Transfer Pricing Changes Introduced by the Finance Act, 2021

The Finance Act, 2021 (gazetted on 1st July 2021) introduced key changes in the transfer pricing (TP) regulatory framework in Kenya.

Section 18(3) of the Income Tax Act (Cap 470 of the Laws of Kenya) read together with the Income Tax (Transfer Pricing) Rules, 2006 (TP Rules) require a taxpayer in Kenya having any transaction with its ***non-resident related parties*** to document and maintain a TP Policy governing the business dealings with the non-resident related party in accordance with the arm's length principle.

For transfer pricing purposes in Kenya, a Branch or a Permanent Establishment (PE) of a foreign company is considered to be a separate and distinct legal entity from its Head Office and other branches or PEs of the foreign entity.

Initially two entities were considered to be related majorly if they were under ***common control*** or common management.

The Finance Act, 2021 introduced the following key changes:

a) Expanded definition of 'control';
b) Enhanced definition of permanent establishment (PE); and
c) Introduction of Country-by-Country (CbC) reporting.

The ensuing pages of this Newsletter analyses the above changes and their implications for businesses operating in Kenya.

Expanded definition of "Control"	Implications for Businesses Operating in Kenya
As per the Finance Act, 2021, a person (including a company) will be deemed to be in control of another person (including a company) if the person: • Holds at least 20% of the voting rights in a company; • Advances a loan that constitute at least 70% of the total assets of the company (excluding loans from third-party financial institutions); • Is a guarantor to a loan constituting at least 70% of the indebtedness of the company (excluding guarantees from a third party financial institution); • Appoints more than half of the board of director of the other company or appoints at least one director or executive member of the governing board of the other company;	The changes will majorly affect the business dealings between resident and non-resident entities. The major implication of the expanded definition of control is ***the definition of related parties*** in the context of *transfer pricing requirements* and application of deemed interest. Some of the entities which were previously considered to be independent will now be considered to be related parties hence falling within the ambit of TP regulations in Kenya. Kenyan entities (which fall under the expanded definition of control) that will be majorly affected include: • Businesses operating under exclusive distributor-dealer relationship/model with non-resident clients;

www.rsm.global/kenya
www.rsm.global/tanzania
www.rsm.global/uganda

info@ke.rsm-ea.com
info@tz.rsm-ea.com
info@ug.rsm-ea.com

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- Owns and has licensed intangible property (e.g. trademark) to the other party which that party is wholly dependent in its business operations;
- Supplies at least 90% of purchases of the company or influences the price/conditions relating to the purchases of the company;
- Sells over 90% of its sale to that other company or influences the price/conditions in which such sales are made; and
- Has any other relationship, dealing or practice which the Commissioner may deem to constitute control.

- Businesses operating under franchising models where such franchising arrangements are with non-resident entities;
- Captive contract manufacturers servicing only one non-resident customer;
- Captive service provider who exist to service one client only (where such a client is non-resident); and
- Licensing arrangement (for trademarks and tradenames, patents, and copyrights) with non-resident entities.

In line with Section 18(3) of the Income Tax Act and the Income Tax (Transfer Pricing) Rules, 2006, the above entities will be required to document a transfer pricing policy (that govern their business dealings with their non-resident related parties) and avail it to the Commissioner upon request.

Enhanced definition of "Permanent Establishment"

The Finance Act, 2021 enhanced the definition of scenarios in which a foreign firm will be deemed to have a Permanent Establishment (PE) in Kenya to include the following:

a) ***General PEs*** – A fixed place of business through which business is wholly or partly carried on.

It includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction or exploitation of natural resources, a warehouse in relation to a person whose business is providing storage facilities to others, a farm, plantation or other place where agricultural, forestry plantation or related activities are carried on and a sales outlet;

b) ***Construction Site PEs*** – A building site, construction, assembly or installation project or any supervisory activity connected to the site or project, but only if it continues for a period of more than 183 days;

c) ***Services PE*** – the provision of services, including consultancy services, by a person through employees or other personnel, for a period(s) exceeding in the aggregate, 91 days in the year of income;

d) ***Exploration Activities*** – An installation or structure used in the exploration for natural resources where the exploration activities continue for period (s) of at least 91 days in the year (of income);

e) ***Dependent Agent PE*** – A dependent agent of a person who acts on their behalf in respect of any activities which that person undertakes in Kenya including habitually concluding contracts or playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the person.

The determination of a PE excludes certain activities of a preparatory or auxiliary character.

Implications for businesses operating in Kenya

A PE is a '***taxable presence***' in a country which creates tax obligations for the foreign company in the local country. The key consideration is the calculation of the income/profit attributable to PE that is taxable in the local country.

The income attributable to the PE in Kenya will be ascertained using the transfer pricing (TP) principles. As indicated above, a PE is considered to be a separate and distinct legal entity from its Head Office for TP purposes in Kenya.

As such, the transactions between non-resident person and its PE in Kenya should be treated as if the parties were independent persons dealing at arm's length for tax purposes. Consequently, where a foreign entity has crystallised a PE in Kenya, they are required to maintain a TP Policy to govern the terms of their business transactions with its Head Office and other branches (in accordance with the ***Arm's Length Principle***).

In addition, the following expenses are treated as non-deductible expenses in determining the taxable income of the PE;

- Interest, royalties or management or professional fees paid by the PE to the non-resident person; and
- Foreign exchange loss or gain with respect to net assets or liabilities established between the PE in Kenya and the non-resident person.

Foreign entities operating in Kenya will need to review their engagements to assess the implications of the enhanced definition of PEs and plan accordingly.

Of key interest will be the foreign entities providing services in Kenya, including consultancy services, through personnel physically present in Kenya. It is vital for these entities to consider the reduced timelines for creating a Services PE in Kenya and put in place the necessary measures to ensure compliance with the relevant laws & regulations.

Introduction of Country-by-Country (CbC) Reporting	Implication for businesses operating in Kenya
Effective 1 January 2022, Multinationals Entities (MNEs) headquarted in Kenya (and not owned by another entity) that has subsidiaries, branches or PEs in other countries will be required to submit a 'CbC' report/return to the Commissioner on an annual basis. The CbC report/return should detail information of each of the Group entities (local and foreign entities). The information include amount of revenue, income before tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees and tangible assets. The report should be submitted to the Kenya Revenue Authority (KRA) not letter than 12 months after the end of the group's financial year. The KRA will announce the threshold of gross turnover of MNEs for submission of the CbC report.	The CbC requirements seeks to enhance transparency in reporting of the Multinational companies headquartered in Kenya. The introduction of CbC will result in additional reporting requirements for MNEs which have their ultimate parent companies in Kenya. In addition, the CbC reports will also facilitate deeper scrutiny in the event of tax audits on the local and foregn operations of Kenyan MNEs Kenya is a signatory to The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MCMAAT) which entered into force on 1 November 2020. The CbC reporting requirements are in line with MCMAAT as Kenya seeks to align its taxation framework with international best practices.

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 need.

Ashif Kassam
Executive Chairman
RSM (Eastern Africa) Consulting Ltd
akassam@ke.rsm-ea.com
+254 772786110

Nihla Mazrui
Partner – Mombasa Office
RSM (Eastern Africa) Consulting Ltd
nmazrui@ke.rsm-ea.com
+254 780768076

Samuel Maina
Tax Senior – Transfer Pricing
RSM (Eastern Africa) Consulting Ltd
smaina@ke.rsm-ea.com
+254 711974880