

Strong collaborative relationships
based on mutual understanding



TAX ALERT – DRAFT TRANSFER PRICING RULES 2023

Background

The Kenya Revenue Authority (KRA) on behalf of the National Treasury and Economic Planning, has developed the Draft Income Tax Act (Transfer Pricing) Rules, 2023 that will replace the current Income Tax (Transfer Pricing Rules) 2006. This tax alert summarizes the key components of the proposed draft TP Rules, 2023 that companies should consider in respect of related party transaction.

Transactions Subject to TP Rules

The Draft TP Rules, 2023 have broadened the scope of transactions subject to transfer pricing regulations to include the following:

- a) The purchase, sale, transfer, lease or use of tangible property (a modification of the TP Rules, 2006 that entails only sale and purchase of goods).
- b) The purchase, sale, transfer, lease or use of intangible property;
- c) The provision of services;
- d) Financing transactions, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business (a move to encompass various forms of financing aspects beyond lending and borrowing of money not currently covered under TP Rules, 2006).
- e) Insurance and re-insurance, transactions (a new addition aimed at including transactions for companies proving coverage and managing risk with related parties across borders within the ambit of transfer pricing)

- f) Transactions of business restructuring or reorganization entered into by a person with an associated person, irrespective of the fact that it has bearing on the profit, income, losses or assets (a new addition to encompass all forms of business restructuring irrespective of having a profit bearing).
- g) Cost contribution arrangements (a new addition targeting contractual arrangements among business enterprises to share the contributions and risks involved in the production or the obtaining of assets or services)
- h) Transactions involving derivatives (a new addition seeking to cover forward & futures contracts, options and swaps among related parties).



Scope of the Guidelines

The Draft TP Rules, 2023 will broaden the scope of the of the arm's length principle to be applied to the entire Section 18 i. e Sections 18,18A, 18B, 18C, 18D, 18E and 18F of the Income Tax Act.

Transfer Pricing Methods

In accordance with International Transfer Pricing Guidelines, the taxpayer may choose the **most appropriate** transfer pricing method to employ in determining the arm's length price. The Draft TP Rules, 2023 specify the following transfer pricing methods of determining arm's length prices:

- a) Comparable Uncontrolled price method (CUP);
- b) The Resale Price Method;
- c) The Cost Plus Method;
- d) The Profit Split Method; and
- e) The Transactional Net Margin Method

Use of an Alternative Method – a taxpayer may apply any other TP method as may be prescribed by the Commissioner where in the opinion of the Commissioner the arm's length price cannot be determined using any of the above five methods.

Intercompany Pricing of Commodity Transactions

As per the draft TP Rules, 2023, "commodities" includes agricultural produce, fisheries products, solid or liquid or gas minerals, hydrocarbons and derivatives thereof, other products or natural minerals or mineraloids obtained from the land or waters, and, in general, goods where publicly quoted price exists.

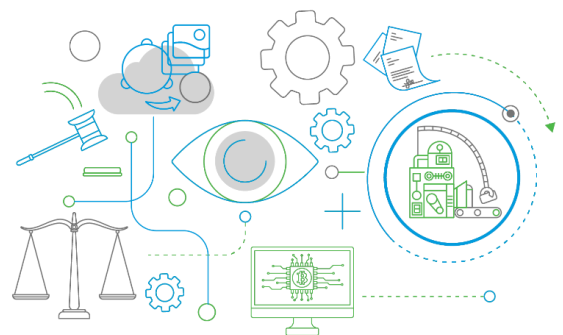
A taxpayer is required to adopt the following approaches in determining the intercompany price for commodities:

- Quoted prices on the date on which goods are shipped, regardless of the means of transport, shall be, **without considering the price that was agreed upon with the related person**, the sale price used for the purposes of computing the taxable income.
- Such quoted price shall be determined by taking an average of the prices five days before and after the shipping date as evidenced by relevant shipping documents

Contents of TP Documentation and Relevant Support

The Draft TP Rules, 2006 seeks to broaden the information that the Commissioner can request beyond the one in the TP Rules, 2006 to include;

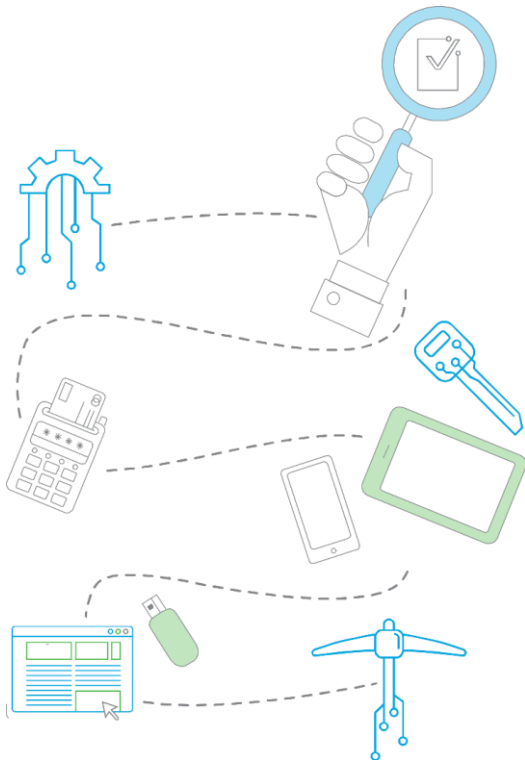
- a. Description of the controlled transactions stating parties involved, timing, transaction value, settlement, currency, contractual terms and conditions, trading models of the controlled transactions and comparison with uncontrolled transactions.
- b. Amount of payments and receipts for each controlled transactions.
- c. Details of the relationship of each entity with the taxpayer;
- d. Copies of contracts or agreements relating to the controlled transactions and their execution;
- e. Detailed functional analysis showing the functions performed, risks assumed and assets by each party to each controlled transactions;
- f. Detailed comparability analysis in respect each category of the controlled transaction including the search process for comparables, data source, selection criteria and rationale for rejecting potential comparables including any potential internal comparables;
- g. List and description of selected comparable uncontrolled transactions and the information of those comparables including financial data, and agreements in case of license fees;
- h. Explanation of the selection of most appropriate TP method(s);
- i. Explanation of the selection of the appropriate tested party;
- j. Key factors affecting the pricing of controlled transactions such as location specific factors such as cost savings and market premium;



- k. A summary of the important assumptions made in applying the transfer pricing methodology;
- l. An explanation of the reasons for performing a multi-year analysis;
- m. Details of any industry analysis, economic analysis, budgets or projections relied on;
- n. Description of any comparability adjustments performed;
- o. A conclusion as to the consistency of the conditions of the controlled transactions with the arm's length principle, including details of any adjustment made to ensure compliance;
- p. Details of any advance pricing agreements or similar arrangements in other countries that are applicable to the controlled transactions;
- q. In case of transactions involving commodities where the commodity is exported to a connected person who subsequently sells the commodity to unconnected persons, the third party agreements and sales invoices relating to that sale.

Application of Arms-length Pricing

Where a person has a controlled transaction the Rules mandate the preparation of a transfer pricing documentation to determine the arm's length price. Such documentation should be availed to the Commissioner upon request



RSM's Analysis and Opinion

While the draft TP Rules, 2006 provides reasonable clarity compared to the current TP Rules, 2006; compared to the transfer pricing regulations in other East African Countries and international best practice, the draft TP Rules, 2023 have missed the following key elements:

- a. **There is no provision on the transactions between a permanent establishment (PE) or a branch and its head office.** The current TP Rules, 2006 provides that a PE or a branch is to be treated as a separate and distinct entity from its Head Office or other branches for TP purposes and thus the internal dealings between head office and permanent establishment should be determined in accordance with the arm's length principle.
- b. The **requirement for third party agreement and sales invoices** under part (q) of the information the Commissioner may request is unreasonable given the fact that such arrangement is between independent parties and does not fall within the ambit of transfer pricing.
- c. The **proposed use of general quoted prices as reference for setting intercompany prices for commodities does not consider the following:**
 - *The differences in the contractual terms and economically relevant characteristics. Quoted price should only be used as reference only if the contractual terms of the intercompany transaction is similar to the terms in respect of the quoted price.*
 - *Intercompany commodity transactions often involve complex terms and conditions that are not fully reflected in market prices. For instance, long-term supply contracts with fixed pricing may not align with quoted prices*
 - *The requirement to use prices around the shipping date may not align with the actual timing of some transactions. Some businesses may have lead times or delays that make this window less relevant*
- d. The **draft TP Rules, 2023 still do not make reference to the OCED Transfer Pricing guidelines.** As a standard practice, the TP Rules should be in harmony with international best practice

- e. Similar to the TP Regulations in Tanzania and Rwanda, the TP Rules should have provision for:
- **Advance Pricing Arrangement** to provide room for taxpayers and the KRA to agree on reasonable criteria to set the intercompany pricing before a transaction happen. This allows for tax certainty when setting the prices for complex intercompany transaction;
 - **Corresponding Adjustments** to allow for the taxpayer to make transfer pricing adjustment if a corresponding adjustment is made by their related parties on the same transaction. This will mitigate the risk of double taxation; and
 - **Mutual Agreement Procedure** to allow room for transfer pricing dispute resolution between KRA and revenue authorities in other countries hence mitigating the risk of double taxation.
- f. The **computation of arm's length range of values need to be anchored in the TP Rules** to provide certainty. The TP Rules should also specify circumstance under which the KRA can make a TP adjustment in the event of an audit and the extent of such an adjustment. Ideally, a taxpayer should not be subjected to adjustment when its results fall within the interquartile range.
- g. The **draft TP Rules, 2023 are not consistent with the transfer pricing disclosures introduced by the KRA on iTax in April, 2023**. There should be harmony between the requirement on iTax when filing returns and the actual TP legislation. Requirements for relevant taxpayers to disclose the financial data of the parent company remain a controversial issue.

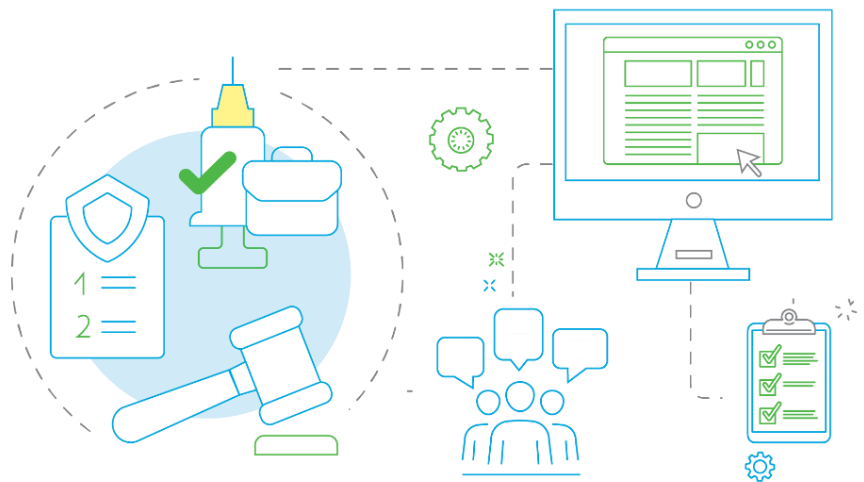
The KRA has invited public comments on the draft TP Rules, 2023 and RSM will be submitting its comments and analysis to help improve the TP Rules, 2023 before finalization

Should you need further specific guidance on how the above changes impact your business, kindly feel free to contact any of the below or your usual RSM contact who will be always available to offer guidance and assistance that you.

Jilna Shah
Tax Director
 RSM (Eastern Africa) Consulting Ltd
jshah@ke.rsm-ea.com

Nihla Mazrui
Partner – Mombasa Office
 RSM (Eastern Africa) Consulting Ltd
nmazrui@ke.rsm-ea.com

Samuel Maina
Transfer Pricing Manager
 RSM (Eastern Africa) Consulting Ltd
smaina@ke.rsm-ea.com



CAVEAT

This newsletter has been prepared by RSM (Eastern Africa) Consulting Ltd, and the views are those of the firm, independent of its directors, employees and associates. This newsletter is for general guidance, and does not constitute professional advice. Accordingly, RSM (Eastern Africa) Consulting Ltd, its directors, employees, associates and its agents accept no liability for the consequences of anyone acting, or refraining from acting, in reliance on the information contained herein or for any decision based on it. No part of the newsletter may be reproduced or published without prior written consent. RSM (Eastern Africa) Consulting Ltd is a member firm of RSM, a worldwide network of accounting and consulting firms. RSM does not offer professional services in its own name and each member firm of RSM is a legally separate and independent national firm.