

Tax alert

The draft Income Tax (Transfer Pricing) rules, 2023



Overview

On 4 September 2023, the Cabinet Secretary, National Treasury and Economic Planning, published the Draft Income Tax (Transfer Pricing) Rules, 2023 (Draft TP Rules 2023 or “the rules”) for public input and comments. The Draft TP Rules 2023 propose to revoke the Income Tax (Transfer Pricing) Rules, 2006 (TP Rules 2006) which are currently in force.

In response to increased growth of international trade and commerce and to align to global efforts to combat base erosion and profit shifting (BEPS), the government has over the last two years introduced comprehensive regulations to govern controlled or related party transactions in Kenya. The Draft TP Rules 2023 complement the changes introduced through the Finance Act, 2022 on country by country (CbC) reporting and transfer pricing documentation filing requirements for multinational entities (MNEs) in Kenya.

The Draft TP Rules 2023 are substantially modelled on the Organization for Economic Cooperation and Development (OECD) and Africa Tax Administration Forum (ATAF) suggested approaches for drafting transfer pricing legislation.

We discuss the key changes below;

Scope of the draft tp rules 2023

The Draft TP Rules 2023 have aligned the scope of covered transactions to Section 18 of the Income Tax Act, Cap 470 Laws of Kenya (ITA), to include;

- a) Non-resident person carrying on business in Kenya with a related resident person or permanent establishment;
- b) A resident person carrying on business with a related person operating in a preferential tax regime;
- c) A resident person carrying on business with a non-resident person located in a preferential tax regime;
- d) A resident person carrying on business with an associated enterprise of a non-resident person located in a preferential tax regime; and
- e) A resident person carrying on business with a permanent establishment of a non-resident person operating in Kenya where the non-resident person is located in a preferential tax regime.

The inclusion of the scope of covered transactions to encompass a broad spectrum of transactions and presents an additional level of scrutiny for multinational entities and their associated persons operating in Kenya to consider the levels of transparency and exchange of information in the jurisdictions where they conduct business.

Transactions subject to the draft tp rules 2023

The Draft TP Rules 2023 have expanded the scope of transactions subject to the adjustment of prices. In addition to the transfer of goods or services, loans and any other transaction that may affect the profit or loss of an entity, the rules shall be applicable to;

- 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;
- insurance and re-insurance transactions;
- a transaction of business restructuring or reorganisation entered into by a person with an associated person, irrespective of the fact that it has bearing on the profit, income, losses or assets of such persons at the time of the transaction or at any future date;
- Cost contribution arrangements; and
- Transactions involving derivatives.

The expanded scope of transactions carries noteworthy implications for MNEs operating in Kenya. Businesses engaging in dealings involving loans, insurance, restructuring, shared costs, and derivatives, will be required to ensure that their pricing aligns to the arm’s length principle and be prepared for increased tax authority scrutiny.

Transfer pricing methods

Kenya has maintained the transfer pricing methods as provided in the TP Rules 2006 and in line with the OECD Guidelines which include;

- a) Comparable Uncontrolled Price (CUP) method which compares the price in a controlled transaction with the price in a comparable uncontrolled transaction;
- b) Resale price method which compares the margin on price for a controlled transaction among associated persons with the margin on the price of a comparable uncontrolled transaction;
- c) Cost plus method which compares the cost-plus mark up on a controlled transaction among associated persons with the mark-up on a comparable uncontrolled transaction;
- d) The profit split method which compares the profit split in a controlled transaction among associated persons with the profit split among independent enterprises;
- e) The transactional net margin method which compares the net profit margin in a controlled transaction among associated persons with the net profit margin earned in a comparable uncontrolled transaction; and
- f) Any other method as may be prescribed by the Commissioner from time to time where in the view of the Commissioner and in view of the transactions, the arm’s length price cannot be determined using any of the methods above

For the application of the CUP or any other method that the commissioner may prescribe, the draft TP Rules 2023 have introduced guidance on the application of the methods for transactions involving commodities as follows;

- For the export or import of commodities, the sales price shall be the quoted price obtained from an international or domestic commodity exchange market, or from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, or from any other index that is used as a reference by unrelated persons to determine prices in transactions between them;
- Where adjustments are made to the quoted price, the burden of proof shall be on the taxpayer, to demonstrate that the adjustments are appropriate and in line with the arm’s length principle;
- The 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

Commodities are defined in the rules to include; “*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 as described in rule 7, exists.*”

The draft provisions seek to prescribe a specific method for dealing with commodity transactions.

A point of interest is that the rules provide for a 10 day window within which the prices are acceptable but provide the shipping date as the point of reference for determination of the quoted price. In transactions involving commodities, the shipping date may not always coincide with the sales date and thus poses a challenge for businesses when considering the practical aspects of commodity transactions.

Further, the rules provide that where the price agreed upon between a person and a non-related person is higher (for exports) or lower (for imports) than the quoted price, the agreed price in this case will be considered as the sale price or purchase price for the purposes of computing the seller’s taxable income in Kenya. This differential treatment where the agreed price with unrelated parties takes precedence over the quoted price could potentially create ambiguity and compliance challenges for taxpayers.

The rules empower the Commissioner to issue guidelines specifying conditions and procedures to guide the application of the methods set out above.

Documentation requirements

The Draft TP Rules 2023 have provided detailed information requirements for taxpayers, including but not limited to;

- Documents relating to the selection of the method, calculations and price adjustments, global organisational structure, the details of the transaction under consideration and the assumptions, strategies, and policies applied in selecting the method;
- For each category of controlled transactions, details on the parties involved and their relationship to the taxpayer and tax jurisdiction, transaction values, contractual terms and conditions, trading models and comparison to trading models under uncontrolled transactions, agreements, detailed functional assets and risks analysis, detailed comparability analyses and rationale for rejected comparables, key factors affecting the pricing of controlled transactions, description of any comparability adjustments undertaken, details of any advance pricing agreements (APAs) or similar arrangements in other countries that are applicable to the controlled transactions, third party agreements relating to resale transactions between related parties; and
- Financial information, including audited financials for the taxpayer for each accounting year, financial statements for the tested party based outside Kenya, segmented financials and analysis where the controlled transactions do not relate to the entire business of the taxpayer, allocation schedules and comparables financial data.

The Draft TP Rules 2023 have also empowered the Commissioner to request for any other information where necessary to enable a review of the controlled transactions of the taxpayer.

We note that whereas the Commissioner has requested for information on APAs in other countries, Kenya does not have a legal framework for APAs which may allow a taxpayer to apply a transfer price that has been agreed bilaterally or multilaterally in other jurisdictions. It may be beneficial for the government to consider an inclusion of APA provisions in the Draft TP Rules 2023 to provide certainty regarding the pricing of cross-border transactions and promote business stability.

Penalty for non-compliance

The penalties for non-compliance have been aligned with the Tax Procedures Act, 2015 (TPA) in order to consolidate the procedural rules for the administration of tax laws in Kenya. The 2006 rules made reference to the penalties in the Income Tax Act though these have since been repealed in the Income Tax Act and all penalties now contained in the TPA.

Non-compliance in relation to fraud, failure to furnish returns and underpayment of tax shall apply in accordance with the provisions of the TPA.

Going forward, businesses should conduct a thorough review of their existing transfer pricing policies and documentation to ensure they are aligned to the new rules, should these be gazetted into law. Maintaining detailed transfer pricing documentation and supporting evidence will be essential in defending taxpayer positions and ensure engagement with the tax authority in a constructive and transparent manner.

We will be providing our comments/inputs on the Draft TP Rules 2023. Please reach out to us for any queries, input or comments, as well as assistance on how you can contribute to the Draft TP Rules 2023.

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