the law must intervene to protect settled expectations.³¹⁴

In the circumstances it is clear that a successful administration of an APA programme in Kenya would require more than just the agreement itself. Public officials administering the programme may not only be required to comply with the procedural aspects of the Kenyan law, but would also be expected to refrain from making representations (express or by conduct) which would be construed as creating legitimate expectation for the benefit of a taxpayer.

³¹⁰ *ibid*, para 33

³¹¹ See for example, *R. v Commissioner of Customs Services, Exp-Parte Tetra Pak Ltd* [2012]eKLR, p.9 available at <<http://kenyalaw.org/caselaw/cases/view/84764>> accessed on April 25, 2015

³¹² The Supremacy of the Constitution is declared under Article 2, Constitution of Kenya, 2010

³¹³ See for example, *R. v Kenya Revenue Authority, Commissioner of Custom Services Ex-Parte Europa Healthcare Limited* [2014] eKLR, para 40 available at <<http://kenyalaw.org/caselaw/cases/view/97632/>> accessed on April 25, 2015

³¹⁴ *Keroche Industries*, (n. 100) p.32

CHAPTER 5

5 RECOMMENDATIONS AND CONCLUDING REMARKS

Despite the presence of newspaper reports indicating that the Kenya Revenue Authority could be considering implementing APAs,³¹⁵ to date, the programme is yet to be implemented. It may be speculated that the absence of APAs in Kenya could be attributable to among others, the criticisms that have been leveled against APAs, some of which were highlighted at Chapter 3 above. However, in the Author's opinion, the advantages offered APAs outweigh the disadvantages. While it is true that the adoption of the programme may not in itself make difficult TP issues go away,³¹⁶ it is equally true that non-adoption of the programme does not solve the problems either. The APA programme, if successfully implemented has the potential of offering more confidence to foreign investors by offering the necessary certainty on the tax treatment of their transactions, hence serve to attract the much needed foreign direct investment into the country. The adoption of the programme would also enhance certainty to the Kenyan government by ensuring that the correct amount taxes from the Kenyan based members of multinational enterprises are collected when such taxes are due.

With available statistics indicating that the use of APAs has currently expanded to over 50 countries, some of which are Kenya's major trading partners,³¹⁷ the APA programme in Kenya will not only serve to boost international trade, but will also help to align Kenya's internal tax system with current global trend in international taxation. The experiences from countries such as China, India and the US on APAs can serve as a vital reference point for Kenya in the implementation of the programme. However, care must always be taken to ensure that such experiences are adapted to reflect Kenya's unique economic and legal circumstances. One such experience would for example, for the country to initially focus more on unilateral APAs as it develops the necessary experience and confidence to be able to engage on the more technical bilateral and multilateral APAs.

In the implementation of the programme, it must however be remembered that the APA programme must harmoniously coexist with the rest of the country's tax, legal and constitutional provisions. In the context of Kenya for example, constitutional provisions such as the right for fair administrative action, equity and equality issues, among others, must be respected.

In the premises, it is recommended that the Kenyan government should consider introducing the APA programme to help in resolving its TP issues. This could be done for example by amending the Income Tax Act by inserting a rule 8A under the TP Rules, 2006 to empower the Commissioner of income taxes with the power to negotiate and conclude APAs.

³¹⁵ Titus Nguhiu (n.8)

³¹⁶ See Annet W. Ogotu (n. 231)

³¹⁷ The latest (2014) statistics released by the Kenya National Bureau of Statistics indicate that some of the leading Kenya's trading partners include China, India, US, UK, France, Germany, Italy; all of whom have APAs. (see Statistical Abstract 2014, Available at, <http://www.knbs.or.ke/index.php?option=com_phocadownload&view=category&id=106&Itemid=1177> accessed on May 12, 2015)

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