TRANSFER PRICING IN EAST AFRICA: TANZANIA AND KENYA IN COMPARATIVE PERSPECTIVE

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A THESIS SUBMITTED IN FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN LAW OF THE OPEN UNIVERSITY OF TANZANIA

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CERTIFICATION

The undersigned certifies that they have read and hereby recommends and approve for acceptance by the Open University of Tanzania a thesis entitled " **Transfer Pricing in East Africa: Tanzania and Kenya in Comparative Perspective"** in fulfilment of the requirements for the degree of Doctor of Philosophy (PhD) in Law of the Open University of Tanzania.

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DEDICATION

To my husband Frank and Children Arnold, Abigail and Aldwin.

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ABSTRACT

The desire for EAC countries to attract MNCs with a view of obtaining tax has brought challenge in curbing transfer pricing manipulation arising out international transactions by associated MNCs. In the absence of aggressive tax legislation, human and financial resources, such countries are at high risk of losing substantial right share of tax due to this vice. This concern raises question as to what can be done by EAC countries to address the risk and hence prevent potential tax loss. This study addresses this concern. It focuses on the adequacy of existing international and domestic transfer pricing laws in curbing transfer pricing manipulation. The study examines interplay between transfer pricing and MNCs theories, international transfer pricing standards, aggressive tax planning and their impact to existing manipulation of transfer prices. The study brings out the failure of existing transfer pricing standards in particular arm's length principle to curb the vice and the need to supplement the same. In order to obtain desired results doctrinal legal research methodology is mainly employed and supplemented by empirical and comparative methods. This study has found that the existing transfer pricing law in EAC countries are not adequately curbing transfer pricing manipulation. The study recommends for amendment of existing laws by offering theoretical insight of important issues which can be taken in to account in crafting transfer pricing laws.

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LIST OF ABBREVIATIONS

APA	Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting Action Plan
CFC	Controlled Foreign Company
CISG	Convention on International Sale of Goods
COMESA	Common Market for Eastern and Southern Africa
CPM	Cost Plus Method
CUP	The Comparable Uncontrolled Price
CURT	Constitution of United Republic of Tanzania
DTA	Double Taxation Agreement
EAC	East African Community
EACCM	East African Common Market
EACCU	East African Community Custom Union
ECOWAS	Economic Community of West African States
EU	European Union
GGM	Geita Gold Mining
HC	High Court
IMF	International Monetary Fund
ITA	Income Tax Act
ITU	International transfer pricing unit
KRA	Kenya Revenue Authority
LDCs	Less Develop Countries
LOB	Limitation on benefits rule

MAP	Mutual Agreement Procedures
MNCs	Multinational cooperation
OECD	Organization for Economic Co-operation and Development
PE	Permanent establishment
PPT	Principle purpose of test rule
PSM	Profit Split Method
PWC	Price Waterhouse Coopers
RPM	Resale Price Method
SADC	Southern African Development Community
TAT	Tax Appeal Tribunal
TIC	Tanzania Investment Centre
TNMM	Transactional Net Margin Method
TRA	Tanzania Revenue Authority
TRAB	Tax Revenue Appeal Board
UK	United Kingdom
UKL	Unilever Kenya Limited
UN	United Nations
UNCTAD	United Nations Conference on Trade Development
USA	United States of America
UUL	Uganda Unilever Limited
WB	World Bank

TABLE OF LEGISLATION

Tanzania

Constitution of United Republic of Tanzania, 1977

Income Tax Act, Cap 332 RE 2008

Tax Administration Act, 2015

Income Tax (Transfer Pricing) Rules, 2014

Tanzania Revenue Authority Act, 2006

Tanzania Investment Act, 1997

Export Processing Act, 2002

Special Economic Zone Act, 2006

Kenya

Constitution of Republic of Kenya, 2010

Income Tax Act, Cap 470 RE 2014

Kenya Revenue Authority Act, RE 2016

Tax Appeals Tribunal Act, 2013

Tax Procedures Act, 2015

Income Tax (Transfer Pricing) Rules, 2006

Regional Instruments

Protocol for establishment of East African Community Custom Union, 2005

Protocol for East African Community Common Market, 2010

Treaty for the establishment of East African Community, 1999

East African Investment Code, 2006

EAC Agreement on Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, 2011

International Instruments

United Nations Convention on International on Contracts for International Sale of Goods, 1980

United Nations Model Double Taxation Convention between developed and developing countries, 2011

Model Tax Convention on Income and Capital, 2010

United Nations Practical Manual on Transfer pricing for Developing Countries of 2013

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FG München 41 EFG 707 [1993].

IRC v Willoughby [1997] STC 995, 2004

Karguelen Sealing & Whaling Co ltd v CIR [1939] AD 487, 10 SATC:363 Appellate Division

Keroche Industries v Kenya Revenue Authority & 5 others 2007. High Court of Kenya, Misc. Civil Application No.743 of 2006

Mbeya Company Ltd v Commissioner General TRA, Court of Appeal of Tanzania, Civil Appeal no 19, 2008

McDowell & Co. v CTO [1985] 154 ITR 148,Supreme court of India

Millin v CIR [1928] (AD) 207, 3 SATC 170.

München Finanzgericht

Republic v Kenya Revenue Authority Ex-Parte Abdalla Brek Said T/A Al Amri Distributors & 4 others 2015 High Court of Kenya, miscellaneous application. NO. 57of 2014.

Rhodesia Metals Ltd (in liquidation) v CoT 11 SATC 244

Sappi v ICT Canda 1992 3 SA 306 (A). South Africa.

Transvaal Associated Hide and Skin Merchants v Collector of Taxes Botswana, 29 SATC 97

Tullow Oil v Uganda Revenue Authority, TAT App no.40 of 2011 Uganda Tax Appeal Tribunal 1(16 June 2014

Unilever Kenya Ltd v Commissioner of Income Tax. High Court of Kenya, Income tax appeal no. 753 of 2005

Union of India and Azadi Bachao Andolan [2003] SC 56ITR

Zain International BV v Commissioner General and URA, Uganda High Court ,2011

CHAPTER ONE

INTRODUCTION

1.1 Background to the Problem

In recent years, the East African Community (EAC) has witnessed an ongoing discovery of untapped natural resources such as gas, oil and minerals.[1] Such resources have fueled foreign investments by multinational corporations (MNCs)[2] in the sub-region.[3] However, availability of natural resources and an increase in foreign investments do not seem to be translating into increased livelihoods for the citizens in the EAC countries. Critics of globalization have argued that MNCs' investments in the sub-region are not prompted by fair trade, which would benefit both the developing countries and the investors, but rather, increased presence of foreign investors that emanates from factors that seem to be benefiting the MNCs more than the African regions.[4] Borkowski posits that increasingly, sophisticated and complex economical, political, technological and legal regulatory environments, especially in developing countries are major factors in the rise of cross border transactions by associated MNCs.[5] Tax incentives including tax holidays given to MNCs by the EAC countries encompass another factor. In addition, globalization and introduction of free market economy in developing countries have equally influenced

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[1] EAC was established in 1999. At present the EAC comprises the following countries: Kenya, Uganda, Tanzania, Rwanda, Burundi and South Sudan.

[2] Multinationals are corporations operating in several countries but managed by from one country.

[3] United Nations Conference on Trade Development (UNCTAD), Global Value Chains: Investment and Trade for Development, World Investment Report, United Nations Publication, 2013, p.40.

[4] Sikkaa P and Willmott H., The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness, *Critical Perspectives on Accounting* 21, 2010, 342–356 p. 342.

[5] Borkowski S.C., The *Transfer Pricing Concerns of Developed and Developing countries*, the International Journal of Accounting,1999 Vol. 32 No. 3 pp 321-336 at 321.

involvement of MNCs in the sub-region.[6] In order to attract more foreign investors, the EAC partner countries formulated various laws to govern and regulate trade relations among themselves. Accordingly, the East African Community Treaty (EAC Treaty) requires partner states to take measures to ensure rationalization and harmonization of investment tax incentives with the view of promoting the community as a single investment area.[7] In fulfilling this requirement, partner states established the East African Community Custom Union (EACCU) and East African Common Market (EACCM).[8] The objective of EACCU and EACCM, among others, is to enhance foreign investment in the region.[9] The rationale behind this is to attract many foreign investors so as to obtain revenues through taxes that will arise from international transactions by MNCs. This is because tax is a necessary precondition of a functioning state, which in itself is essential for economic growth.[10] The impact of the stated measures is an increase in cross-border cooperation in trade and investment thereby multiplying involvement of associated MNCs in the region. As cross border trade and investment are enhanced, integration of EAC in global economy is bolstered such that there will be exposure of countries to cross-border

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[6] The globalization and removal of international trade barriers and the effort to harmonize sales law by Convention on International Sale of Goods (CISG) has increased number of companies involved in international transactions.

[7] Article 80 (1) (d) and (f) of the EAC Treaty.

[8] Ibid, Articles 2, 75 and 76 respectively.

[9] Article 3(c) of the Protocol for the establishment of the EACCU

[10] Action Aid., Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa, Action Aid United Kingdom at p.6, www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance , accessed 20th December, 2011. It is worth noting that, tax is very important in running activities of the country. Over the years tax has been used by various governments in financing public services, stimulation of economic growth and redistribution of worth; for example tax can be used as a tool to promote local industries which produce products which are similar to the imported products by imposing high tax for imported goods and reduce the price for the local products. See also Kibuta O., Tax Compliance in Tanzania: Analysis of Law & Policy Affecting Voluntary Tax Compliance, Mkuki na Nyota, Dar es Salaam, 2011 p. 16; Luoga F., A Source Book of Income Tax Law in Tanzania, Dar es Salaam University Press, 2000, P.5. Ring D.M., International Tax relations Theory and Implications, Tax Law Review, 2006.p.1.

problems, whose solution(s) might need a transnational approach.[11] MNCs import (inbound investment) as well as export (outbound investment) capital and other resources in and outside the sub-region.[12] For MNCs to be established and operate their activities efficiently, they require equity or debt capital.[13] However, the most pertinent form of capital by associated MNCs is debt.[14] A parent group of associated MNCs usually divides activities to its subsidiaries or to a permanent establishment. For example, services and intangible activities may be done in centers operating for the whole group or specific parts. A finance company may operate like internal banks, whereas production of parts and assembly of final products may take place in many different countries.[15] In order to manage their intercompany transactions, MNCs usually sell and buy goods within associated entities or group of companies through transfer pricing. It has been estimated that two-thirds of the world's trade is done within MNCs and from which transfer pricing is practiced.[16]

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[11] Amani H.K., Challenges of Regional Integration for Tanzania and the Role of Research, a Paper presented at the general convocation meeting of the Open University of Tanzania, 2005.

[12] For details of inbound and outbound investments see Olivier L and Honiball M., 'International Tax: A South African Perspective', fourth edition Ciber Ink Capetown, 2008 p.2; Arnold J.B et al., International Tax Primer, Kluwer international, Second Edition, 2002, p.4.

[13] According to Business dictionary," Equity capital is investment money that in contrast to debt capital is not repaid to the investors in the normal course of business. It represents the risk capital staked by owners through purchase of a company's common stock ie ordinary shares. The value of equity capital is computed by estimating the current market value of everything owned by the company from which the total of all liabilities. It is also known as share capital. Debt capital is part of a firms' total capital which commonly comprises of loan capital and short term bank loans such as over draft." available at www.businessdictionary.com/.../equity-capital.html Accessed 20th February,2013.

[14] Adams C. and Coombes R., Global Transfer Pricing: Principal and Practice, Tottel Publishing Inc., Haywards Heath 2003 p.49.

[15] United Nations, Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth meeting Geneva, 10 - 14 September 2001, ST/SG/AC.8/2001/CRP.6, p.2

[16] Awasth R., Transfer Pricing Technical Assistance Global Tax Simplification Program, Global Tax Simplification Team, A paper presented in Brussels, 24 February 2011.

Therefore, transfer pricing is a set-up of price charged by one segment of an organization for goods or services that it renders to another segment of the same organization.[17] Gareth extends that transfer pricing includes loan and intangible assets arranged between associated MNCs.[18] However, transfer pricing has become a potential problem because it has been alleged as means of denying countries their right share of tax revenue.[19] It is done by increasing or reducing profits superficially or creates losses with a view of concealing profit thereby lessening their tax burden.[20] This is achieved by using interplay of differences of tax avoidance laws across countries through aggressive tax planning.[21] The practice becomes rampant when a parent company operates from low tax countries, where tax policies made aim at diverting finances and capital from high to low tax countries.[22] Thus, transfer pricing manipulation becomes an acute problem because MNCs contribute

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[17] Horngren C.T. and Sundem G.L., 'Introduction to Management Accounting,' 9th Edition Prentice Hall International Inc 1993 p.336.

[18] Gareth, G., Transfer Pricing Manual, BNA international Inc., London 2008, p.5, See also Sikkaa P and Willmott H., note 4 p. 342; UN Guidelines 2013 para 1.1.6.

[19] The Global Financial Integrity report 2014 shows that, EAC lost $1.3 billion between 2001 and 2010 due to manipulation of transfer pricing , led by Uganda $680, Tanzania $333, Kenya $112, Rwanda $158 and Burundi $ 49 million. See Kar D and Spanjers J., Global Financial Integrity, Illicit Financial Flows from Developing countries: 2003 to 2012, 2014. The Christian Aid, Death and Taxes: the True Toll of Tax Dodging, 2008 reports that poor countries loose $160 billion a year which is more than the aids they receive from donor countries. See also Curtis M., et al, The One Billion Dollar Question: How Can Tanzania Stop losing So Much Tax Revenue, a Report by Tanzania Episcopal Conference, National Muslim Council of Tanzania and Christian Council of Tanzania, First Ed. June 2012. This report points out that Tanzania is losing $150 million through mispricing; United Nations Economic Commission for Africa, Illicit Financial Flow: Why Africa Need to "Track it, Stop it and Get it", High Level Panel on Illicit Financial Flows from Africa, 2014, p.3. The report shows that Africa is losing USD 50 billion per year due to transfer pricing manipulation. Although the figures differ from various sources, all findings show that there is serious problem with regard to transfer pricing manipulation.

[20] Oguttu A.W., 'Curbing Offshore Tax Avoidance: The Case of South African Companies and Trusts, PhD thesis', PhD Thesis, University of South Africa, 2007 p. 48; See also, Boldman N, *International Tax Avoidance* , 35 Bulletin for international fiscal Documentation,1981, p 443; Arnold, J.B et al , p.53, note 12.

[21] This is achieved by concealing authentic documents on the actual costs and transactions between associated MNCs to tax authorities.

[22] OECD Report, Harmful Tax Competition: An Emerging Global Issue, 1998 p.14.

substantially to revenue of the country.[23] Therefore, any abuse of transfer pricing by MNCs may substantially affect revenue of countries. Notably, international trade and investment have enhanced integration of the EAC countries in global economy and exposed such countries to international transfer pricing risks, whose solution(s) may need a transnational legal approach.

The legal response to the rise of transfer pricing manipulation through tax avoidance schemes is the enactment of tax avoidance legislation. Transfer pricing and thin capitalization are some of tax avoidance rules aimed at deterring companies from shifting profits to associated companies through under- or over- pricing of cross border transactions.[24] The rules are enshrined under international and regional instruments and in countries' domestic laws. Transfer pricing regulations require goods and services to be transferred at an arm's length price,[25] a transaction in which buyers and sellers of a product act independently and have no relationship to each other. The arm's length price ensures that both parties in the deal act in their self-interest and would not be subject to any pressure or undue influence from the other party. In this context, revenue authorities are empowered to make adjustments where

[23] For example in Kenya, it is estimated that MNEs account for a significant percentage of the large taxpayer population, which contributes to about 75% of total tax revenues; see PWC Report, Transfer Pricing and Developing Countries, A Project by European Aid Implementing the Tax and Development Policy Agenda, 2011at p. 19.

[24] In United States for Example, the earliest transfer pricing was introduced in section 262 of Revenue Act, 1921. This provision permitted commissioner to prepare consolidated returns on behalf of controlled entities so as to enable them to reflect their true tax liability. In United Kingdom, the earliest transfer pricing regulations are provided under sections 770 to 773 of the Income and Cooperation Taxes Act, 1988. For more details see Desai N, Transfer Pricing Problems, Strategies and documentation: Recent Case Law on Transfer Pricing, 2002, p.4 - 5. In East Africa countries, transfer pricing rules were introduced in very recent years.

[25] In Tanzania see for example section 33 of the Income Tax Act, Cap 332 RE2008, Section 18 Income Tax Act, Cap 470 RE 2014 of the laws of Kenya, and Articles 9 of UN model and Article 9 of OECD model respectively.

a special relationship seems to have influenced the determined price. Arguably, this requires aggressive tax laws and sophisticated revenue authorities including international cooperation to deal with transfer pricing intricacies.

Internationally, OECD Model Tax Convention on Income and Capital (OECD model) and United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model) are used in regulating transfer pricing.[26] These models have served as a useful tool for revision of domestic transfer pricing rules. In practice, to date, EAC countries are referring to OECD model rather than local transfer pricing laws in dealing with intricacies of transfer pricing cases.[27] Arguably, EAC is lacking comprehensive and aggressive tax laws to deal with transfer pricing intricacies. In the absence of proper transfer pricing regulations, both revenue authorities and the MNCs have limited guidance to refer when dealing with transfer pricing issues. The OECD model, which is used by EAC and most developing countries, was developed from the view point of developed [28]countries in preserving their revenue. Indeed, the model is not necessarily relevant to developing countries.[29] Similarly, the UN model, which is made with the view of helping developing countries, is not very much used by such countries. While there are challenges in adopting such models, the risk of losing the right of revenues through

[26] The purpose of both OECD and the UN model conventions is a uniform basis for solving the problem of international juridical and economic double taxation primarily to encourage investment by preventing double taxation of profits.

[27]See for example decision in the case of *Unilever Kenya Limited v The Commissioner of Income Tax*, Tax appeal number 753 of 2003 High Court of Kenya where the High court applied the internationally accepted principles of OECD on ground that Kenyan law is not sufficiently addressing Transfer pricing issues.

[28] The founding members are high income economies such as United Kingdom, United States of America, and Belgium, Netherlands, France, Germany to mention few.

[29] See discussion on chapter three at 3.6.

transfer pricing manipulation by MNCs is growing and the transfer pricing laws in EAC are still lagging behind.

1.2 Statement of the Problem

This study addresses the growing potential of losing tax revenue through international transfer pricing manipulations by associated MNCs' transactions within EAC. The risk is of three-fold: firstly, failure by legislator to address legal challenges that are caused by application of arms 'length principle to arrive at arms' length price. Secondly, failure to make appropriate choices commensurate to the local context while taking into account international transfer pricing standards in crafting local laws. Thirdly, failure to recognize and draw attention on growing challenges of international transfer pricing emerging from an increase in foreign associated MNCs' investments. The risk of losing tax is inherent in the MNCs' endeavour of maximizing their profits. For that reason, MNCs have discretion to sale goods and services with each other at specific arrangements. Although associated MNCs are controlled from one country, they do not pay tax as one company. Each company is a taxpayer in a country where it operates. The fact that MNCs operate in different countries, they are at liberty to benefit from different legal systems. However, tax regulations of a country differ from one country to another. They include differences between countries' tax rate, transfer pricing rules and their interpretation as well as policy, documentation requirements, standard of administration reporting and enforcement, confidentiality of financial including business transactions of tax payer and government attitude towards income derived from multinationals. Because of these differences, MNCs may not report the same

transfer pricing for a given transaction in all countries. As a result, MNCs may use tax avoidance rules to avoid tax beyond what is legally accepted by exploiting variations in law to transfer goods and services within the company.

Given their international nature, multinational transactions between MNCs are made in different currencies other than EAC currencies. The differences on rules of conversion of the foreign currency can be used in manipulating transfer prices and shift profit from one country to another particularly in tax haven countries. Yet, there is potential for an intercompany loan, which has been regarded as service, to use interest payable on loan to shift profit from one country to another with the view of lessening tax liability. Notably, MNCs normally, earn a fixed rate of interest and are protected by contractual obligations with respect to their investments. Interest received by a foreign company granting the loan is normally subject to an exemption in the country where the receiving company is situated. However, contractual obligations offered to investors ordinarily do not reflect issues of transfer pricing but rather, they reflect tax incentive. Likewise, MNCs normally hold valuable trademarks in countries from where they operate and not where they invest. For subsidiaries or a permanent establishment to use it, they must incur cost. If such transactions are not well regulated, they may lead to transfer pricing manipulation.

The significant challenge in crafting transfer pricing laws commensurate with the local context is affected by desire of EAC countries to attract more foreign investors with a view of obtaining more tax among other things. As a result, such countries have been enacting laws and policies, which attract more foreign investors without taking into account risks that may be associated with such steps particularly transfer

pricing. Other factors include constant pressure from developed countries to developing countries like EAC to strengthen their economies by importing capitals through MNCs' investments. Equally important, requirement by multinational institutions to developing countries to follow international transfer pricing standards as benchmark in reforming local transfer pricing laws is another factor. There is consensus that such standards as set in tax convention models to facilitate foreign investment as imposed by multilateral institutions have not been working well in developing countries like EAC. This is due to the fact that they were made without taking into account specific needs of these countries.[30] Hence, standard norms of transfer pricing as set by tax convention models [31]have tended to have adverse impact on EAC countries that have required embracing them. The adverse impact on such countries is mainly because application of such laws, in particular, arms' length principle has been benefiting MNCs more than host countries.

Tanzania and Kenya to date, have different and incompatible provisions of law governing transfer pricing in their respective countries.[32] Such laws are of wide variety ranging from lack of coordination to lack of clarity in some cases. Although the arm's principle has been enshrined in various countries' ant-avoidance legislation, its application is limited to certain areas and it leaves much to be desired. Furthermore, transfer pricing laws have not largely tested in the court of law[33] to

[30] McGauran K., Should the Netherlands Sign Tax Treaties with Developing Countries?, SOMO, 2013 p.13 – 15.
[31] OEDC and UN models.
[32] Each state through its investment laws appears to be competing with the others to attract more strategic investors to supply its internal market.
[33] See for example Tanzania no transfer pricing cases has been taken to the court. It is only Kenya had opportunity to test transfer pricing case in court of law in land mark case of *Unilever Kenya*

establish their efficacy. Yet, these countries are largely referring OECD transfer pricing rules, which are not binding and may not necessarily be relevant in EAC countries.[34] At regional level, the EAC investment code, which regulates investors, is also silent on matters of transfer pricing.[35] In addition, the EAC Agreement on Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income Agreement, which provides for taxation of associated MNCs be done at arm's length price, its application is not uniform among member countries.

Arguably, manipulation of transfer pricing within MNCs will continue to erode EAC tax base. This would make EAC member states continue to be denied their right of tax from international transactions. If manipulation of transfer pricing by MNCs is not properly governed by nation's legislation and international instrument, then MNCs will continue to shift profits from EAC countries to countries from which a parent company operates and to the low tax jurisdiction. Hence, EAC will continue to suffer from deficient tax to the detriment of their national economies. Thus, it was necessary to study concerns of transfer pricing rules and effectiveness of legislation and international instrument in curbing manipulation of transfer pricing by associated MNCs in EAC.

1.3 Literature Review

Several scholars have written on the subject of transfer pricing laws and their roles in tax revenue in a country or region. McClure posits that transfer pricing and tax

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Limited V. Commissioner of Income Tax, Income Tax Appeal No. 753 of 2003[2005] of the High Court of Kenya.

[34] If they are relevant, the OECD model treaty and guidelines may only solve problems caused by diverse of rules and regulation but not those caused by unsophisticated revenue authorities.

[35] East Africa Investment Code 2011.

havens have adversely affected less developed countries' (LDCs) ability to raise tax revenues, primarily from avoidance of corporate taxes.[36] He stresses that LDCs are adversely affected more by capital flight and untaxed foreign earnings than those of OECD countries. McClure provides four reasons LDCs are maimed by transfer pricing. Firstly, laws and regulations dealing with transfer pricing are inadequate to tackle transfer pricing problem.[37] Secondly, lack of sound administrative capacity to deal with transfer pricing problem even where legal framework for monitoring transfer pricing exists.[38] Thirdly, lack of comparable uncontrolled transactions and relevant evidence on profitability are even less likely to exist for tax administrators in LDCs than it is in developed countries.[39] Fourthly, there are long period that elapses before transfer pricing cases are settled and uncertainty of unfavorable outcomes lead LDCs relatively uninterested in pursuing them.[40]

The adverse effect is greatly felt by developing countries because of reliance on developed countries to assist them, either because they choose to do so or as a result of measures to protect their own tax bases. In this context, the LDCs have nothing to do individually or collectively to stanch outflow because most of the capital flows from poorer countries are invested in OECD countries, which control means to taxation reform. He concludes that tax reforms of the last several decades could not

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[36] Mclure Jr C.E., Transfer Pricing and Tax Havens: Mending the Less Developed countries Revenue Net, Hoover Institution, Stanford University.

[37] Cobham A et al., Transfer Pricing and the Taxing Rights for Developing Countries, Action aid, a paper presented at the Tax Justice Network Africa Research Conference, Nairobi on April 2010, p.9. *available at* www.christianaid.org.uk/images/CA_OP_Taxing_Rights.pdf; accessed 1st May 2013; Monkam N., ATAF Regional Studies on Reform Priorities of Tax Administrations: African wide Report, November, 2012.

[38] Ibid, see also, PWC., Transfer Pricing and Developing Countries, A Project by European Aid Implementing the Tax and Development Policy Agenda, 2011.

[39] Ibid.

[40] McClure Jr., p.12 note 36.

have been expected to deal adequately with revenue cracks created by tax havens and transfer pricing. Hence, whatever action has occurred seems more likely to benefit developed countries than to help LDCs patch holes in their revenue nets.[41] Consistent with McClure‘s view, a report by Price Waterhouse Coopers (PWC) includes lack of documentation requirement or inability to enforce existing documents due to lack of capacity to process as well as evaluate such information, partly because of lack of technical expertise and necessary resources at their disposal to process the data as a problem to developing countries.[42] A possible resolution is for the European Community (EU) to render support necessary in helping developing countries to reform their transfer pricing rules. Support must be offered to enable developing countries to adopt internationally accepted OECD Guidelines.[43] However, support goes with preconditions that developing countries should improve economic growth in key sectors including legal services in accepting international tax laws of the OECD and improvement of both human resource and office facilities by tax authorities.[44] It is argued that if developing countries decide to introduce transfer pricing regulations on their own, there is a danger that such endeavourr will lead to emergency of diversity in transfer pricing legislation in various countries in the globe.[45] However, the argument does not hold water because the right to tax belongs to the country. Therefore, any country, whether developed or developing, has the right to establish tax laws, which are relevant to its interest. In this context, this

[41] Ibid p. 30.
[42] PWC. p. 9 note 38.
[43] Ibid, p. 5, The report posit that the rationale behind this is to help developing countries to increase their domestic tax collection by processing tax information better and ensuring tax compliance for all economic actors, in line with international standards.
[44] Ibid p.20-21.
[45] Ibid.

study intended to suggest appropriate choices relevant for EAC, which take into account international transfer pricing norms.

Nyamori offers an analysis of effectiveness of Kenyan's transfer pricing regime. The author's analysis takes into account the decision of the court in *Unilever case* that applied OECD Guidelines in absence of Kenyan guidelines.[46] Nyamori argues that Kenya is not a member of OECD and therefore, could not participate in drafting the Guidelines. He questioned the necessity for the court to rely on OECD Guidelines instead of resorting to foreign jurisprudence. He is of the opinion that ultimately, substantive laws of Kenya could be construed and applied. The author analyzes transfer pricing based on substantive laws, rules and international treaties. He finds that substantive law provisions are susceptible and insufficient guidelines on how to arrive at arm's length price. Transfer pricing rules, which came to rescue the situation also, have problems because they fail to make mandatory documentation requirement and issues of cost arrangement among other things are not mentioned. In addition, some rules do not exist in the enabling Act. A problem with this is that rules are subsidiary legislation and cannot override the enabling Act.[47] Moreover, the rules confer broad discretion powers to the Commissioner on imposing penalty and on estimating tax to be paid by a tax payer in case of default. He concludes that complexity of transfer pricing with scarcity of its experts and lack of comparable data for determining arm's length price are impediments to efforts of alleviating manipulation of transfer pricing by MNCs.

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[46] Nyamori B., *An Analysis of Kenya's Transfer pricing Regime*, International Transfer pricing Journal , March/ April 2012.
[47] Ibid, p.159.

Policy Forum argue that Tanzania is losing taxes due to mispricing by MNCs not trading at arm's length price as required by the law.[48] They find that Tanzania loses billions of dollars each year due to tax evasion by MNCs through trade mispricing of profits to subsidiaries in tax haven countries like Canary Island and Cayman to avoid tax liability in Tanzania.[49] Mispricing is done by inflating of deflating import or export of goods and services traded between associate MNCs. It is estimated that at least United States of America dollars (US$) 150 million a year are lost through mispricing.[50] To date, transfer pricing laws are largely untested in the court of law.

There are no cases and no procedures on how to investigate transfer pricing issues.[51] Thus, it remains a challenge for Tanzanian authorities to identify transfer pricing manipulations and combat the problem. Its revenue authority should also ensure that a standard ethical procurement principle for associated MNCs to implement their transactions at arm's length price is adhered to.[52] Hans- George Petersen report analyses general tax system of EAC and found that one of the issues of concern is transfer pricing manipulation by MNCs.[53]

The report views transfer pricing manipulation is caused by weaknesses of the existing transfer pricing laws in that only four member states, namely, Tanzania, Kenya, Uganda and Rwanda have transfer pricing while Burundi has none. Yet, member states with transfer pricing laws have divergent approaches in their

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[48] Policy Forum, How Much Revenue are we Losing, An Analysis of Tanzania's Budget Revenue Projections 2009/2010, Policy Briefing 2.09 p.3., See also Monkam N., note 37.
[49] Ibid.
[50] Ibid, p. vii-viii.
[51] Ibid, p.31.
[52] Ibid, p.4.
[53] EAC/GTZ, Report of the EAC/GTZ programme, Tax System and Tax Harmonization in EAC: Hans-Georg Petersen, University of Potsdam, 2010.

application. Although arm's length principle enshrined in member state legislation are in line with OECD Guidelines, other rules consist of vague and general clauses such that their application is limited to certain transactions and companies.[54] Moreover, no specific directives for handling transfer pricing queries. Each case is handled according to circumstances of particular case and hence, they create arbitrariness on handling transfer pricing cases.[55]

Borkowsk argues that serious economic consequences are caused by transfer pricing manipulation in both developed and developing countries.[56] She argues that the problem of transfer pricing is caused by what constitutes an acceptable method to arrive at transfer price.[57] She cited United Kingdom (UK) and United States of America (USA) as having their own perception on correct methods and willingness to challenge tax authorities including risk audits.[58] Despite their having detailed and rigorous sets of transfer pricing regulations,[59] the developed countries are also subject to transfer pricing manipulation. The problem is worse in developing countries for two main reasons. Firstly, for couple of years, some developing countries shunned transfer pricing controls for fear from discouraging foreign investment(s). Secondly, developing countries do not know the true extent of transfer pricing problem due to difficulties in obtaining physical evidence of transfer pricing manipulation. This is due to difficulties in ascertaining the true profit or loss of the

[54] Ibid, p. 81.
[55] Ibid.
[56] Borkowski S., note 5.
[57] Cobham A et al., note 37.
[58] Ibid.
[59] Ibid, p.9.

transnational companies' residents in their countries and hence, ascertainment tax liability becomes difficult.

On the contrary, MNCs apply sufficient resources to deal with transfer pricing transactions using procedures that may be difficult to get exposed by tax authorities of the developing countries.[60] All these create unequal bargaining power between developed and developing countries when dealing with transfer pricing. Consequently, developed countries and emerging economies can result in companies apportioning greater profits to their countries to avoid the risk of transfer pricing disputes.[61]The result is that transfer pricing problem in developed countries is lower than in developing countries.[62] Hence, developed countries are in a better position to deal with transfer pricing than developing countries.[63]

In this context, it is difficult for developing countries to alleviate manipulation of prices by using less aggressive transfer pricing laws than the case may be. In solving such problems, scholars suggest various ways including establishment of global transfer pricing that will be accepted globally and that OECD and UN Guidelines may be adopted at government's discretion.[64] Disclosure of financial statements is necessary to ensure transparence in order to reduce suspicion on income shifting.[65] Other measures include existence of qualified auditors in transfer pricing,

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[60] Ibid.
[61] Ibid.
[62] Ibid, p. 2.
[63] Ibid, see also OECD, Dealing effectively with the challenge of the Transfer pricing, OECD Publishing 2012, p.71. available at http://dx.doi.org/10.1787/9789264169493-en accessed 29th October 2013, p.71.
[64] Borkowski S., note 5.
[65] Ibid, see also Cobham A. et al., p.11 note 37.

amendment of regulations, cooperation among regional revenue authorities and effective exchange information.[66] Agreeably, the stated solutions are viable. The researcher endeavoured to study, in detail the legal loop holes in existing transfer pricing laws which enable MNCs to avoid tax in EAC context.

Osei offers a comparative discussion and analyses of transfer pricing in the African context in reality of transfer pricing in Ghana.[67] He found that the problem of abuse in transfer pricing is caused by the following; - uncertainties of Ghanaian tax litigations due to judges being overworked and underpaid; poor court facilities with lack of computer devices to record proceedings; lack of continuing legal education to judicial cadres; lack of effective record management as well as storage; and prevalence of corruption in judiciary system.[68] Osei remarks that with such problems, no wonder Ghana was unable to produce case laws capable of guiding taxpayers on how they were expected to work in transfer pricing cases.[69]

Another cause is inherent practical problem of establishing an arm's length price despite international acceptance of arm's length standards. In his view, proper determination of arm's length price requires developed national case laws, for without it, it is difficult to determine arm's length price.[70] Additionally, weak rule of law and problem of judiciary produce frequent violation of *stare decisis*;

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[66] Ibid.
[67] Osei E.K.,*Transfer Pricing in Comparative Perspective and the need for Reforms in Ghana*, Transnational law &Contemporary problems, NBr 19-2, 2010.
[68] Ibid, p. 628
[69] Ibid.
[70] Ibid, p 627.

consequently, the arm's length standard connotation is largely unknown in Ghana.[71] Moreover, weak administrative enforcement of the tax code by Ghanaian revenue authority due to lack of relevant data to deal with transfer pricing issues enhanced the problem.[72] The result is that the magnitude of transfer pricing in Africa is very high, for it is estimated that the world's poorest countries lose more than development aid they receive annually.[73] To solve such problems, Ghana largely imported OECD and UN models where there are comparable items.[74]

In absence of comparables, Ghana uses prices of goods and services in the international market to determine a tax rate.[75] He concludes that many developing countries that include Ghana perceive OECD model highly appropriate for negotiations between poor countries but inappropriately suitable for capital importing countries.[76] This is a contradictory argument such that if developing counties are capital importers, how can OECD model be appropriate for negotiation and irrelevant, on the other hand? Additionally, Osei did not explain extent OECD model will help developing countries to obtain the right share of tax arising from MNCs' transactions.

While appreciating developing countries' awareness on risk posed by transfer pricing, the OECD report argues that many developing countries do not understand the number and type of MNCs operating in their countries together with type of

[71] Ibid.
[72] Ibid.
[73] Ibid.
[74] Ibid, p. 622.
[75] Ibid, p. 623.
[76] Ibid, p. 620; see also UNCTAD, *Investment Policy Review of Ghana*, at iii, U.N. Doc. UNCTAD/ITE/IPC/ MISC.14/Rev.1 (Feb. 2003), available at http://www.unctad.org/en/docs/iteipcmisc14rev1_en.pdf Accessed 2nd May 2013.

transfer pricing risks that are likely to arise.[77] This translates into a difficulty of working out on how to think up transfer pricing rules. As such, countries do not have full knowledge of issues to be addressed and the problem that can rise from it.[78] It is uncertain whether or not this is true. The assumption is that African countries do not have any regulation and procedure to govern foreign investment. In the contrary, there are law and institutions, which govern foreign investors, for example, Tanzania Investment Act[79] and Tanzania Investment Centre that acts as one stop centre to co-ordinate, encourage, promote and facilitate investment.[80] The report further argues that developing countries lack legal requirements for companies to file accounts to be publically available.[81]

In settling transfer pricing disputes, the report argues that disputes normally involve a significant amount of tax and there is no single right answer. Yet, most transfer pricing issues are settled through negotiations between tax authorities and MNCs making compromises.[82] This is easily achieved in developed countries because they have experience in dealing with transfer pricing cases. To the contrary, developing countries lack experience in dealing with transfer pricing cases through negotiation.[83]

One of reasons is that tax auditors may be easily corrupted because most of the transfer pricing queries involve a huge amount of tax and hence, they cannot give

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[77] OECD note 63 p.68.
[78] Ibid, p. 69.
[79] 1997.
[80] See section 5 of the Act; See also, Kiunsi H.B., Tanzania Investment Act, 1997: Analysis of Law and practice. A Research Submitted in partial fulfillment of Bachelor of Laws (LL.B) of the Open University of Tanzania, 2005.
[81] Ibid.
[82] Ibid, p.75.
[83] Ibid.

real results.[84] Thus, tax administrators of developed countries can help developing countries in settling transfer pricing cases like it is done in South Africa.[85] It is true that there is corruption in countries in various sectors.

An overview of literature reveals various problems in relation to transfer pricing in Africa. First, African countries do not know the extent of transfer pricing problem and therefore, it is not easy to deal with transfer pricing problems. Second, inadequate transfer pricing rules and where there are adequate rules, there are no experts to deal with it. Third, African countries cannot make transfer pricing rules unless they are helped by developed countries; either they choose to do so or as a result of measure to protect their own bases. Fourth, uncertainty results from transfer pricing litigations and unfavorable judgment to many developing countries discouraged development of transfer pricing rules. Fifth, tax administrators lack resources, experience and capacity to deal with transfer pricing intricacies. Sixth, the solution for curbing tax evasion through transfer pricing is by adopting OECD Model with help from developed countries.

Agreeably, many authors point out transfer pricing problems. However, most literature sources are based on general developing countries or Africa and nothing specific for EAC. Studies have been focused on a single country or for general report purposes, across continental or between developed and developing countries. Transfer pricing problems including identified and suggested solutions lack clarity as well as certainty such that in some instances, they contradict themselves.

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[84] Ibid.
[85] Ibid.

Moreover, EAC, at large, is not extensively covered and therefore, there is an apparent dearth of transfer pricing literature to appropriate solution. Therefore, this study endeavoured to explore appropriate and implementable approach in curbing transfer pricing manipulations. A legal solution will be suggested in solving transfer pricing problems, and where applicable, non-legal solutions will be suggested so as to fill the research gap.

1.4 Objectives and Research Questions

1.4.1 General Objective

The main objective of this study is to provide an insight into legal loop holes used by MNCs to avoid tax through transfer pricing manipulation and suggest how might be plugged to protect tax base of the EAC countries.

1.4.2 Specific Objectives

(i) To examine transfer pricing problems posed by foreign investors in particular associated MNCs.

(ii) To analyze the adequacy, relevancy and appropriateness of the existing transfer pricing standards and regulations in dealing with transfer pricing problems in EAC.

(iii) To suggest ways which could help EAC countries to devise and implement transfer pricing legislation suited to their strategic needs and environment, so as to enhance certainty, clarity and predictability in curbing transfer pricing manipulation by MNCs and protect its tax base.

1.4.3 Research Questions

(i) Do existing transfer pricing rules and standards in EAC adequately curb transfer pricing manipulation?

(ii) To what extent are the general principles and Guidelines of OECD and UN model relevant in curbing transfer pricing manipulation in EAC countries?

(iii) What strategies should be considered and employed in formulating an effective transfer pricing regime for EAC?

1.5 Research Methodology

This study mainly used a doctrinal research method supplemented by empirical and comparative methods. Doctrinal method was used to review literature on transfer pricing and evaluate transfer pricing legislation.[86] There are two reasons for selecting doctrinal method. First, primary data for the study were obtained from legislation through reading the relevant sources. Doctrinal research is the main methodology of legal research because it primarily focuses on what the law is as opposed to what the law ought to be.[87] Under doctrinal methodology, a researcher's main goal is to locate, collect the law (legislation or case law) and apply it to specific set of material facts in view of solving legal problem.[88] In examining various laws, the researcher employed historical, analytical and applied perspective approach. Under historical perspective, the researcher looked into history of the transfer pricing legislation. The

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[86] Singhal A.K. and Malik I., *Doctrinal and Social Legal Methods: Merits and Demerits*, Educational Research Journal, Vol. 2(7) pp 252-256, 2012. p.252.

[87] Makulilo A.B., Protection of Personal Data in Sub-Saharan Africa, PhD Theses, University of Bremen, 2012 at P. 52.

[88] McGrath J.E., Methodology Matters: Doing Research in the Behavioural and Social Sciences, in R. M. Baecker *et al*., (eds), Readings in Human-Computer Interaction: Toward the Year 2000, Morgan Kaufmann Publishers, 1995, p. 154, as quoted in Makulilo A, B., note 124. See also, Singhal, note 86 p. 252.

main questions included the following: “What were issues of the day when legislation was enacted? What were material conditions of the day? What was mischief to be cured by particular law?” The rationale behind is to establish whether or not issues, mischief and material conditions of that particular time are still relevant to the contemporary transfer pricing problems.

Under analytical level, the researcher analyzed whether or not existing transfer pricing rules give relevant answer(s) to existing transfer pricing problems. Then under applied level, the researcher critically examined the manner and extent the existing transfer regulations are sufficient enough to solve existing transfer pricing problem. Documentary review and analysis were included but not limited to legislation, policies international instrument such as treaties, conventions, cases, articles, reports, books, journals, parliamentary hansards, dissertations, thesis; bills, court decisions and commentaries by various scholars on transfer pricing. As for documentary review, the researcher used various libraries such as Open University of Tanzania and University of Dar es Salaam. Websites were also used to access information from various sources in the world, which are relevant to the current work. Legislation were used as a primary source of information by analyzing how they are effective in regulating transfer pricing issues.

To complement doctrinal research, empirical method was employed to establish external factors that actually affect operation of the law. This method is important in revealing and explaining practices of legal, regulatory redress and dispute resolution together with impact of legal phenomenon on a range of institutions, businesses as

well as citizens.[89] During field work, the researcher contacted key persons dealing with or closely connected to transfer pricing laws and policies in government institutions such as Ministry of Finance Tanzania, In addition, Tanzania and Kenya Investment Centers, statistics bureaus, and revenue authorities were visited. The researcher also visited few MNCs such as Geita Gold mine and Vodacom Tanzania limited. Other visited places included law firms dealing with transfer pricing and accounting firms responsible for tax planning, like KPMG and Paulclem and Associates as well as tax tribunals.

The field research intended to establish how the government institutions administered and implemented the existing transfer pricing legislation in curbing transfer pricing manipulation by MNCs. Likewise, the study was effected in order to establish the manner MNCs were affected by application of different transfer pricing laws in the EAC as a single investment area, on one hand and on the other, to establish how they comply with existing tax regulations. The field research also served as a tool to establish factors that contributed the most appropriate means for government to obtain right share of revenues from MNCs. In data collection, the researcher used interviews to get insight into institutions' experiences in dealing with transfer pricing problems. In addition to interviews, well crafted questionnaires were administered to seek for meaningful responses from various institutions. The questionnaire was administered to government institutions, while interviews were administered to MNCs and other private sectors entities.[90] Comparative analysis was

[89] Ibid, p.53 -54.
[90] The use of interview to MNCs is due to complexity and sensitivity of transfer pricing issues to tax payer.

also employed in conducting the research. In particular, the researcher was interested to make comparison among status of laws and policies in the partner states so as to detect any positive trends towards complying with the EAC Treaty requirement of removing trade barrier within EAC. This is because the extent of the problem may not be the same among all member states because some might have put initiatives worth being followed by others.

1.6 Scope of the Study

This study was limited to EAC countries only and Tanzania as well as Kenya was used as case studies. The choice of Kenya was based on her comprehensive transfer pricing rules and case law. In addition, Kenya is highly experienced in transfer pricing matters and therefore, it was necessary to examine in answering research questions. Tanzania was selected because it lacks both comprehensive transfer pricing legislation and case law and yet, it has more foreign investors than Kenya.[91] Uganda was left out because its position in transfer pricing is equivalent to Kenya. Burundi was left out due to the fact that it lacks comprehensive transfer pricing legislation, which could have been worth to study. Use of French in Burundi created language barrier thereby made it difficult to access legal documents and other literature sources. In addition, Burundi is using civil legal system unlike other EAC member states, which are practicing common law. Although Rwanda is having various provisions of transfer pricing, it was not selected because it has same limitations like Burundi. However, Rwanda is in transition from civil legal system to common law.

[91] UNCTAD Report 2013. Note 2.

1.7 Structure of the Thesis

This thesis organized in eight chapters. Chapter one provides the Problem and its Context. Chapter two presents concept and theories for international transfer pricing. In the chapter, relevant transfer pricing concepts and theories for existence of transfer pricing are explained. Since transfer pricing is practiced in associated MNCs, the concept and theories of existence of MNCs are also explained and discussed. The rationale is to show how transfer pricing plays a significant role in fulfilling objectives of existence of associated MNCs. Problem and issues involved in international transfer pricing are explained.

Chapter three presents international transfer pricing under auspices of international tax. The chapter documents source and resident as basis upon, which taxes with foreign elements can be executed. It also shows standards of international transfer pricing as enshrined in international tax treaty models. It explains and discusses that the pivot arm's length principle as corner stone to transfer pricing methods to arrive at arm's length price.

Chapter four explains transfer pricing legislation in EAC. It shows how facilitation of foreign investment enhanced involvement of associated MNCs' transfer pricing practices in the region. Such challenges have forced EAC countries to adjust their policies and laws to adopt transfer pricing standards including principles to attract further foreign investors.

Chapter five examines aggressive tax planning strategies and their linkage to transfer pricing manipulation by associated MNCs. Use of international transfer pricing

standards and principles through aggressive tax planning to facilitate manipulation of transfer pricing are discussed. The BEPS Action, which came to rescue failure from existing transfer pricing standards and its efficiency in curbing manipulation in EAC context is also explained as well as discussed. In addition, alternatives to arm's length principle is discussed explained.

Chapters six review existing transfer pricing laws of Tanzania. It focuses on examination of Tanzania's tax regime in particular Income Tax Act and its adequacy in curbing transfer pricing manipulation by associated MNCs in the country. The chapter also makes comparison with Kenya's tax regime. It also analyses whether or not aligning transfer pricing outcomes with value creation principle is enshrined in Tanzanian's law.

Chapter seven reviews existing transfer pricing laws of Kenya. It focuses on Kenyan's tax regime, in particular, Income Tax Acts and their efficiency in curbing transfer pricing manipulation by associated MNCs in the country. The chapter also makes comparison with Tanzanian tax regime. It also analyses whether or not aligning transfer pricing outcomes with value creation principle is enshrined in Kenyan‘s law Chapter eight provides key findings, conclusion and recommendations.

CHAPTER TWO

CONCEPT AND THEORIES OF TRANSFER PRICING

2.1 Introduction

Transfer pricing is corner stone for operations of associated MNCs operating in various countries. For transfer pricing to be performed or implemented, various issues need to be considered in arriving at actual transfer price. This chapter presents relevant concepts and theories for existence of transfer pricing and its role in MNCs. The rationale is to show the manner transfer pricing plays significant role in fulfilling objectives of existence of associated MNCs and problems as well as issues involved in international transfer pricing.

2.2 Transfer Pricing Concepts

2.2.1 Transfer Pricing

In a modern economy where volume of associated MNCs is increasing with globalization, transfer pricing is corner stone of all transactions. Traditionally, it describes a setting of prices of goods, services and intangibles between associated MNCs.[92] However, scholars have assigned different meanings. There are those who view transfer pricing as proper means for MNCs to maximize profit through manipulations while others view it as proper means for obtaining government

[92] Elliot J., Managing International Transfer Pricing Policies: A Grounded Theory Study, A PhD Thesis, University of Glasgow, 1999, p.5, see also Horngren and Sundem p. 336 note 17; Sikkaa and Willmott note 4 p.332; Gareth note 18 p.5. It is important to note that, for international transfer pricing to be practiced the following must be established: - there must be associated corporation in foreign jurisdiction, significant inter corporation transfer of tangible and intangible goods and services between associated corporations, and that both parties charge each other for such transfers. There must be intercompany leasing of property, performance of research and development services and intercompany loans.

revenue through arm's length price. In some instances, there are mixed feelings about transfer pricing between MNCs and governments under their revenue authorities on what constitutes a real transfer pricing. Additionally, there are scholars who try to demarcate from realm of transfer pricing by giving both positions as to when it is a tool of maximizing profit and reduce tax burden, and when it is an important source of income tax to governments. The problem of defining transfer pricing is based on its ambiguous character of being capable to give different results when applied.[93] The first group of scholars views transfer pricing as a tool of MNCs to shift profit so as to minimize overall company tax liability with a view of maximizing profit.[94] This is sought to be achieved by using financial engineers to manipulate various transactions including business restructuring so as to retain wealth. In this context, taxation of profit by MNCs is targeted as a cost and that needs to be avoided.[95] Thus, MNCs have freedom to move capital and other resources to their associates in other countries where they can save cost. Sikka and Willmott point out that;-

> *"Reducing or eliminating taxes is attractive to corporations as it boosts shareholder values, it also increases company dividends and executive rewards as these are linked to reported earnings. Since the amount of tax payable is dependent on costs and income,*

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[93] It may either give countries involved right share of tax and right share of profit to MNCs or MNCs will benefit more than government and vice versa

[94] UN,Transfer Pricing: History, State of the Art, Perspectives, Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth Meeting, Geneva, 10-14 September 2001, Sikka and Willmott note 17 See also Urguidi A.J., *An Introduction to Transfer Pricing*, New school Economic Review, Volume 3(1), 2008,27-45 p.1; Plasschaert S.R., Transfer pricing and Multinational Corporations: An Overview of Concepts, Mechanisms and Regulations,1979, p.19, describes transfer pricing as a leeway of MNCs to manipulate the prices on intra firm and services flow for the purpose of making profit; Curtis, M., et al, note 4 p.16. Christian Aid, False Profits: Robbing the Poor to Keep the Rich Tax-free, A Christian Aid Report, March, 2009 p.4 ; Hearson M. and Brook, note10; Hasset K. and Newmark, K., *Taxation of and Business Behaviour: A Review of Recent Literature*, In Diamond J., Zodrow G., (eds), Fundamental Tax Reform: Issues, Choices and Implications, MIT Press, Cambridge 2008, 191-2 14.

[95] Sikka and Willmott, note 17.

> *corporate attention becomes more intently focused on transfer pricing strategies.''*[96]

As most of investments are from developed countries, MNCs' parent companies operate from such countries where there have aggressive transfer pricing laws. Since their economies are based on long run private investments, they have control over their associates and companies are benefiting from profits by reducing their overall tax liability. Accordingly, policies and laws of the investor countries are devised to stimulate as well as sustain economies through expansion of the economy, and corporations are legally bound to increase profits as well as dividends for the benefit of their share holders.[97] Therefore, it is becoming difficult to avoid effects of transfer pricing across countries. This is partly attributed by an increase in associated MNCs as a result of desire to maximize profit and minimize cost and partly, implementation of multilateral institutions'[98] policies that require developed countries to invest in developing countries so as to boost economies of such countries.[99] The effect of losing tax through transfer pricing manipulation is higher in developing countries including EAC than developed countries. This is because EAC is capital importer and lacks capacity to invest in the developed world. Due to differences in economy levels between developed and developing countries, the returns arising from investment through MNCs are more likely to benefit the investors' countries.

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[96] Ibid, p. 345.
[97] See for example section 172 (1) and (2) of the UK Company Act, 2006.
[98] IMF,UN and WB.
[99] See discussion in chapter three below.

It is interesting to note that developed countries also view transfer pricing as means for MNCs to maximize profit and reduce tax liability. For example, in a transfer pricing dispute between GlaxoSmithKline and United States Government,[100] the Internal Revenue service clearly stated that, "We have consistently said that transfer pricing is one of the most significant challenges for US in the area of corporate administration. Transfer pricing is a practice meant to minimize United States taxable profits by overpaying foreign subsidiaries for product supplies."[101] The same view was given by Sir David Varney when he said that, "Transfer pricing is the practice where profits of United Kingdom (UK) based foreign multinationals are channeled through a Northern Ireland Office without actually bringing any additional economic activity in the province."[102]

From legal point of view, transfer pricing is described as a system of setting up prices of goods and services between associated parties at a market price, as if the parties are operating independently. This is sought to be achieved by applying arm's length principle.[103] The principle requires that transfer of goods and services between associated MNCs should be similar to those made between independent parties operating in a market.[104] Where a special relationship seems to have influenced transfer price between associated MNCs, revenue authorities are

[100] 117. T.C. No. 1, United States Tax Court.

[101] Reuters, GlaxoSmithKline to settle Tax dispute with US. The New York Times September 12, 2006 available at http://www.nytimes.com/2006/09/12business/world accessed on 16th September 2013.

[102] Brown J.M., Corporation Tax blow for North Ireland", Financial Times, May 30, 2007 available at www.ft.com/cms/s/o/444dfoe4a Accessed on 17th September 2013.

[103] Arms' length principle implies condition that parties to a transaction are independent and on equal footing.

[104] The definition is inferred from international standards of transfer pricing as enshrined under article 9 of UN and OECD Models respectively, and from ant avoidance provisions of domestic laws which requires goods between associated MNCs be transferred at arm's length price.

empowered to make adjustment.[105] The principle seeks to ensure that a country where associated MNCs operate obtains the right share of tax arising from associated MNCs' transactions.

From government perspective, arm's length provides legal basis for revenue authorities to have right share of taxes and right share of profit to associated MNCs.[106] Courts also have been of the same opinion. In *Hicklin v SIR*, [107]the court held that, "dealing at 'arm's length' was a useful and often easily determinable premise from which to start the inquiry. It connoted that each party was independent of the other and, in so dealing, would strive to get the uttermost possible advantage out of the transaction for him or herself."[108] In this context, most countries' transfer pricing laws require goods and services to be transferred at arms' length price.[109] Consequently, revenue authorities see transfer pricing as a target with potential of producing very large government revenue through transactions by MNCs.[110] Therefore, transfer pricing laws are devised to obtain the stated objective.

However, it is unlikely the objective can be achieved in EAC because the very nature of transfer pricing laws has been threefold. First, as condition to attract more foreign investment required by multilateral institutions, tax laws do not necessarily take into

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[105] PWC, International Transfer Pricing 2013/14, available at www.pwc.co/internationaltp, Accessed 17th September 2013; see also Owens J., Resolving International Tax disputes: The Role of OECD, 2004.

[106] De Ruiter M., An Alternative methods of Taxation of Multinationals, a Written Contribution to Conference, Helsinki Finland, June 2012. See also Arnold et al Note 12, p. 56

[107] 41 SATC 179(A),South Africa.

[108] Ibid.

[109] See for example in Tanzania, section 33 of ITA Cap 332 RE 2008 and Section 18 ITA cap 470 RE 2014 of the laws of Kenya.

[110] PWC, International Transfer pricing Report 2013/2014 p.13 available at http://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf accessed 1st May 2014.

account the real desire of EAC to raise tax. Second, the laws are imposed from developed countries where they were intended to be used between them. Third, the original purpose of transfer pricing laws was to avoid double taxation.[111] Additionally, given complexities involved in applying the arm's length principle, the said principle may not be effectively implemented in EAC. Complexities of transfer pricing, which are attributed by absence of universal rule for determining right transfer price have put MNCs at risk of disagreement with tax authorities on taxable amount reported to tax authorities. Consequently, revenue authorities do not agree that there are different outcomes to any transfer pricing, as PWC pointed out that,

> *"There are many different possible outcomes to any transfer pricing analysis, a number of which may be acceptable and some of which may not, with the accountants need for a single number to include in reported earnings and you have what many commentators have termed the 'perfect storm'. This perfect storm threatens:- the risk of very large local tax reassessments, the potential for double taxation because income has already been taxed elsewhere and relief under tax treaties is not available, significant penalties and interest on overdue tax, the potential for carry forward of the impact of unfavorable revenue determinations, creating further liabilities in future periods, secondary tax consequences adding further cost – for example the levy of withholding taxes on adjusted amounts treated as constructive dividends, uncertainty as to the group's worldwide tax burden, leading to the risk of earnings restatements and investor lawsuits."*[112]

Despite general view that transfer pricing is a tool of maximizing profit and minimizing tax, some scholars demarcate from that realm. Pogan shows his concern while reviewing OECD tax force report that,

> *"The disappointing of Tax force is that it sends a strong signals that the issue of transfer pricing is still dominated in government circles by outdated and incorrect view that, it is mainly about counteracting tax avoidance by MNEs…the order in which issues are dealt with and the shades of emphasis throughout leave no doubt that the spectre of tax avoidance looms disproportionately*

[111] See purpose of OECD and UN Models in chapter three.
[112] PWC, note 105.

> *large. Thus the tax force report provides continuing encouragement for the incorrect use of the term transfer pricing to mean, in a pejorative sense, pricing decision by an MNE to deliberately shift income from one member of the group to another to reduce the tax liability in the first member country."*[113]

Other scholars argue that government efforts to minimize transfer pricing risks, through increasing aggressive transfer pricing laws, increasing expert human resources and other resources have affected minimization of transfer pricing by MNCs.[114] Not all MNCs are likely to adopt tax minimization. Non-manufacturing firms are more likely to adopt tax minimization while manufacturing firms and less internationalized MNCs are focused on tax compliance goal.[115] MNCs which focus on tax minimization goal incur high cost on their tax planning because they require highly experienced expert personnel in international transfer pricing and more resources in their departments. To the contrary, the MNCs which focus on tax compliance do not incur extra expenses. They conclude that most MNCs assess their transfer pricing practices on compliance based rather than tax minimization measures, a pattern, which is contrary to the stereotype of being a tool to reduce MNCs' tax burden.[116]Notwithstanding the foregoing view they agree that transfer pricing is material tax minimization tool.[117]

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[113] Pagan J.C., *Indication Future Policy in the Latest OECD Tax Force Report*., Bullet in for international fiscal Documentation, Vol. 47, no.4,1993, pp.181-186 p.181- 182.

[114]Klassen K, etal, Transfer Pricing: Strategies, Practices and Tax Minimization. available at www.tax.mpg.de/.../Paper_Kenneth_Klassen_Petro. Accessed *2* Februar 2014

[115] Ibid.

[116] Ibid, p.5.

[117] Ibid, p. 28.

In additional, revenue authorities see transfer pricing as a soft target with potential of producing very large government revenue through transactions by MNCs.[118] Therefore, transfer pricing laws are devised to obtain this objective. Absence of universal rule for determining right transfer pricing have put MNCs at risk of disagreement with revenue authorities on taxable amounts reported to authorities. Because of desire to obtain revenues from international transactions, revenue authorities disagree that there are different outcomes to any transfer pricing, as PWC pointed out that,

> "*There are many different possible outcomes to any transfer pricing analysis, a number of which may be acceptable and some of which may not), with the accountants need for a single number to include in reported earnings and you have what many commentators have termed the 'perfect storm'. This perfect storm threatens:- the risk of very large local tax reassessments, the potential for double taxation because income has already been taxed elsewhere and relief under tax treaties is not available, significant penalties and interest on overdue tax, the potential for carry forward of the impact of unfavourable revenue determinations, creating further liabilities in future periods, secondary tax consequences adding further cost – for example the levy of withholding taxes on adjusted amounts treated as constructive dividends, uncertainty as to the group's worldwide tax burden, leading to the risk of earnings restatements and investor lawsuits,".*[119]

Consequently, governments, through revenue authorities, have created uncertainty to MNCs' business operations. It is further argued that tax is not a sole issue considered by MNCs. Other transaction costs such as resource allocation, supply chain and management compensation, among other costs, are taken into account

[118] PWC, note 105.
[119] Ibid.

while planning tax.[120] Likewise, economic rationale for MNCs to charge transfer prices is for evaluation of performance of the associated MNCs concerned. This, in turn, enables MNCs to decide whether to sell or buy goods and services within MNC or to the open market.[121] Hence, most MNCs comply with tax authorities and the taxable amounts arising out of international transaction are certain and well documented as required by the law.[122] In line with this view, the OECD report states that, "The consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes."[123]

An overview of understanding of transfer pricing concept reveals the following conclusions. First, transfer pricing is not defined in laws and therefore, it is deemed to be not a legal term. However, the terms, which are used between associated MNCs, affect any transfer of goods and services if they are not set according to the arm's length principle as a requirement of the law. Second, different perceptions of transfer pricing lay on the fact that when used, they are capable of giving two different results. It can either give countries' right share of tax and associated MNCs' right share of profit when prices are set according to the requirement of the law or it can deny countries' right share of taxes when requirement of the law is not followed. The former entails that when prices between associated MNCs are made at arm's length principle, then the government will get its right share of tax while the MNCs

[120] Ibid, p.15.
[121] United Nations Secretariat, "*Transfer Pricing: History, State of the Art, Perspectives*, " Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth Meeting, Geneva, 10-14 September 2001.
[122] Ibid.
[123] OECD., Report on Transfer Pricing and Multinational Enterprises, 1979. Para 3 of the preface.

will be only taxed over the required amount and maintain their profit. The latter entails that when prices between associated MNCs are set without taking into account the principle of arms' length, MNCs are likely to benefit more and countries involved lose the right share of tax.

It is in this context that transfer pricing is perceived to be a tool of maximizing profit and minimizing tax. This is achieved under the auspices of tax planning whereby MNCs manipulate prices within law parameters in such a way that it is not easy for a revenue authority to detect that the law is actually infringed. In *McDowell & Co. v CTO,*[124] the court observed that "tax planning may be legitimate provided it is within the framework of the law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honorable to avoid payment of tax by resorting to dubious methods." For these reasons, both MNCs and revenue authorities are required to comply with tax laws when dealing with transfer pricing.

2.2.2 Transfer Price

Once price set-up is made, the question that follows is, 'which should be actual transfer price for a particular transaction?' From an economic point of view, transfer price is "the amount charged by one segment of an organization for a product or service that it supplied to another segment of the same organization."[125] Arguably, transfer price between associated MNCs does not necessarily reflect the arm's length price. From a legal point of view and for the purpose of tax, transfer price is the

[124] [1985] 154 ITR 148. Supreme court of India.
[125] Horngren and Sundem note 17.

arm's length price obtained by using arm's length principle.[126] To arrive at transfer price or arm's length price, specific methods need to be followed. The methods are provided under international Guidelines of the OECD and UN models.

They are comparable uncontrolled price method, resale price method, cost plus method; transactional profit split method and transactional net margin method.[127] In practice, for a tax payer to rely on any method, functional analysis is required to establish all activities performed for a particular product in a particular transaction. In most cases, functional analysis includes functions performed such as design, assembling, manufacturing, sales activities, inventory, after sale service and any other relevant function performed.[128] Other factors considered include risk assumed such as financial, market, regulatory, technology and product. Accordingly, assets used and contributed must be identified, whether they are tangible or intangible assets.[129] The whole process of determining transfer price is based on comparability to independent parties' transactions so as to bring both parties on an equal footing. Thus, functional analysis is important to identify and understand intra-group transactions, basis for comparability, points of adjustments in compared transaction, and to have materials for transfer pricing documentation.

An overview of transfer price definition provides the following conclusion: First, transfer price is the amount set by applying arm's length principle. Second, it is not

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[126] For more details on arms' length principle see discussion in chapter 3.

[127] Chapter 2 of the OECD guideline 2010., Although there is no specific hierarch of methods, the comparable uncontrolled price, resale price, cost plus methods have been referred as traditional methods as they are commonly used. For more details on the methods see discussion in chapter 3.

[128] See UN and OECD Guidelines respectively.

[129] Olivier, L and Honiball, M., note 12 p.493, chapter 5 OECD, SARS practice note no. 7, and OCED Guidelines 2010.

easy to arrive at arm's length price such that special and long procedures must be followed. Functional analysis and comparability are key factors for any chosen method. Third, there is no right answer for any method used to arrive at transfer price as per arm's length principle. Because such methods are not really legal but rather, economic mathematical oriented. However, each used method depends on circumstances of each transaction. Nevertheless, a price determined by using arm's length principle is real transfer price between associate MNCs.

2.2.3 Multinational Corporations (MNC)

An MNC is another concept, which acts as a key player in international transfer pricing. Traditionally, it refers to corporations operating in various jurisdictions but controlled from one country.[130] Internationally, MNCs are defined as all enterprises, which control assets, factories, mines, sales, having 10 percent control of voting stock or 25 percent of assets or sales in more than one country.[131] This is equated with foreign direct investment (FDI). In many jurisdictions, MNCs, for tax purposes,

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[130] See note 1, see also Dunning J. H., The determinants of international production, Oxford Economic Papers, 25:289-335, 1973, p.13, Buckley P. J. and M.C. Casson., The Future of Multinational Enterprise. London: The Macmillan Press.1976, p.1., Hood et al, The Economics of Multinational Enterprise. London: Longman. 1979,p1.

[131] United Nations, Department of Economic and Social Affairs Commission on Transnational Corporations, Multinational Corporations in World Development. New York, 1973, p. 5. It should be noted that, MNCs have been given different names like transnational enterprises, international corporations, firms, and multinational enterprises which share common feature that operates across borders. For the purpose of this work, MNCs is used, because the concept firm is related to economic which maximizes certain variables within a competitive market framework. Enterprises entails creative combination of labour and capital by an entrepreneur a situation which is not applicable in the contemporary corporation where chief executives and officers are appointed to lead organizations rather than entrepreneur skills. For more details see Harrod J.W.J., *Multinational Corporations, Global Transformation and World Futures, Knowledge, Economy and Society*, Vol. 1.Available at http:/www.eolss.net/Eolss-sampleAllchapter.aspx. Accessed November 2013.

refer to related or associated entities including corporations which can be either affiliated,[132] branch, subsidiary,[133] controlled foreign company or intermediary.

In addition, associated MNCs, by using organizational structure, diversify their investment geographically through special purpose entities.[134] To establish whether an individual or legal entity is an associate, domestic law provides for test either through voting right, capital share or benefit rights. For example, in Tanzania, a person other than natural person is said to be associate if directly or through one or more interposed entities, controls or may benefit from 50 percent or more of the rights to income or capital or voting power of the entity.[135] Scholars have extended the meaning of MNCs to include franchise, management contracts and leasing, which provides for value added activities of which a parent corporation receives income from such activities.[136] To this extent, the MNC is defined as a firm, which has more than 10 percent of equity or contractual involvement like management

[132] An affiliate is an entity partially or wholly owned and controlled by an MNC and includes subsidiaries, branches, joint ventures or any legal entity under partial or complete control.

[133] Subsidiary company is a legal term defined under national laws, generally as a company which is fully or partly owned and or controlled by another parent company.

[134] OECD explains special entities as " financing subsidiaries, conduits, holding companies, shell companies, shelf companies and brass-plate companies which are all legal entities that have little or no employment, or operations, or physical presence in the jurisdiction in which they are created by their parent enterprises which are typically located in other jurisdictions. They are often used as devices to raise capital or to hold assets and liabilities and usually do not undertake significant production. An enterprise is usually considered as an SPE if it meets the following criteria: *(i)* the enterprise is a legal entity, a. Formally registered with a national authority; and b. subject to fiscal and other legal obligations of the economy in which it is resident. *(ii)* The enterprise is ultimately controlled by a non-resident parent, directly or indirectly. *(iii)* The enterprise has no or few employees, little or no production in the host economy and little or no physical presence. *(iv* Almost all the assets and liabilities of the enterprise represent investments in or from other countries*(v)* The core business of the enterprise consists of group financing or holding activities, that is – viewed from the perspective of the compiler in a given country – the channeling of funds from non-residents to other non-residents. However, in its daily activities, managing and directing plays only a minor role". See OECD Benchmark Definition of Foreign Direct Investment 4th Edition.

[135] See section 3 of the ITA RE 2008.

[136] Dunning note 130 p. 5.

contracts, franchising, and leasing agreements in more than one country.[137] The international character of MNCs of having either branch, affiliate, subsidiary or controlled foreign company or any other relation capable of being recognized by law are established in country other than where the parent corporation operates. Thus, associated entities once established for purpose of conducting business, and actually carryout business, they become permanent establishliment (PE).They may be a branch, an office, a factory, a workshop, a mine, oil or gas well, a quarry or any other place of extraction of natural resources,[138] and they become tax payers in countries where they operate. In taxing the business profit of such establishments, the concept of PE is used to determine whether or not a country has right to tax business profit of a nonresident tax payer. However, only business profits of a non-resident that may be taxed by a country are those attributable to a permanent establishment.

The rationale behind this is that the PE is incorporated and situated in that other country and therefore, it obtains residence of that country as well as becomes a taxpayer in that particular country. In this context, the PE provides evidence that a foreign country conducted significant business within the host country and therefore, the host country should benefit for taxing PE.[139] Oguttu and Tladi point out that PE provided incentive for resident and source to cooperate in reducing international

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[137] Kusluvan S., A Review of Multinational Enterprises Theories, Cilt:13, Sayı:I, Yıl:1998 pp163-180 p.164.

[138] Article 5 of OECD model 2010.

[139] Oguttu A.W and Tladi S., *The challenges E-commerce Commerce Poses to the Determination of a Taxable Presence: The Permanent Establishment Concept Analyzed from a South African Perspective*, Journal of International Commercial Law and Technology,Vol.4.Issue 3,2009, pp 213 - 223, p 213, see also Kaufman N.H., *Fairness and the Taxation of International Income*, 29 Law & Pol'y Int'l Bus,1998, p. 145; Mclure C.E., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 Tax Law Review 1997, 269, 361-62; Tillinghast, D.R., *The Impact of the Internet on the Taxation of International Transactions*, 50 Bulletin for International Fiscal Documentation 1996 at 524 – 525.

double taxation thereby promoting international trade.[140] It is important to study MNCs' concept in EAC because of the volume of foreign investment investing in EAC. Thus, when the government encourages foreign investment, it should know the kind of entities it is going to deal with.

2.2.4 Tax Havens

The main purposes of MNCs are to maximize profit and minimize tax. For that reason, most of them have been investing in low tax countries commonly known as tax havens. There is no precise definition of tax havens. However, tax haven generary refers to a country, which has a lower rate of taxation than that prevails over other countries.[141] OECD describes tax haven as the country, which is able to finance its public services with no or nominal income taxes that actively makes itself available to non-residents for tax avoidance that would otherwise be paid relatively under high tax rate.[142] The OECD provides the following four elements in identifying the tax haven jurisdiction: there is no or nominal taxes on income, lack of effective exchange information about tax payer benefiting from low tax jurisdiction, lack of transparence in operation of legislation, legal or administrative provisions and absence of a requirement that a qualifying activity needs to be substantiated.[143]

It is important to note that there are variations regarding tax haven from one country to another. Others call low tax jurisdiction or offshore finance centres.[144] Gravelle points out that even elements identified by OECD exclude low tax jurisdiction like

[140] Oguttu and Tladi note 139, p.215-216.
[141] IBFD, International Tax Glossary 2001 p.347.
[142] OECD, note22
[143] Ibid, p. 23.
[144] Olivier and Honiball note 12, p.553. For the purpose of this work, tax haven will be used.

Ireland and Switzerland, which are also OECD members.[145] Zorome defines offshore finance centre as a country or jurisdiction that provides financial services to nonresidents on a scale that is incommensurate with the size and financing of its domestic economy.[146] He describes key elements of offshore finance centres that they are specialized in supply of financial services on a scale far exceeding needs and size of their economies.[147]

Various reasons have been advanced for MNCs' investments in tax haven countries. First, laws of tax haven countries and other measures are used to evade as well as avoid tax laws or regulations of other jurisdictions. Second, presence of minimization of tax liability gives advantage to MNCs in profit making. Third, secrecy in banking and finance business face low regulatory supervision.[148] Consequently, tax haven countries have been used by tax planners as an important tool for generating more profits of associated MNCs. Findings by Christian Aid reveal that in tax haven countries, there are no substantial economic activities that are carried on such that the associated corporations in tax haven jurisdiction are there for purposes of avoiding and evading tax.[149] In line with these findings, OECD points out that profit shifting issues arise when MNCs use existing loopholes, gaps, frictions

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[145] Gravelle J.G., Tax Havens: International Tax Avoidance and Tax Evasion., Congressional Research Service, 7-5700 p.3 available at www.crs.gov accessed 27/04/2014, see also Hines J.R. and Rice EM., *Fiscal Paradise: Foreign Tax havens and American Business*, Quarterly Journal of Economics, vol. 109, February 1994, pp. 149-182.

[146] Zoromé A.,. Concept of Offshore Financial Centers: In Search of an Operational Definition. Working Paper 07/87, 2007 Washington DC: IMF.p.7.

[147] Ibid.

[148] Tax Justice Net work, Identifying Tax Havens and offshore finance, available at www.taxjustice.net/.../Identifying_Tax_Havens_Jul_0 . Accessed 1 December 2013

[149] Christian Aid, Who pays the price? Hunger: The Hidden Cost of Tax Injustice, 2013, p.31.

or mismatch in interaction of countries' domestic tax laws.[150] Such situation, in particular, is happening in tax haven countries because the laws are always made to contrast other countries' tax laws. Thus tax haven countries play significant role in transfer pricing by allowing profits be made in such countries.

2.2.5 International Agreement

When MNCs sell and buy goods from associates, there must be an international agreement for transfer pricing purpose. The international agreement is an agreement entered between associated MNCs operating in various jurisdictions indicating terms and conditions upon which goods and services will be supplied between them. Some jurisdictions clearly provide for international agreement for transfer pricing purposes; see, for example Section 31(2) of South Africa Income Tax Act. However, scholars argue that international agreements under electronic commerce (e-commerce) are affected because they are vulnerable such that they can be easily deleted at any time if a data controller wishes to do so for the purpose of tax evasion.[151] Under e-commerce, terms and conditions can be easily altered without being detected. Moreover, assumed functions and risk(s) may be split by the data controller, an aspect, which makes difficult to obtain relevant data for comparables to arrive at arm's length price.[152] The understanding of international agreement is important as it plays significant role in transfer pricing adjustment and corresponding adjustment including avoiding double taxations.[153]

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[150] OECD, Action plan on Base Erosion and Profit shifting, 2013, OECD Publishing, http://dx.doi.org/10.1787/9789264202719 accessed on 1stDecember 2013.

[151] Oguttu note 20.

[152] Ibid, see also Canadian Tax Foundations, Report of the proceedings of the fifty first Tax Conference, 1999, para 2-27- 28.

[153] See for example section 128 of Cap 332 RE 2008.

2.2.6 Transfer Pricing Manipulation

Transfer pricing manipulation is a process of setting unarms' length prices of transaction between associated parties with a view of maximizing profit of the corporation and minimizing tax liability. This is achieved by over or under invoicing of such transactions in order to avoid government tax regulations or to exploit cross border differences in tax rates, for example, shifting deductable expenses to the high tax country and revenue to the low tax country in order to reduce overall tax payment.[154] Motivation for manipulation of transfer pricing originates from theories of MNCs and transfer pricing. The former requires MNCs to establish their businesses where there is ownership specific advantage, location and internalization advantage and where the operation cost is low. In this context, management of MNCs may arrange their structure to take advantage of various laws, incentives and local market features offered by a particular country. The latter is based on profit maximization and gives potentials for concealment of relevant information between associates and parent company. In such circumstances, it easy for MNCs to manipulate prices so as to reflect their objective of minimization of tax liability as a whole. This is possible because MNCs take advantage of complicated and long procedures to setting-up prices, which do not reflect arm's length principle.[155] In this context, there is potential for revenue authorities not to discover such manipulation. Accordingly, where revenue authorities have doubt in whether the price was arm's length price or not, sometimes it may be hard for them to prove. The reasons are simple. In auditing MNCs, revenue authorities have to rely on bulk documents

[154] Eden L., *Taxes, Transfer pricing and Multinational*, in Alan Rugman and Thomas Brewer, Oxford Handbook of International Business, London, UK: Oxford University Press, 2001, p. 593.

[155] To arrive at arm's length price require comparability of various issues, preparation of the documents and selection of the specific method for transfer pricing in a particular circumstances.

prepared solely by taxpayers in making reassessment for additional tax. All these take time and sometimes revenue with less aggressive administrative capacity may not manage.

Transfer pricing concepts as discussed in this study have direct impact on setting transfer pricing between associated MNCs. Consequently, in counteracting manipulation of prices, such concepts ought to be taken into account. Notably, transfer pricing concept is predominantly used in this thesis in two perspectives. Firstly, it explains transfer pricing in context of arm's length principle in which host countries may obtain the right share of tax. Secondly, it explains transfer pricing in context of unarm's length price indicating transfer pricing manipulation. Likewise, transfer price is also used to indicate arm's length price between associated MNCs. Other concepts such as international agreements, tax havens and MNCs provide an insight of important issues that countries under the study have to consider when dealing with transfer pricing issues.

2.3 Theories for Existence of Transfer Pricing

Generally, transfer pricing is referred to be a byproduct of decentralization by an organization, whose study requires integration of various disciplines.[156] In order to understand the role of transfer pricing in MNCs, it is important to understand theories for existence of transfer pricing. At this point, it is important to note that transfer pricing is of multi- disciplinary nature involving accounting, marketing, economic, law and taxation. Thus, the study of transfer pricing theories may not

[156] Elliot note 92 p.41.

necessarily reflect a legal argument or point of view, but rather, other disciplines, in particular, accounting and economic disciplines. However, principles developed in these theories form an important part in determining the relevant arm's length price applicable to transfer of goods and services between associated MNCs. The following are theories of transfer pricing as developed by various scholars, namely, economic, accounting, mathematical programming, and organization theories.

2.3.1 Economic Theory

Economic theory provides two assumptions. First, transfer price between associated MNCs should be one that will lead the corporation to profit maximization. Second, the central managers from where the parent company operates impose transfer prices to its associates. Economic theory of transfer pricing was first developed by Hirshleifer.[157] He was concerned with problems of pricing goods and services between interdependencies of corporations while influencing such divisions to maximize the profit of corporation as a whole.[158] The theory assumed two divisions, one, manufacturing with no external market for its products and second, distribution or buying division with competitive external market for its products.[159] While taking into account technology and demand condition, Hirshleifer concluded that transfer of goods and services between associated MNCs should be made at a market price only

[157] Hirshleifer J., *On the Economics of Transfer Pricing*. Journal of Business, 1956, vol. 29, no. 3, pp. 172-184, p.172.
[158] Ibid, p. 172.
[159] Ibid, p.173. See also Myers J.K. and Collins M.K., *Historical Review of Transfer Pricing: A dressing Goal Congruence within the Organization*, Proceeding of ASBBS Annual Conference, February 2011, Vol.18 Number 1, p.2.

if a perfectly competitive market exists.[160] The assumption is that where there is no perfect competitive market, the price of goods and services between associates is marginal cost of producing such goods and services.[161] It means that goods and services between two divisions of the same company must be transferred at a specified price in order to attain profit as required by the parent corporation while maintaining their autonomies.

The requirement that divisions should yield profit forms basis for evaluation of managers' performance. In due regard, when divisional managers are evaluated based on their divisional profits, as it is often the case, the temptation frequently would exist not to supply truthful, relevant information.[162] Kanodia, on basis of Hirshleifer's argument, extended theory by taking external market to a mathematical programming approach and employed uncertainty conditions. In this context, Kanodia posits that central management sets transfer price by using linear programme on the basis of true reports of manufacturing and distribution divisions.[163] The price set by central management is then imposed to divisions of associated MNCs. The fact that prices are set by central management provides room not to report honestly because the whole procedure is done by central management.[164] Because of this, Kanodia changed the model for uncertainty with distribution division facing varied market prices and probabilities for the final

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[160] Hirshleifer J. note 129, p.176; See also BenkeR. L. Jr. and Edwards J. D., Transfer pricing: Techniques and Uses, National Association of Accountants 1980. Kanodia C., *Risk Sharing and Transfer Price Systems under Uncertainty*, Journal of Accounting Research, Spring 1979, pp. 74-98.

[161] Hirshleifer, note 129.p.179.

[162] Avoseh O.O., An Empirical Evaluation of the Advance Pricing Agreement Process in UK, PhD Thesis, University of Glasgow, United Kingdom, 2014. p.52; Myers and Collins, note 159.

[163] Kanodia note 160.

[164] Avoseh O.O, note 163, p.53.

product.[165] Together with the uncertainty, central management provided divisional managers with certain percentage of profit generated at the division as an incentive.[166]

Consequently, risk was only reflected to distribution division and hence, allocation of rewards would not be Pareto optimal[167] and maximization of the overall objective of the firm was not guaranteed. In order to balance, Kanodia introduced risk sharing scheme between manufacturing and distribution divisions situated within the country and at international level by imposing a vector of values for transfer price and making it conditional on the final price.[168] At international risk sharing scheme, Kanodia posits that transfer price is determined by equating corporate objectives with division manager's risk aversions. To that extent, linear programme solves total corporation desires of maximizing profit. Kanodia concludes that both international and local sharing schemes motivate management to increase profit.[169]Critics of economic theory assert that it ignores the autonomy power of division managers in setting-up the transfer price and yet, the managers are evaluated as if they have autonomy.[170]

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[165] Ibid.
[166] Ibid.
[167] Pareto is an economic term which refers to an economic equilibrium in which it is impossible to change the allocation of resources without improving the lot of one agent at the expense of another. See Microsoft® Encarta® Reference Library 2005. © 1993-2004 Microsoft Corporation. All rights reserved.
[168]Kanodia note 160 p.88. With regard to risk sharing scheme of divisions situated within the country, Kanodia posits that, the transfer price was attained by forcing a separation between divisional managers' risk aversions. A linear program is run to find the transfer price which is imposed on the divisions. Hence, the interactions of the divisions will produce the distribution of total firm profits.
[169] Ibid, p.3.
[170] Kaplan R., Advanced Management Accounting, Prentice-Hall, 1982. See also Eccles R., The Transfer Pricing Problem: A Theory for Practice, Lexington, MA: Lexington Books, 1985.

Accordingly, the theory highly concentrates on maximization of profit and ignoring the manager's position.[171] Moreover, it ignores business strategy because it does not address the manner the corporation will compete with each other. Despite the critics raised against economic theory, it can be argued that it is directly applicable to issues raised today by countries on manipulation of transfer pricing on the view of profit maximization. This is because manipulation of transfer pricing originates from concealment of information on part of managers who are afraid of being evaluated on the basis of their profit performance. The theory also harmonizes fairly with transaction cost or internalization theory for establishment of MNCs on minimizing cost and profit maximization.

2.3.2 Mathematical Programming Theory

Mathematical Programming Theory explains that transfer price should be an opportunity cost of producing goods.[172] The theory views profit maximization by MNCs' division as the main constraint, which can be solved by linear programming. The approach introduced a pricing mechanism that determines allocation of resources when constraint on operation capacity exists or when multiple buying divisions exist.[173] The division is assumed to be operating under capacity constraints when there is no competitive external market for the product and thus, mathematical programming should be used to solve the situation.[174] In addition, since goods are

[171] Elliot note 92 p. 44; Myers and Collins note 159, p.3.
[172] Ibid, p. 43, see also Avoseh, O.O note 162 p. 53.
[173] Eccles note 170 .
[174] Solomons D., Divisional Performance Measurement and Control, 1965, Homewood, IL: R.D. Irwin, as quoted from Avoseh O.O, note 162 p. 52.

transferred from one division to another, the buying division is forced to source internally.[175]

Like economic theory, mathematical programming theory aims at profit maximization and transfer prices are set by central management and imposed to divisions. The theory also has an element of misrepresentation of information when division managers are evaluated on basis of their profit performance.[176] However, the mathematical programming theory has been criticized on grounds that it ignores division autonomy of division managers by imposing transfer pricing.[177] Yet, it provides an incentive on concealment of truthful information.[178] In addition, the theory has been criticized on ground that it is difficult to apply in practice.[179] Despite the criticism of mathematical programming theory, it remains an important tool for allocation of resources within MNCs.

2.3.3 Accounting Theory

Accounting Theory is based on an assumption that transfer pricing is one that motivates division managers to make decisions that benefit the corporation as a whole. Accounting theorists agree with economists that market price should be used to transfer goods and services when there is a competitive external market. In its absence, goods should be transferred at marginal costs.[180] Where there is no outside competitive market and transfers are not a major portion of the distribution division,

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[175] Ibid.
[176] Kaplan note 170, Eccles note 170 ; Avoseh note 162 p.53; Myers and Collins, note 159, p.5.
[177] Ibid.
[178] Ibid.
[179] Elliot note 92 p.43.
[180] Myers and Collins, note 159
[180] Ibid, Solomon note 174

Solomon suggests two–part tariff price to be used. First, a charge per unit equal to marginal cost and annual lamp-sum for fixed costs and profit.[181] Second, where there is no outside competitive intermediate market, transfers are significant but the selling division has capacity constraints and cannot meet all requirements and thus, programming method should be used to arrive at transfer price.[182] Although Solomon recognized the effect of transfer pricing on performance evaluation, to him, transfer price was a method of resource allocation.[183]

Kaplan agrees on use of marginal cost in absence of competitive perfect market. He is of the view that marginal cost limits profit performance, which makes supplying division to lack incentive. In this context, negotiated market price can be used in absence of competitive perfect external market to solve performance evaluation problem of division managers.[184] Benke and Edward, while forfeiting objective of profit maximization as key for performance evaluation, established a rule that transfer pricing should prescribe standard variable cost plus lost margin.[185] The price should be applicable in both situations when there is perfect competitive external market and in absence of external markets. Antony and Deardon, departing from relying on marginal cost in absence of competitive market, they suggested transfer price to be based on three cost methods. First, standard variable cost plus a monthly charge for fixed costs. Second, standard variable cost plus a portion of contribution earned. Third, dual pricing where the selling division receives an approximation of outside sales price minus a discount and the buying division pays standard variable

[181] Ibid.
[182] Elliot note 92 p. 51.
[183] Solomons note 174.
[184] Ibid.
[185] Myers and Collins note 159 p.6.

cost.[186] Critics of accounting assert that the theory ignores division's strategic situation that may cause it to operate under different objectives and constrains.[187]

2.3.4 Organization Strategy Theory

Organization Strategy Theory has its roots in the work by Swieringa and Waterhouse who analyzed how an organization should handle transfer pricing problem. They looked into four organization models, namely, behavior model,[188] the garbage can model,[189] the organizing model[190] and markets hierarchies' model.[191] Under organization model, a firm was seen as a coalition of participants with different goals, expectations and choices. Goals were seen as constraints. In this context, transfer pricing was seen a result of bargaining processes to solve such constraints.[192] In their analysis, Swieringa and Waterhouse argued that transfer pricing rules of organization are those resulted from goals of cost savings and strengthened decentralized system.[193] Garbage model explains that organization facilitates in solving problems and conflict resolution through bargaining. In this model, available choices are seen as a constraint, which depends on available solution. To this extent, transfer pricing process must reflect these problems altogether. In these models, Swieringa and Waterhouse argue that resultant transfer price is one that would reflect problems worked on in the context of choice.[194]

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[186] Ibid.
[187] Ibid.
[188] Developed by Cyert and March 1963.
[189] Developed by Cohen and March 1974.
[190] Developed by Weick, 1973.
[191] Developed by Williamson, 1975.
[192] Elliott note 92 p.46 . See also Myers and Collins note 159 p. 8.
[193] Ibid.
[194] Ibid.

Organization model saw processes of organization as cyclical and members of organization were seen as creating an environment to which they adopt.[195] This is because retained interpretations largely determined what actions are responded to and what meanings are given to those actions.[196] Thus, transfer price is one that will be used as means to legitimize members' past actions, which shaped their choices.[197] The market and hierarchal were the last models reviewed by Swieringa and Waterhouse. Market model explains exchange of goods and services achieved by negotiating as well as contracting individuals who are bound rationally and precluded from foreseeing all possible courses of their contract implications.[198] William was of the view that an individual may create problem(s) due to self-interest and make false claim(s) just like in economic as well as mathematical programming theories.[199] Thus, determination of transfer price by using market model is costly and time consuming.[200] Hierarchal model explains that series of market contracts should be replaced with single employment contract and common resource ownership. Thus, the transfer price will be one that will reflect the best results of the organization.[201] The authors concluded that all models could be used to view transfer pricing problem because they complement each other. Consequently, the choice and process of choice cannot be conveniently abstracted from complications of the context.[202]

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[195] Ibid.
[196] Ibid.
[197] Ibid.
[198] Ibid.
[199] Ibid.
[200] Swierenga R.J. and Waterhouse J.H., *Organization view of Transfer Pricing, Accounting, Organization and Society,* Vol.7, no.2, 1982, pp.149 -165, p.156.
[201] Myers and Collins note 159 p.8.
[202] Sweirenga and Waterhouse note 200, p. 162.

Spicer while considering transfer pricing in organization, considers uncertainty as a constraint, which causes firms' differences and integrations. He argues that, "an organization theory of transfer pricing process requires a wider consideration of relationships among firm's diversification strategy, its intra firm transactions, organization structure, management accounting and control system."[203] Thus, internal transfer of goods and services is related to an organization's strategic choice of whether to buy or make them.[204] Spicer developed three assumptions that lead to genuine organization's transfer pricing by asserting that,

> "*Where standardized intermediate products are the subject of transfer involves product per which the degree of customization is minor, market prices will be the primary basis for setting internal transfer prices and for profit centre managers choosing between internal and external supplies and customers.*"[205]
>
> *"Where the internally transferred intermediate product involves a moderate degree of customization and a material transaction-specific investment, internal manufacturing costs will play a greater role in the initial negotiations to set transfer prices and in ex-post proposal to adjust them.*"[206]
>
> "*where the internally transferred intermediate product is idiosyncratic, and involves a large investment in transaction specific human and or physical capital, internal manufacturing cost will be the primary bases for setting transfer prices; and there will be central control over the make or buy decision. Whether internal transfers are made at simulated market prices (cost plus), or simply at measure of cost, is a function of the degree of uncertainty associated with the intermediate product and the control strategy adopted by the firm.*"[207]

From the foregoing, transfer pricing theories developed different transfer prices in context of organization. Such transfer prices purely take interest of the organization

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[203] Spicer B.H., *Towards an Organizational Theory of the Transfer Pricing Process*, Accounting, Organizations and Society, Vol. 13, no 3, p303-322 p. 304.see also Elliott, note 92 p.47.
[204] Ibid.
[205] Spicer note 203p. 318.
[206] Ibid, p.319.
[207] Ibid, pp.319- 320.

and countries where they operated are not taken in to account. All along, the transfer prices suggest maximization of profit and minimization of cost. In addition, such theories clearly demonstrate potentials of price manipulations for transactions between associated MNCs. Accordingly, transfer prices suggested focuses on solving organization's problem such as evaluation performance and resource allocation within the organization. Consequently, the transfer prices developed seem to be more advantageous to MNCs than countries where they operate.

The fact that suggested transfer prices were developed from MNCs perspective, countries where MNCs operate would need transfer price which will take in to account their interest. In this context, market price should be used to transfer goods and services between associated MNCs. Ordinarily everyone is free to enter in to market and there may be no possibility of arranging prices in a special manner that could affect market. In this context, prices of goods and services will be determined by market forces. If associated MNCs sells at market price whether within or across borders both countries and MNCs will get their right share of income.[208] However, such endeavor must be governed by the law. It is in this context that arms' length principle comes in to pray to regulate the transaction between associated parties. The application of arm's length is justifiable for two reasons is capable of counteracting transfer pricing theories and it takes into account interest of countries where MNCs operates. The former takes into account relevant issues from transfer pricing theories and counteract by regulate them.[209] First, it explains transfer price in context of

[208] Right amount of tax on part of government and right amount of profit on part of MNCs.
[209] Although transfer pricing theories are highly in favour of MNCs, there are theories that outweigh others and therefore, it is possible to make preference of a particular theory to suit arm's length

market price where competitive perfect market exists. The market context of transfer price fits well with transfer pricing laws, which lay down arm's length principle under such that any transaction between associates made at a market price is considered to be in compliance with the law. Second, arms' length principle, takes in to account separate entity principle which requires entities to be treated separately when determining transfer price between them as enshrined in various laws and international instruments. Third, it takes in to account functional analysis in determining transfer price because the principle is based on comparison of different situations in the market, functions performed and risk assumed as enshrined in international as well as domestic guidelines. Fourth, the theory provides a leeway to transfer pricing in absence of a competitive market for comparison purposes. In this context, associated parties are obliged by arm's length principle to transfer goods and services at market price while following special methods and procedures. It is thus submitted that transfer price for transfer of goods and services between associated parties is arms' length price.[210]

2.4 Theories for Existence of MNCs

The philosophical foundation of MNCs can be traced back from MNCs' theories, which explain reasons for their existence, take different forms; operate across borders and the manner they manage intercompany transactions. Traditionally, there are two theories in existence of MNCs, namely, Dunning's eclectic paradigm and transaction cost theory also known as internalization theory.

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price. Thus, the approach does not take into account other theories that, to a large extent, aim at profit maximization and tax minimization as costs. In this study, economic theory was preferred despite its limitation due to the following reasons

[210] For more details of arms' length price see para 2.2.2.

2.4.1 The Eclectic Paradigm Theory

This theory explains a pattern, which determines the degree to which MNCs engage into foreign direct investments. The theory explains reasons for firms to conduct foreign production in a foreign country rather than producing at the home country and export. This theory includes a number of integrated economic theories such as international capital theory, which explains reasons a firm moves capital outside the country.[211] Industrial organization theory explains why international firms take place based on ownership advantage. Location theory explains why the firm produces in a particular country and theory of firm operates in an imperfect market.[212]

However, scholars argue that Dunning theories focus on one aspect and have weaknesses that cannot sufficiently explain theoretical existence of the MNCs. Elliot, for example, argues that industrial organization theory does not explain the manner a foreign firm can compete with domestic firms.[213] To overcome such weakness, the firm engaged in foreign production must rely on a set of advantages that are unavailable in the domestic country. In combining these theories, Dunning came up with three specific advantages, which a corporation producing across borders should have, namely, ownership specific advantage (O), location specific advantage (L) and internalization advantage (OLI). He argued that;

> *"Firms with headquarters in one country will set up and/or expand value adding activities outside their national boundaries whenever:*
> *a) They perceive that, due to their nationality of ownership or degree of multinationality, they possess some kind of competitive*

[211] Elliott note 92 p.35.
[212] Ibid, see also Dunning J.H. *Towards an EclecticTheory of International Production: Some Empirical Tests.* Journal of International Business Studies Vol. 11(1) Spring/Summer: no.1 1980, p. 9-3.
[213] Ibid.

> *advantage over indigenous firms (actual or potential) in the host country;*
> *b) They find it economic to exploit these advantages themselves, i.e., to internalize their use, rather than sell the rights to do so to host country firms, via an arm's length transaction (e.g., a technical service agreement or management contract);*
> *c) They believe that it is in their global interests to produce at least part of the value added from a foreign rather than a home location."*[214]

Under ownership specific advantage, normally, MNCs consider issues, which have ownership advantage over local corporations and other MNCs operating in a host country. They include, but not limited to, technology, trademarks and an organization's skills. Thus, capital is moved across countries preferably in countries where there is low interest rate. For that reason, associated MNCs expand where the return of investment is higher.[215] The MNCs then transfer technology, management, and organization skills within MNCs and control the same. Under location advantage, MNCs prefer production and distribution of goods as well as services to take place where production costs are relatively lower from where the parent company operates and where its markets are situated.[216] In line with Location Theory, Burkely reiterates that MNCs venture across borders where there is raw materials, cheap labour, protection and untapped markets.[217]

Furthermore, location advantage theory may be used as means to overcome trade barriers in countries where a parent corporation exist. For example, government restrictions of trade rules within the country where the parent company operates.

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[214] Dunning J.H., International Production and the Multinational Enterprise, London: Allen and Unwin, 1980 p.34.
[215] Kusluvan note 127, p.165.
[216] Ibid.
[217] Buckley P. J., *A critical view of Theories of the Multinational Enterprise*, in P. J. Buckley and M. Casson (eds.), The Economic Theory of Multinational Enterprise. London: The Macmillan Press. 1985 pp 1-9 see also, Kojima, K., Direct Foreign Investment: A Japanese Model of Multinational Business Operations. London: Croom Helm, 1978, as quoted from Kusluvan note 127.

Under this perspective, economists view that strict rules affect MNCs' decision to establish associates outside their countries due to strict rules imposed in the country where they operate.[218] For example, the regulation of imported goods, levy on taxes and profit regulations. Another reason was advanced by Aliber that corporations from strong currency economies establish associates in weak countries so as to obtain advantage over a weak currency of the host country.[219] Although the argument was criticized by Hennart on ground that MNCs raise their funds where the parent companies operate, it is not where the investment takes place and capital is not the most important component of the MNCs.[220] The theory is still relevant in developing countries like East Africa where the shilling is weak to USA dollar and most investments are rated in terms of the USA dollar. Some scholars argue that MNCs exist as a supplement to international trade, since each country has specialization of a product or resources that can be obtained at a relatively lower cost. Similarly, demands differ from one country to another. In some cases, countries may have resources and cheap labour but they are unable to produce because of lack of technology know how.[221] For one country to obtain its demand, MNCs come to play. As Samuelson and Nordhaus pointed out that,

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[218] Calvet A. L., *A Synthesis of Foreign Direct Investment Theories and Theories of the Multinational firm*, Journal of International Business Studies, 12(1): 1981, 43-59, see also, Ragazzi, G., Theories of the Determinants of Direct Foreign Investment, IMF Staff Papers, 20(July): 1973, pp 471-498., as copied from Kusluvan noted 127 p.166.

[219] Aliber R. Z., A '*Theory of Direct Foreign Investment*,' in C. P. Kindleberger (ed.), The International Firm. Cambridge, Mass: MIT Press. 1970, pp 17-34 As quoted from Kusluvan note 214,p. 166.

[220] Hennart J. F., A Theory of Multinational Enterprise. Ann Arbor (Michigan): Michigan University Press, 1982, p142.

[221] For example East African countries are endowed with untapped natural resources like gas and oil, but lacks technological knowhow. Governments are inviting foreign investors to invest which they come in form of MNCs.

> *"Each country will specialize in the production and export of those goods that it can produce at relatively lower cost in which it is relatively more efficient than other countries, conversely, each country will import goods which it produces at relatively high cost in which it is relatively less efficient than other countries."*[222]

However, Dunning eclectic's theory was criticized on ground that only location and internalization advantage are sufficient to explain existence of MNCs. Ownership advantage is highly pertinent to survival of MNCs and cannot sufficiently explain existence of MNCs.[223] From the foregoing, Dunning's theory provides the following conclusions with reasons multinationals invest out of their parent countries. First, ownership advantages such that most MNCs are large firms with annual worth millions of USA dollars. They are having technology or they have widely recognized market that other competitors cannot use. Second, is localization advantage whereby normally, MNCs furnish stock to the nearby market and where raw materials are available. Third, internalization benefits such that MNCs benefit from owning technology, brand and expertise. However, most of the MNCs are from developed countries and EAC countries are mere sources of providing such advantages. As such, the potential risk that may be caused by volume of foreign investments through MNCs, in particular, transfer pricing manipulation would be high. This is mainly because EAC countries are less developed lacking capacity to invest largely outside the region and, in particular, in developed countries.

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[222] Kusluvan note 127 p.167.

[223] Buckley P.J., and Casson, M.C., The *Internalization Theory of Multinational Enterprises: A review of the Processes of Research Agenda after 30 Years*, Journal of International Business Studies, 2009, pp1563-1580 p.1564; Hennart note 219.

2.4.2 Transaction Cost Theory

Transaction Cost Theory, also known as internalization theory[224] explains that corporations expand or source activities outside the country to minimize cost by exchanging resources with the environment.[225] The theory insists on cost minimization for all transactions done within the corporation. Coase rightly pointed out that, "every company has to carry out his functions at less cost within the company than outsourcing the activities to external providers in the market."[226] The theory argues that MNCs is a result of organized individuals with similar or different interdependencies who pulled together their capabilities to generate income and become social institutions that endeavor to organize economic activities. When social institutions become efficient to organize, interdependencies become firm. Hence, when a firm grows well, it becomes more efficient than external markets and organizes interdependence with agents across borders hence development of MNCs.[227] Hennart further points out three things for the firm to expand. First, an interdependency agent must be in a different country. Second, the firm must be the most efficient way to organize interdependencies. Third, costs incurred by the firm in organizing interdependencies are lower than benefits of so doing.[228]

The problem of trading interdependently within the nation poses less serious problems. Serious problems arise when MNCs operate across countries facing different legal problems, tax rate, currency, registration requirement(s), and work

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[224] Ibid, the theory was developed by Buckley and Casson 1976, Hennart J.F., A Theory of Direct Foreign Investment, PhD Thesis, University of Maryland, 1977, p176.
[225] Ibid, p. 208 -209.
[226] Coase R., The Nature of the Firm. Economica 5: 386-405, 1937, p.5.
[227] Hennart note 223 p.132 .
[228] Ibid.

permit for their experts, risk of repatriation, exchange risks and other legal requirements that increase costs of operation to the MNCs. These are known as transaction costs that are organized through price and hierarchy.[229] Hence, the cost of each transaction differs, depending on the chosen method.[230] The firm's interdependence presupposes that both countries are aware of the firm or corporation's profit to be gained by agreeing on sharing of resources and avoid any chances that will lead to lose profit by MNC.[231] The theory argues further that firms and markets are instrument used to organize as well as coordinate economic activities performed within the company. Hennart points out such that markets rely on decentralized autonomous adjustment by economic agents where price is the key actor.[232] Thus, a decision-maker must be in a position to foresee, correctly, future prices for goods and services of a firm supplied or offered.[233] To this extent, MNCs normally opt for the least cost location for each activity with other profit and growth based on continuous processes of innovation of technology, new products, business methods and commercial applications of new knowledge.[234] From legal point of view, international trade exchange taking place between related parties should be trading at arm's length price at international markets where traders react to market prices. To the contrary, part of international trade between related MNCs results from the manager's decision and not trading at arm's length price. The rationale

[229] According to Hennart, hierarchy describes a method of control and not managers, who implement it in firms, see Hennnart note 223 p.133.
[230] Ibid, p.46.
[231] Ibid, p. 133.
[232] Hennart note 219 p.50.
[233] Ibid.
[234] Buckley and Casson note 216.

behind is to minimize cost and therefore, all internal policies including rules are made with intention of reducing cost in the corporation against the market.

From foregoing overview, it can be submitted that the main purpose of MNCs to expand across countries is to maximize profit and minimize cost. MNCs are very keen to see the cost of any transaction across border is minimized as much as possible. Hence, for MNCs, while setting up prices they focus on profit maximization by making sure that transfer of goods and services between them are reasonably cheaper than the open market. MNCs always view tax as a cost of doing business that needs to be avoided whenever possible. To them, tax increases cost not only from the country where MNCs operate but also the whole group of companies is affected. This is because transaction of one segment of a corporation is not stand alone and it affects the whole company. For that reason, MNCs normally invest heavily on accounting firms and tax advisers to save the tax cost through aggressive tax planning. The fact that MNCs have sufficient resources to deal with transfer pricing transactions and procedures may not be easily traced by tax authorities. Thus, MNCs' theories reveal a true colour of MNCs' desire such countries under study ought to take into account when crafting transfer pricing laws.

2.5 Conclusion

Transfer pricing concepts and theories have direct impact on setting transfer prices between associated MNCs. Accordingly, there are agreements and disagreements with regard to meaning, scope and approach of such concepts including theories, depending on context of interpretation. While one approach is seen in favour of MNCs and from perspective of developed countries for profit maximizing, it was not

seen fovourable to governments unless they are construed in context of arm's length so as to ensure that governments obtain their right share of tax.

These circumstances seem to justify countries to strengthen transfer pricing laws so as to counter transfer pricing manipulations. Thus, it is important that transfer pricing theories and concepts should be understood from legal point of view so as to avoid uncertainty that may occur while determining transfer price. In this context any transaction between associated parties are to be transferred at arm's length price. Nevertheless, concepts expose true colour of transfer pricing. This might be useful to be considered when developing laws and other measures to counter manipulation of transfer pricing in EAC countries.

CHAPTER THREE

TRANSFER PRICING UNDER INTERNATIONAL LAW

3.1 Introduction

The shift of profit by MNCs through transfer pricing manipulation has led to a serious concern to both developed and developing countries. The desire for countries to tax profit on investments by MNCs on either source or resident basis has necessitated countries to harmonize national laws so as to facilitate investment by MNCs. In order to promote investment through MNCs, countries have found that it is necessary to eliminate any barrier that impedes cross border trade.

Among barriers they include double taxation on MNCs' profits by governments and profit shifting by MNCs. For taxation of profit by MNCs to be effective and efficient, substantive laws should be harmonized or unified. This need has facilitated development of international transfer pricing standards under the umbrella of tax conventions initiated by multilateral institutions. It is within this context that attention has been given to transfer pricing standardization so as to regulate transaction between associated MNCs.

Thus, tax conventions provide standards for transfer pricing laws and serve as a benchmark upon which countries consider when crafting domestic laws. However, transfer pricing standards that have emerged as benchmarks for standardising establishment of domestic transfer pricing laws originate from developed countries such that they may have some limitations to developing countries like EAC. This chapter highlights transfer pricing laws as manifested in international law. It starts by

looking briefly about international tax with a view of providing the basis for international transfer pricing. The principles of international tax as a base for taxation under international tax are highlighted. Raising and elimination of double taxation in relation to transfer pricing as enshrined under tax treaties are explained. The desire to have international transfer pricing standards and overview of tax models in whereby standards are enshrined is given. Specific transfer pricing standards are discussed followed by methods to arrive at arms' length price. In addition, international transfer pricing documentation requirements and dispute mechanisms as enshrined under tax treaties are analysed.

3.2 International Transfer Pricing under Auspices of International Tax Law

It is the fact that MNCs operate across countries becomes the subject of international tax. International tax is concerned with problems arising when an individual or a corporation is taxed in more than one country. However, there have been different opinions on whether or not there is international tax. One group of scholars argues that no international tax exists. Olivier and Honiball argue that international tax is a misnomer because no tax laws exist that are applicable to all countries and that right to tax forms part of a state's sovereign powers.[235] Similarly, Ring argues that there is no formal or specific definition of international tax, but it refers to income of a resident earned outside the country and income of nonresidents earning inside the country.[236]

[235] Olivier, L and Honnibal, M., note 12 p. 2, .
[236] Ring note 10, p.3.

Scholars on another group argue that international tax exists and it is part of international law. Arnold and McIntyre posit that international tax encompasses all tax issues arising under a country's income tax laws, which include some foreign elements such as income tax of cross–border trade in goods and services; investments; manufacturing by MNCs; and taxation of individuals who work or do business outside the country where they usually reside.[237] Other international issues are recognition of MNCs with foreign subsidiaries in several countries.[238] Avi-Yonah, for example, provides four reasons for existence of international tax. First, a country can tax nonresidents that have connection to it on foreign income. Second, non-discrimination norm means that nonresidents from a treaty country should not be treated worse than residents embodied in all tax treaties. Third, the arm's length standard applies in all tax treaties in determining proper allocation of profits between related entities. Fourth, there is prevention of double taxation through credit or exemption methods.[239] He further argues that where international national legislation exists, it overrides customary international law and treaties.[240] But in the absence of legislation, customary international law can be used.

However, Avi-Yonah was criticized on grounds that not all international tax issues can be answered by using international law, in particular, issues of domicile and nationality. This is because international law involves an interaction between two domestic legal systems as opposed to application of legal principles generally

[237] Arnold J.B. and McIntyre M.J., International Tax Primer, Kluwer international, second Edition, 2002, p.3.
[238] Ibid.
[239] Avi- Yonah R. S., International Tax as International Law, Public Law and Legal Theory, Research paper No. 41, see also Olin, J.M., Centre for Law and Economics; Research paper No. 04-007 p. 12 - 15.
[240] Ibid.

accepted internationally.[241] However, whether or not international tax exists, both scholars demonstrate magnitude of the problem in dealing with tax issues involving foreign element. Hence, international transfer pricing plays as an important part of international tax as it involves taxation of profit by MNCs operating across countries.

3.3 Source and Residence as Basis for International Taxation

Under international tax law, all income that arises from international transactions can be taxed either at source or residence basis.[242] The work of taxation at source or residence basis can be traced back from the 1920s. This happened when the International Chamber of Commerce, under the auspices of League of Nations, adopted a resolution on prompt agreement between governments of allied countries to prevent individuals from being compelled to pay tax on the same income in more than one country.[243] The first resolution to solve double taxation was that an individual or companies should be taxed on both residence and source.[244] In 1923, there was a remarkable development when it was decided that in classifying and assigning specific categories of incomes to source or resident, the objective test of economic allegiance must be used. The test entails to weigh various contributions made by different countries to production and enjoyment of income.[245] In this

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[241] Olivier L and Honiball M. note 12, p.2.

[242] Avi – Yonah note 239. See also Tax Justice Network, Source and Residence Taxation, September 2005, available at http://www.taxjustice.net/cms/upload/pdf/Sourceresidence.pdf. accessed 1st January 2014.

[243] Herndon, J.G., Relief from International Income Taxation: The development of International Reciprocity for the Prevention of Double Income Taxation 1932, p.20 as copied from Graetz M. J. and O'Hear, M. M., The Original Intent of U.S. International Taxation Faculty Scholarship Series. Paper 1620, 1997, P.1066, available at http://digitalcommons.law.yale.edu/fss_papers/1620. Accessed 1st January 2014.

[244] Ibid.

[245] League of Nations, Report on Double Taxation submitted to the Financial Committee by Professors Bivens, Einaudi, Seligman and Sir Josiah Stamp, League of Nations Doc E.F.S.73 F.19, 1923.

context, the two issues had to be considered, namely, where the wealth originated, that is, source and where the wealth was spent, that is, residence.[246] The source of production of wealth involved stages up to the point where wealth reached fruition that may be shared in by different countries on residence basis.[247]

The rationale for taxation on bases of source and residence was stated in the case of *Karguelen Sealing & Whaling Co ltd* v *CIR* [248]that,

> *"In some countries, residence (or domicile) is made the test of liability for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is 'source of income,' again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that* wealth, wherever the recipient of it may live. In both systems there is, of course, the *assumption that the country adopting the one or the other has effective means to enforce the levy."* [249]

Since MNCs operate in more than one country, tax may be charged on resident or on source basis. Under source principal, the country has the right to tax any income arising within its boundaries, regardless of physical or legal residence of income recipient.[250] The rationale behind is that tax payers are expected to share cost of infrastructure, which makes possible production of income, its maintenance, investment and use through consumption.[251] Some jurisdiction defines the term

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[246] Ibid, see also OECD, Addressing Base Erosion and Profit Shifting, OECD Publishing 2013, p.35 available at. http://dx.doi.org/10.1787/9789264192744-en. Accessed 2nd May 2014.
[247] Ibid,
[248] [1939] AD 487, 10 SATC:363 Appellate Division; see also Ring note 10 pp. 33 – 34.
[249] Ibid.
[250] Sher C., Taxation of E-commerce, 39 Income Tax Reporter 2000, p. 172. See also Olivier and Honiball note 12 p.51.
[251] Olivier and Honiball note 12 p. 52.

source[252] and some do not. However, case law describes source as not a legal concept but rather, something, which a practical person would regard as a real source.[253] The court also establishes a test upon, which a source can be determined. First, determinations of original cause and second, location of the cause once determined.[254] The former explains activities that gave rise to taxable income and the latter explains where activities were actually carried out. However, determination of source of income depends on nature of the transaction carried out.

Sometimes it is not easy to establish where the source of income originated if activities that gave rise to such income were partly carried out in both countries. For example, a corporation, which is situated in Germany has permanent establishment (PE) in Tanzania. The PE in Tanzania enters a three years contract with the government to construct roads. The design and capital are from Germany but services are rendered in Tanzania. Tanzania has the right to tax on source basis because activities were carried out in Tanzania. Similarly, Germany will tax because the design and capital, which gave rise to that income, are from Germany. In determining true source of income, case law laid principle that a true source of income is the place where activities, which gave rise to such income were carried out including royalties accrued to investors from patents and similar assets.[255]

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[252] See for example sections 67, 68 and 69 of ITA Cap 332RE 2008.
[253] *Rhodesia Metals Ltd (in liquidation) v CoT* 11 SATC 244.
[254] *CIR v Lever Brothers ltd* 14 SATC1. It should be also noted that, determination of source under international tax depends of a particular activities that were carried out by MNCs. For example royalty, interest, lease agreement, services, manufacturing activities among others.
[255] *Millin v CIR* [1928] (AD) 207, 3 SATC 170.

Where for any reason it seems that taxable income arises from more originating cause, the distinction between dominant and incidental cause must be made. In this context, countries may agree to apportion their incomes.[256] In *Transvaal Associated Hide and Skin Merchants v Collector of Taxes Botswana,*[257] the fact of the case was that a Transvaal company purchased hides and skins and other livestock by-products at Botswana where the animals were slaughtered and then disposed in South Africa. Before skins were transported to South Africa, they were salted and cured. The initial preparation of treating skins did not change the essential character of the skins. The issue was whether curing of skins in Botswana amounts to dominant or incidental original cause of the derived income. The Court of Appeal held that, "the dominant factor in deriving income from the disposal of the skins was the curing that had taken place in Botswana."[258] It is necessary to establish the source of income because it affects rules of calculating taxable income derived from source and foreign country.

Residence is another principle in determining the taxable income involving a foreign element. It entails taxation of residents on their worldwide income without taking into account sources of such income.[259] For a country to tax on resident basis, various tests are employed in establishing residents of an individual or legal person.[260] First, a corporation is deemed a residence of a particular country if it is incorporated, established or formed in the particular country even if management and control of the corporation are not in the country. Second, it entails if management

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[256] Olivier and Honiball note 12 p. 53.
[257] 29 SATC 97.
[258] Ibid,
[259] Oguttu W.A. and Der Merwe B., *Electronic Commerce: Challenging the Income Tax Base?* 17 South Africa Merchantile Law Journal, 2005, 305 -322 p. 306.
[260] For purpose of this work only corporation as legal person will be dealt with.

and control of corporation are exercised in that country under particular year of assessment. Third, there has to be a declaration by the Minister of Finance that the particular corporation is residence for tax purposes.[261] Likewise, countries also have rights to tax controlled foreign corporation on resident's basis. The general rule is that so long as the company is incorporated in a particular jurisdiction according to the company's law of that country, it is liable for tax in that country and in its worldwide receipts.

3.4 Rise and Elimination of Double Taxation

The fact that each country wishes to tax incomes of investment by MNCs operating across countries on source or resident bases, it causes complex problems not only to countries involved but also to MNCs. Countries are competing to obtain their right share of tax arising from cross border transactions, while MNCs are at risk of being taxed in both countries. Consequently, double taxation may arise. There are various reasons for double taxation.

First, dual residence whereby a corporation is deemed to have dual residence if it is incorporated and situated in one country, while its effective management is in another country where the parent corporation operates. In this context, both countries feel to have sufficient connection with the tax payer and therefore, they have the right to tax the profit. Second, source to source conflict may ensue whereby two or more countries may institute taxes on source basis. Third, residence to source

[261] See for example Section 2(1 b) (i), (ii) and (iii) ITA cap 470 RE 2014; Section 66 (4) (a) and (b) of ITA Cap 332 RE 2008; USA IRC S.7701 2006. See also Marian O., *Jurisdiction to Tax Corporations*, B.S.L. Rev.2013, 1613 – 1665, p.1619-1620.

conflict whereby one country claims rights to tax income on source basis and the other on residence basis.[262]

In order to avoid double taxation, tax avoidance rules are employed. However, there is no hard and fast term of tax avoidance. Fuest and Riebel explain tax avoidance as an activity that a person or a business may undertake to reduce their tax in a way that runs counter to the spirit and purpose of the law without being strictly illegal.[263] Krishna defines tax avoidance as use of perfect legal methods of arranging one's affairs so as to pay less tax.[264] On the other hand, tax avoidance is essentially a misuse or abuse of the law driven by exploitation of structural loopholes in the law to achieve tax outcomes that are not intended by the parliament.[265] A court also has been in the same opinion. In *CIR v Challenge Cooperation Limited*,[266] the court held that,

> *"Income is avoided and a tax advantage is derived from an arrangement when the tax payer reduces his liability to tax without involving him in the loss or expenditure which entitles him that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had."*

This is achieved by artificial arrangement with little or no economic impact upon the tax payer that is usually designed to manipulate tax laws in order to achieve results

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[262]Vogel K, *Double Tax Treaties and Their Interpretation*,4 Int'l Tax & Bus. Law 1,1986. P.6.Available at: http://scholarship.law.berkeley.edu/bjil/vol4/iss1/1. Accessed 10th May 2014

[263] Fuest C. and Riedel, N., Tax Evasion, Tax Avoidance and Tax Expenditure in Developing countries: A Review of the Literature, Report prepared by the UK Department for International Development (DFID), Oxford University Centre for Business Taxation, 2009 p.4. See also Oguttu note 20, p. 2; Hickey L., What is the Difference between Tax Avoidance and Tax Evasion? Available at http://www.accountacyage.com/aa/analysis/1775584/what-difference-avoidance-evasion accessed 10th May 2014.

[264]Krishner V., Tax Avoidance: The General Ant Avoidance Rule, 1990 p. 9.

[265] Australian Government, Final Report of the Review of Business Taxation: A system Redesigned, 1999, at 6.2. (c).

[266] [1987] AC 155, New Zealand Court of Appeal.

that conflict with or defeat the intention of the parliament.[267] Manipulation of tax laws through artificial schemes that have little economic substance undermines the ability of national government to set and implement economic as well as social policies of the country.[268] From the foregoing, it is clear that tax avoidance is divided in two, first, tax avoidance, which is done according to what the law requires and second, tax avoidance, which is not done according to the requirement of the law but uses same rules to avoid tax illegally.

The legal response to rise of double taxation for MNCs with respect to avoiding double taxation is enactment of tax avoidance legislation. Internationally, double taxation elimination is done through double tax treaties.[269] These are agreements made between countries with a view of capturing taxes arising from international trade and investment, which cannot be captured by using domestic laws only. Once countries have signed double tax treaty, invariably, give up some taxing rights, which are subject to negotiation with another country whereby mutual investments take place. Double tax treaties set-up standards upon which taxing rights between contracting states are allocated and avoid double taxation by granting exemption, credit or tax sparing. Thus, tax treaties regulate types of income, which the source country is entitled to tax and when residence country is obliged to grant tax relief to

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[267] South Africa Revenue Authority, Discussion paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962, 2005, P.4.

[268] Brooks, M. and Head, J. '*Tax Avoidance :In Economic'* , law and Public Choice" in G.S Cooper, Tax Avoidance and the Rule of Law, p. 71; see also, Groenewegen C.P., "Distributional and Allocation Effects of Tax Avoidance " In D. Collins, Tax avoidance and the Economy 1984, p. 23.

[269] The Treaties may be unilateral, bilateral or multilateral .Unilateral treaty entails that domestic tax laws take into account tax liability borne or presumably borne by their tax payers in countries in which their foreign source income originated. Therefore taxpayers are entitled to double tax relief either by full or progression exemption, tax credit and tax deduction. Bilateral treaties Entails that countries take extra measures to combat tax avoidance and tax evasion by entering tax treaties with countries where their tax payers are involved. Under bilateral treaties contracting states agrees that, one country have exclusive right to tax certain type of income while other country agrees to exempt.

avoid double taxation. In this context, one country's tax gain is another country's tax loss "zero sum game" of international taxation.[270]

As for MNCs, double taxation arises when the same income is taxed to two different tax payers as a result of adjustment. From MNCs' perspective, double taxation increases cost and it reduces profits. In order to avoid double taxations, MNCs tend to permanent establishments in countries where there are low taxes or in tax haven countries so as to maximize profit or where there are ownership, location and internalization advantages.[271] Transactions between parent corporations and the permanent establishment are normally done through transfer pricing under the auspices of tax planning. To this extent, MNCs may take advantage of loopholes of law and treaties to avoid tax beyond law requirements and shift profit through transfer pricing manipulation. Transfer pricing rules are some of tax avoidance rules aiming at avoiding double taxation at the same time deterring companies from transfer pricing manipulation. These rules are enshrined under multilateral and bilateral tax treaties as discussed in the next section.

3.5 Desire for International Transfer Pricing Legal Regime

The need for MNCs to invest outside home countries has linked economies across the globe. Growth of technology where communication and transportation are enhanced has facilitated expansion of MNCs' operations. This is achieved by establishing associated legal entities in various countries but controlled from parent

[270] Avi-Yonah R. S., The *Structure of International Taxation: A Proposal for Simplification*, Texas Law Review, Vol 74, no. 6, 1996, 1301-1359 p. 1303.
[271] See discussion in chapter 2 para 2.4.1.

company. Consequently, MNCs are pursuing many activities, which link production and distribution of goods as well as services in corporations through transfer pricing. As noted before, theoretical aspect for existence of MNCs is maximization of profit and minimization of transaction cost in particular tax. Thus, transactions within corporation may be driven by common interests of the entity rather than market forces. In this context, MNCs may manipulate prices and shift profit thereby leading to non-double taxation or shift taxable income from high tax to low tax country.[272] . Such developments have led enormous policy challenges with regard to allocation of income and legal loopholes that may be used by MNCs to avoid tax on their world wide income beyond legal requirements. From financial perspective, transfer pricing is currently a serious concern on tax worldwide because it puts tax of countries at stake.[273]

The fact that MNCs are tax liable in each country where they operate, each country obtains the right to tax profit and interest arising out of MNCs transactions to the extent of its contribution. However, if transfer price by MNCs is not set at arm's length price, one of the countries is at risk of losing its right share of tax from such transactions. In this context, competing interests may arise. First, the country, which exports capital (the investor), requires a system that will ensure certainty in business with the view of obtaining profit. Second, the importing capital country may require protection of its tax base at the same time attract more foreign investors. It is from

[272] McGauran K., note 30 p. 11.

[273] The rise of many new economies in the developing countries with their infrastructure, skilled labour, low production costs, conducive economic climate, the round-the-clock trading in financial instruments and commodities; and the rise of e-commerce and Internet-based business models are a few of the many reasons why transfer pricing has become such a high profile issue over the last couple of decades.

these concerns that countries are obliged to harmonize domestic transfer pricing laws in order to capture their right share of tax and protect tax base.

Transfer pricing standards are reflected in tax convention models as initiated by multinational institutions.[274] The rationale behind is that transfer pricing is one of avoidance rules and it is not really a standalone issue. Yet, transfer pricing may not necessarily involve tax avoidance issue but rather, means, which enable associated MNCs to transfer goods and services. It is within this ambit attention has been given to international transfer pricing treatment, standardization and indeed, led to debate on efficacy of transfer pricing laws, in particular, arm's length principle. However, development of transfer pricing standards under the auspices of tax avoidance is based on the best practices and specific needs of developed countries.

In order to achieve international standards of transfer pricing, model tax conventions were published by international organization such as United Nations (UN) and the Organization for Economic Cooperation and Development, (OECD). These are United Nations Model Double tax Convention between Developed and Developing Countries (UN model) and the Model Tax Convention on Income and Capital (OECD) model.[275] It is in these instruments that transfer pricing principles, standards and rules have been enshrined. Objectives of these models are to provide full protection of taxpayer against direct or indirect double taxation and to encourage free

[274] United Nations, United Nations Economic and Social council and United Nations Conference on Trade and Development and OECD.
[275] For the purpose of this work, the OECD model and UN model will be used.

flow of international trade including investment as well as transfer of technology.[276] Such models also aim at preventing discrimination between taxpayers in the international field, and to provide a reasonable element of legal together with fiscal certainty as a framework within which international operations can be carried out.[277] In this context, model conventions are believed to contribute substantially to development aims of developing countries.[278]

3.6 An Overview of UN and OECD Models

As indicated before, existing international transfer pricing standards emanate from multinational institutions, namely, the United Nations (UN) and Organization Economic Cooperation Development (OECD). The OECD model is the first international instrument introduced at an international level to deal with issues of transfer pricing. The OECD Model was established by developed countries to regulate, among other things, transfer pricing issues specifically addressing concerns of OECD member countries.[279] It should be noted that although OECD model is a regional instrument, it is highly accepted internationally and it has been applied across in both developed and developing countries.

The UN model was the first international double taxation convention, which enshrined standards of transfer pricing. It was established by the United Nations with

[276] UN model 2011 Introduction para 2.
[277] Ibid.
[278] Ibid.
[279] Currently OECD has 34 members, see http://www.oecd.org/about/membersandpartners/list-oecd-member- countries.htm .Assessed 30th May 2014

a view of helping developing countries in dealing with transfer prices.[280] The UN model was preceded by OECD model and consequently, most of its provisions are derived from OECD model.[281] It is important to note that the UN model was preceded by the League of Nations Draft Convection of allocation of profits and property of international enterprises of 1935.[282] Although the Draft model was not officially adopted, it came up with principles, which form the basis of current transfer pricing laws as enshrined in UN and the OECD models. League of Nations Draft Convection firstly, defined business income for the purpose of taxation.[283] Secondly, it provided principle of income attributable to a permanent establishment (PE) based on the separate account.[284]

Thirdly, it provided methods to be followed based on percentage turn over and fractional apportionment under which net business income was determined by

[280] See UN Model 2011 para 1.

[281] Internationally there was a concern to eliminate double taxation for corporations operating across countries. From 1921 to 1928, the League of Nations through its financial committee undertook various studies on the economic aspect of international double taxation. Nevertheless in 1954 the United Nations stopped working on the problem of double taxation after setting up a fiscal committee to study and advice the council in the field of public finance in legal administrative and its aspects. Consequently, the Europe under OEEC took action on the field of international taxation and came up with OECD model convention.[281] In mid 1960's there was an increase of foreign investment from developed to developing countries. In this context UN saw the foreign need to revive its interest in dealing with problem of double taxation. This was partly a UN desire to promote investment in developing countries to complement economic development processes.[281] Hence, it was necessary to have an instrument to regulate economic relation in particular issues of double taxation, as a consequence the UN Model 2001 was established.

[282] Transfer pricing: History, State of Art, Perspective, Ad hoc Group of Experts on International Cooperation in Tax Matters, Tenth Meeting, Geneva 10 – 14 2001, p.? See also UN Model 2001, paragraph 23. The aim of the League of Nations Draft was to eliminate double taxation of the income of business enterprises as provided under Article 1 of the Draft. This was a result of various studies done by League of Nations between 1920 and 1935, in lieu of eliminating problem of business income between associated MNCs. See Carroll, , M.B., Methods allocating Taxable income, Vol. 4 of League Of Nations, Taxation of Foreign and National Enterprises.

[283] Article II of the Draft convention.

[284] Ibid, Article III (1).

various factors.[285] The most important was formulation of arm's length principle.[286]Nevertheless, both tax models provide standards, guidelines and commentaries upon, which transfer pricing issues, may be handled as discussed below. The fact that UN model borrowed a lot from OECD model and discussion of such models is presented together. However, difference will be made in terms of scope of such principles.

3.6.1 Transfer Pricing Standards as Set by Tax Convention Models

3.6.1.1 Arms' Length Principle

The arm's length principle is found under Article 9 of OECD model and Article 9 of UN model, respectively. Notably, the principle was first introduced in OECD model and reproduced word to world in the UN model. However, the scope of application of arm's length principle differs between the two models because arm's length principle is subject to some limitations under UN model. The principle provides that,

> *"(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
> *(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*
>
> *and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."* [287]

[285] Ibid Article III (3) and (4).
[286] Article IV of the draft convention; see also Mexico and London models.
[287] Article 9 (1) of OECD model 2010 and Article 9(1) UN model 2011

The arm's length principle regulates profits of associated MNCs that for tax purposes are not made at arm's length terms.[288] The principle embodies two criteria at a time, namely, associated enterprises and arm's length. The enterprise is regarded as associate of another if it participates directly or indirectly in either management or control or capital of an enterprise of another contracting state and should be taxed accordingly.[289] Arm's length principle explains requirements that transfer of goods and services between associated enterprises should be made at a market price.[290]

Generally, the scope of application of UN and OECD models is on taxation of income and capital, whose residence of business is in contracting or one of the contracting countries.[291] Consequently, arm's length principle applies to taxation of income and capital of associated MNCs, whose residence of business is in contracting or one of the contracting countries. This means that for arm's length to apply, the associated corporations must be in different states.[292]

Accordingly, it applies only when taxable amount by associated MNCs is not obtained under arm's length but rather, influenced by special conditions that exist

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[288] OECD, "Commentary on Article 9: Concerning the taxation of associated enterprises", In Model Tax Convention on Income and on Capital: Condensed version 2014, OECD Publishing para 1. The arms' length principle was first established by the League of Nations' 1933 Draft Convention on the Allocation of Business Profits between States. The Fiscal Committee of the OEEC (predecessor to the OECD) drafted articles 5, 7 and 9 of the 1963 Draft convention.

[289] Article 9(1) (a) of the OECD 2010 model and Article 9(1) (a) UN model2011.

[290] Article 9(1) para 1 of OECD model and Article (9) para 1of UN model.

[291] Article 1 and 2 (1) of the UN model 2011 and Article 1 and 2 of OECD model 2010. It is important to note that, the term persons are defined under article 3 (a) to include company and individuals. For the purpose of this work, the word corporation will be used to mean company.

[292] The UN model excludes the taxation of associated parties operating within the country. Similarly, partnership is excluded in the ambit of UN model. The liability of taxation of associated corporation is limited to profit obtained under arms' length rate. The provision also excludes foreign held companies exempted from tax on their income by privileges tailored to attract conduit companies. See UN commentary on scope of UN model para 4 and commentary on Article 4 of UN model para 8. 2.

between them. In case it is established that the taxable profit is obtained under arm‘s length, then the provision is not applicable. It is also applicable to inter-loans of associated MNCs in determining the arm’s length interest. The principle extends to determine *prema facie* whether inter loan between associated MNCs should be regarded as loan for transfer pricing purposes or amounts to other kinds of payment.[293] Additionally, the arm’s length is also applicable to royalties[294] and dividends.[295] The purpose of Article 9(1) of both OECD and UN models is to ensure that transactions between associated MNCs are treated as if they had been carried out between two independent enterprises.[296]

Where it is established that the transfer price between associated is not made at arm’s length price, tax authorities of contracting countries are empowered to adjust transfer prices to be in line with arm’s length. Where the transfer price is below arm’s length price, income or expenses may be imputed and where price is higher than arm’s length price, then the expenses and income may be reduced. The increase in income is called primary adjustment. When adjustment is made between contracting

[293] Articles 11 (4) of UN model 2011 and Article 11 (4) of OECD model 2010. See also Commentary on Article 9(1) of UN model para 5 (b). The arm’s length is applicable “if the beneficial owner of the interest, being a resident of a contracting country, carries on business in the other contracting country in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment”.

[294] If the beneficial owner of the royalties, being a resident of a contracting state, carries on business in the other contracting state in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. See Article 12 (4) of the UN model and Article 12 (3) of the OECD model.

[295] Articles 10 (4) of OECD 2010 and Article 10 (4) UN model 2011, if the beneficial owner of the dividends, being a resident of a contracting state, carries on business in the other contracting country of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment.

[296] Lang .M., *Introduction to the Law of Double Taxation Conventions*, Linde Verlag, 2010 p. 467, see also Solilová V. and Steindl M., *Tax Treaty Policy on Article 9 Model Scrutinized*, Bulletin for International Taxation, IBFD 2013, p. 131.

countries under conditions stated in Article 9(1) of both models, the results are two-fold. Firstly, both countries and MNCs obtain their right share of tax arising out of transactions by associated MNCs. Secondly, associated MNCs may be taxed twice in the same income if one of the contracting countries made adjustment on taxes already taxed in another contracting country.[297] In avoiding double taxation, both OECD and UN models provide for corresponding adjustment rule.[298]

However, adjustment allowed under Article 9 (2) of both models is the one which considered being exactly profit that could have been obtained under arms length rate. Thus, any amount of profit obtained, which exceeds actual amounts that could have been obtained should not be adjusted.[299] Notably, Article 9 (2) of OECD and UN model is silent on methods of adjustment and time limit for procedures on corresponding adjustment. Contracting countries are left to decide.[300] Unlike the OECD model, the UN model clearly excludes application of the arm's length adjustment if there is a final decision by court in relation to a penalty for fraud, gross negligence or willful default, to one of the enterprises.[301]

Thus, the purpose of Article 9(2) of both models is to compensate adjustment of contracting country by an appropriate adjustment by the other contracting country.

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[297] OECD para 5 note 71.

[298] Article 9(2) of UN model 2011 and Article 9(2) OECD model2010. The provision provides that, "Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other".

[299] OECD Commentary on Article 9 para 6.

[300] Ibid, para 7 and 10 respectively.

[301] Article 9(3) of UN model2011.

Countries are required to make correspondence adjustment while avoiding double taxation.[302] This is achieved by using exemption and credit methods.[303] However, the OECD model clearly provides that corresponding adjustment is not mandatory.[304] Therefore, Article 9(2) applies to profit adjustments, which are not made at arm's length principle.[305] Furthermore, no secondary adjustment is allowed under both models except if domestic laws allow.[306] Accordingly, Article 9(2) is silent on period as to when corresponding adjustment should be made. Consequently, countries are left to decide on time.[307] In case of dispute between countries involved over amount and appropriateness of the adjustment, Article 25 should be invoked.[308] Accordingly, both models are silent on burden of proof. However, scholars argue that the country which makes adjustment bears the burden of justifying.[309] Yet, adjustments are done according to domestic law because Article 9(1) of OECD model and UN model is not self-executing. From the foregoing, it is submitted that allocation norm of both models is a separate entity approach with arm's length principle for transaction between associated MNCs.[310] The role of Article 9(1) of OECD and UN models is to allocate taxing rights between associated MNCs as well as avoid double tax, which may arise out of adjustment. Accordingly, it makes sure that transactions between associated MNCs are made at arm's length price. Although Article 9(1) of OECD and Article 9 (1) of UN model provides for restriction of taxing rights, it does not

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[302] See commentary on Article 9(2) of OECD Commentary condensed version 2014 para 5.
[303] Articles 23A and 23 B OECD model and Articles 23 A and 23 B of UN model respectively.
[304] OECD Commentary on Article 9 para 6.
[305] Ibid.
[306] Ibid. para 9.
[307] Ibid, para 10.
[308] Ibid, para 11. See also OECD commentary on Article 25, paras 39,40,41,11,10,12,33.
[309] Ibid, see also, Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series of international taxation, vol. 35, Wolters Kluwer, p. 241.
[310] OECD Commentary on Article 9 para 1 and 2; para. 15 of the preface and para. 1.14 of the OECD Transfer Guidelines.

create taxing rights[311] because the same are imposed by domestic laws. In this context, Article 9(1) of both models ensures that domestic transfer pricing law for income adjustment complies with arm's length principle.

Article 9(1) of OECD and Article 9(1) UN model is silent on methods to arrive at arm's length price. However, it provides for the basis upon which comparability conditions are imposed between associated and independent enterprises for the purpose of calculating arms length price. In this context, it helps to find out whether transfer pricing adjustment can be made to reflect arm's length rate or not. This provision is in line with UN and OECD Guidelines for tax payers and tax authorities on comparability of functions performed and risk assumed. It is from Article 9(1) such that methods of determining arm's length price are developed.[312] From the foregoing, it can be argued that originally, the purpose of Article 9 is to allocate taxing rights and avoid double taxation.

3.6.1.2 Resident Principle

Article 4 of OECD and Article 4 of UN model set resident principle as criteria to tax MNCs operating across countries. The scope of application of both models is the same because Article 4 of UN model is reproduced from OECD model without any modification. In both models, a corporation is regarded a resident of contracting state for tax purpose if it is incorporated according to law of that state or if it has a place

[311] Ibid. See also Vogel V.*K.*, note 262 where he states that, Article 9 of the OECD model "is not an allocation rule but has a special role. Although this rule has a confining effect similar to that of allocation rules, it addresses cases of economic double taxation: …" this purpose can also be inferred from origin and development of article 9(1).

[312] It should be noted that, in determining the arms length price, comparability is pre requisite requirement.

of management in that state or any other criterion of similar nature.[313] Where the corporation has dual residence, the residence of the corporation will be in a state where effective management is situated.[314] Both models do not provide for meaning of effective management. However, a commentary on Article 4 of UN model posits that in establishing place of effective management, the following must be taken into account,

> "*The place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept.*"[315]

In due regard, competent authority of contracting states are empowered to determine residence of corporation by mutual agreement.[316] It should be noted that the purpose of Article 4 is to determine persons covered under models for tax convention benefits.

3.6.1.3 Permanent Establishment

Article 5 of OECD model and Article 5 of UN model provide principle of permanent establishment. Although the UN model provision is largely reproduced from OECD, the scope of its application is limited in terms of duration and context of meaning. Ordinarily, when a corporation establishes a business in another state, essentially it operates in two countries. In this context, the residence state wishes to tax on resident worldwide profit and the host state taxes the same corporation on source basis. In

[313] Article 4 (1) of OECD 2010 and Article 4(1) UN model2011.
[314] Article 4(3) of OECD model and Article 4(3) of UN model.
[315] UN, commentary on Article 4 paragraph 3. 10.
[316] OECD commentary on Article 4 para 24.3.

these circumstances, tax disputes may arise between two countries as to extent one country should tax profit of the corporation operating in both countries. It is in this context that permanent establishment concept becomes pivotal in allocating taxing rights between two countries. The rationale for existence of permanent establishment is that host and investor country agrees not to tax profits arising out of transactions between associated MNCs unless those profits are attributable to permanent establishment within their nations. Thus, permanent establishment determines the extent of contribution for each country involved.

Articles 5(1) and (2) of OECD model and Articles 5(1) and (2) of UN model define permanent establishment to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on 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 of natural resources.[317] From this definition, three elements can be established, namely, 'place of business,' 'fixed place' and 'carried businesses.' The places of business presuppose to have physical existence in the host country in form of premise, equipment or machinery to which a foreign company has access to it.[318] The fixed place of business presupposes a specific geographical fixed spot and degree of permanence.[319] This entails that there must be a connection between a business place and specific point but not necessarily connected to the

[317] A real example of permanent establishment is MultiChoice Tanzania is a permanent establishment of MultiChoice Africa which is wholly-owned by Naspers Group registered in Mauritius. see ttps://www.dstv.com/en-tz/news/company-history-1 accessed 2016.
[318] UN, Commentary on Article 5 (1) para 1.3, see also OECD, Commentary on Article 5 para 2.
[319] Ibid.

ground.[320] In *München Finanzgericht*, the court held that, "Commercial agents involved in different affairs were not deemed to form a permanent establishment in respect of their foreign employers."[321] On degree of permanence, scholars and court agree that there must be a certain durability of permanent establishment and that the business must actually be carried out regularly.[322] In essence, if activities are movable and lack degree of permanence, they cannot constitute permanent establishment for purpose of both models. The final element 'through which the business is carried' presupposes that MNCs' business is carried out at a fixed place either partly or wholly at disposal of that enterprise.[323]

Both models extend definition of permanent establishment to include a building site, construction or installation project or supervisory activities.[324] However, under UN model, such items are considered permanent establishment if they last for more than six months.[325] Additionally, consultancy services of enterprise by an employee or personnel engaged by enterprises constitute a permanent establishment if such activities continue for some or connected project for more than aggregated 183 days in any twelve months.[326] Although the UN model recognizes that construction, installation and consultancy may constitute permanent establishment, it is silent on

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[320] Oguttu A. and S. Tladi., note 139 p.214. Olivier and Honiball, note 12 pp.97.
[321] FG München 41 EFG 707 [1993].
[322] OECD, Commentary on Article 5 para 6., see also Olivier and Honiball note 12 p. 99. Doernberg, R. l., et al., Electronic Commerce and Multijurisdictional Taxation, 2001 p 206, see also *Transvaal Associated Hide and Skin Merchants v Collector of Taxes*, Botswana, 29 SATC 97 p. 115.
[323] UN Commentary on Article 5 (1) para 1.3; see also Doernberg et al.,p.206 note 97; Levouchkina K.I., '*Relevance of Permanent Establishment for Taxation of Business Profits and Business Property'* in Hans-Jörgen & Mario Züger Permanent Establishments in International Tax Law, 2003 pp. 20-21.
[324] Article 5(3) (a) UN model 2011 and Article 5(3) of OECD model 2011.
[325] Article 5 (3) (a) of the UN model.
[326] Ibid, Article 5 (3) (b).

business size and equipment required to constitute a permanent establishment.[327] Nevertheless, it is generally agreed that the notion of permanence presupposes to be linked between fixed place and certain time frame of the particular for which the establishment is at the control of the enterprise. However, commentary on Article 5 argues that size and equipment to constitute a business place depend on nature of business.[328] Hence, it is unnecessary for the business place to be attached on earth. Similarly, in *pipeline case*, [329]the court held that it is not a requirement that the business place should be attached to the earth surface or that it is visible on the ground. The UN model also recognizes a deemed permanent establishment where an independent agent is acting on behalf of enterprises and habitually exercises as well as concludes contracts in the name of enterprises in respect of all undertaken activities.[330]

Additionally, the deemed permanent establishment may exist if an agent maintains goods or merchandise from which delivers and merchandize goods regularly.[331] Notwithstanding the provisions, the UN model requires that an enterprise, which deals with insurance business, is deemed to have permanent establishment in the state where it collects its premium.[332] The rationale behind it is that insurance enterprises do large scale businesses in the state without being taxed because sometimes they do not qualify for characteristics offered under Article 5.[333]

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[327] Ibid, Article 5(3) (a) and (b).
[328] OECD, Commentary on Article 5 para 14.
[329] Bundesfinanzhof vorn 30.10.1996, IIR 12.92, BStBI II 1997, S12. Germany
[330] Article 5 (5) (a) of the UN model. Examples of deemed permanent establishment are foreign airline and shipping line services operating in Tanzania.
[331] Ibid, Article 5(b).
[332] Ibid, Article 5 (6).
[333] UN Model, commentary on Article 5 para 6. 29.

The UN model expressly excludes enterprises, which carry on business in contracting state through broker, general commission agent or any other agent of independent nature provided they are acting on their ordinary course of their business.[334] However, this rule does not apply when agents devoted wholly or almost wholly on behalf of enterprises and condition are made between enterprise and agent, which differ from those would have been made between independent enterprises.[335] Moreover, the UN model excludes a controlled foreign company to constitute the permanent establishment for the purpose of enjoying benefits of the convention.[336]

Unlike the UN model, the OECD model extends permanent establishment definition to include a building site, construction or installation project if it lasts for twelve months.[337] To the contrary, the OECD does not extend supervisory activities to constitute permanent establishment. However, in context of OECD model, permanent establishment exists even where an independent agent is acting on behalf of enterprises and habitually exercises as well as concludes contracts in the name of enterprises undertaken, except those excluded under OECD model.[338] Despite extensive details of what constitutes permanent establishment, both models are silent on whether or not Article 5 can be applicable on electronic commerce. However, OECD commentary on Article 5 states that it is applicable.[339] In OECD commentary context, enterprises carrying out electronic commerce may constitute permanent establishment if,

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[334] Article 5 (7) of the UN model.
[335] Ibid.
[336] Ibid, Article 5 (8).
[337] Article 5(3) of OECD model.
[338] Ibid, Article 5 (5).
[339] UN, Commentary on Article 5, para 36.

> "*The enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.*"[340]

Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed.[341] In order to constitute a fixed business place, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of Article 5(1) of the OECD model. In establishing whether or not a business was actually carried on may be examined according to circumstances of a particular case, keeping in mind that the websites are in control of the enterprise.[342] Commentary on Article 5 points out that,

> "*Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise are required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automat*ic pumping equipment used in the exploitation of natural resources."[343]

To the contrary, no permanent establishment is deemed to exist if business conducted electronically is of preparatory or auxiliary nature such as communication link and advertisement for goods.[344]

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[340] OECD commentary on Article 5 para 42.3.
[341] Ibid, para 42.4.
[342] Ibid, para 42.5.
[343] Ibid, para 42.6.
[344] Ibid, para 42.7.

3.6.1.4 Business Profit

Article 7 (1) of OECD and Article 7 of UN model provide for business profit as the income to be taxed for transfer pricing purposes.[345] Accordingly, both models set a general rule that profit of enterprises should be taxed only in the state where it is incorporated or formed.[346] However, an enterprise may be taxed in another contracting country through permanent establishment situated in another contracting country.[347] The principle embodies two criteria at a time, taxation of profit where the enterprise is situated and taxation of only attributable profit where permanent establishment is situated. Thus, the concept of permanent establishment is an important determinant factor in establishing the right of a country to tax business profit. However, there are differences in approach between these two models as discussed below.

In terms of the UN model, business profit of an enterprise is taxed not only on profit attributable to permanent establishment but also to sales, merchandize sold and other activities carried out through permanent establishment.[348] Accordingly, the UN model requires each permanent establishment situated in contracting countries to be taxed on attributable profit and other profits obtained under arm's length rate.[349] The provision applies to any profit obtained by permanent establishment relied on an internal agreement and becomes subject to adjustment by revenue authorities in

[345]It should be noted that, The UN and OECD models provides for income and capital to be taxed, see Articles 2 (1) of the UN model and Article 2(1) of the OECD model.
[346] Article 7(1) of the OECD 2010 and Article 7(1) of UN model 2011.
[347] Ibid.
[348] Article 7(1) (b) and (c) of the UN Model 2011. For example MultiChoice Tanzania as permanent establishment will also be taxed on repatriated profit.
[349] Ibid, Article 7(2).

accordance with arm's length principle.[350] Application of arm's length extends to turnkey contracts whereby permanent establishment is established by construction of a facility in one state done by a contractor who is a resident in another state if the construction lasts for six months.[351] In addition, arm's length principle is also applicable to profit arising out of finance transactions between associated MNCs. The role of Article 7(2) is to make sure that attributable profits and other profits obtained through permanent establishment are made at arm's length rate.[352] The purpose is to ensure that profits between associated MNCs obtained through permanent establishment are treated as if they had been carried out between independent entities.[353] In determining attributable profit of permanent establishment, the UN model sets a general rule that expenses incurred for business purpose, executive and general administrative cost should be deducted in the state where the permanent establishment is situated or somewhere else.[354] The deduction allowed under this rule is actual cost without adding any element of profit.[355] However, there is exception to this rule that,

> *"No such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account*

[350] UN Commentary on Article 7(2) para 12.
[351] Ibid, para 9.
[352] UN commentary on article 7(1) para 8.13.
[353] The role and purpose of article 7(2) are inferred from arm's length principle as enshrined under Article 9 of both models.
[354] Article 7(3) of UN Model. It should be noted that, UN model is silent on means to establish profit amount of PE for taxes purposed. However, commentaries on article 7 states that revenue authorities may use trading accounts. See UN commentary on Article 7(2) para 12.
[355] UN Commentary on Article 7(3) para 29.

> *shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices."*[356]

It follows out that all exceptions should be included in determining attributable profit of the permanent establishment. However, the UN model is silent on deduction of expenses once attribution is made by permanent establishment. The situation gives room for contracting states to apply domestic laws if such deduction arises.[357] In establishing true cost incurred by permanent establishment for purpose of determining attributable amount, arms' length principle is employed.[358] Thus, it is agreed that only initial cost incurred by permanent establishment for purpose of setting the business is considered for deductions. Hence, any expenses or cost, which seems to minimize overall cost with the view of profit maximization it should not be considered for deductions.[359]

In establishing the cost of intangibles, the cost for creation of intangible rights is regarded attributable to all associates of enterprise, which makes use of them. The actual cost of creation or acquisition of intangible will then be allocated to all associated parties without adding any profit margin.[360] The rationale behind is that it is not easy to establish ownership of intangible rights. In establishing the cost of

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[356] Article 7(3) of UN Model 2011.
[357] UN commentary on article 7(3) para 30.
[358] Ibid,para 31.
[359] Ibid, para 32.
[360] Ibid, para 34.

service rendered, a comment provides that the cost of service rendered should be one charged to outside customers.[361] However, there is uncertainty in establishing cost of services for the purpose of deduction or attribution of profit of permanent establishment. Therefore, it is resolved that it should be decided on case to case basis. Although the UN model relies heavily on principle of arm's length for transactions between associated MNCs it compromises. Article 7(4)[362] departs from arms length principle by allowing apportionment method to be applicable in determining an attributable profit to permanent establishment. However, this method is applicable only if domestic laws of the contracting states provide so.[363] Thus, apportionment is used even if the result may differ to some extent if the arm's length could have been used. However, the UN model is silent on methods of apportionment and contracting states are left with discretion to decide according to their domestic laws.[364] In maintaining consistence, the UN model requires that methods used in establishing attributable profit to PE should be used on yearly basis.[365] The rationale behind is to create certainty about tax treatment to tax payer(s) in both contracting states. It is worth noting that the UN model clearly states that whether or not profits should be attributed to a permanent establishment by reason of mere purchase of goods and merchandise for the enterprise that was not resolved. Countries may resolve it through bilateral negotiations.[366]

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[361] Ibid, para 35.
[362] UN Model 2011.
[363] Article 7(4) see also, UN Commentary on article 7(4) para 53.
[364] Ibid para 55.
[365] Article 7(5) of the UN model. See also UN commentary on Article 7(5) para 55.
[366]Ibid, Article 7 (6) para 1.

In terms of OECD, business profit liable for taxation is limited to profit attributable to permanent establishment only.[367] In this context, any other profits generated by other activities through permanent establishment are not business profit for transfer pricing purposes. It means that a tax authority is not required to tax business profits that derived from separate sources of the permanent establishment derived from their country.[368] Thus, the tax authority is required to tax on basis of other provisions of the convention. Article 7(1) of OECD model is applicable to taxation of business profits, which are only attributed to permanent establishment. The role of Article 7(1) of OECD model is two-fold, first, to grant taxing rights to the country where the permanent establishment is situated to the extent of its contribution. Second, strive to prevent the country, which permanent establishment is situated from taxing the enterprises of the other contracting country on profits not attributable to permanent establishment.[369]

The purpose is to limit the right of source country to tax profits of enterprises of another contracting country. The OECD model sets principle that permanent establishment situated in a contracting state should be taxed on attributable profit obtained under arm's length rate.[370] Arm's length enshrined in Article 7(2) of the OECD model applies to attributable profits, which are not obtained under arm's length rate. The rationale is to make sure that attributable profits of permanent establishment are obtained under arm's length rate. This is to ensure that attributable

[367] Article 7(1) of OECD model. See also OECD commentary on Article 7 concerning taxation of business profit paras 11 and 12.
[368] Ibid para 12.
[369] Ibid, para 14.
[370] Article 7(2) of the OECD model.

profits of associated MNCs obtained through permanent establishment are treated separately as if had been carried out between unrelated entities.[371]

In determining attributable profit of permanent establishment, the OECD model sets a rule that the profit of permanent establishment should be treated as a separate entity and independent from a corporation, which it is a part.[372] It follows that profit may be attributed to the permanent establishment even though the corporation as a whole did not made profits. Conversely, in terms of Article 7(2), it may result in no profit even though the corporation as a whole made profits.[373] In determining the attributable profit, due regard must be given to elimination of double tax either by exemption or credit.[374] The OECD model is silent on inclusion and exclusions of deductions in calculating attributable profit to permanent establishment.

However, according to commentaries deductions allowed are only those incurred for purpose of activities performed by permanent establishment[375] and modalities of deductions are to be determined by domestic laws.[376] In so doing, both contracting countries are required to adhere to non-discrimination rule as provided in the convention models.[377] Article 7(3) of OECD model applies to the extent necessary to eliminate double tax that results from adjustment.[378] It also applies with respect to differences in determination of profit attributable to different parts of the

[371] Ibid, Para 15.
[372] Ibid, para 17.
[373] Ibid,para 17.
[374] Article 7(2) of OECD Model 2010. See also OECD commentaries on Article 7 para 18 and 27 respectively.
[375] Ibid, Para 34.
[376] Ibid, Para 30.
[377] Ibid para 33, see also Article 24 (3) of the OECD model 2010, see also OECD commentaries on Article 24 (3) para 40.
[378] Ibid, para 65.

enterprise.[379] The role of Article 7(3) is to deal with attribution of profit for the purpose of allocation of taxing rights between two contracting countries.[380] The rationale is to ensure that there is no unrelieved double taxation of the profits that are properly attributed to the permanent establishment.[381]

Despite their different approach, both OECD and UN models clearly exclude business profit dealt separately in other provisions of the models as a general rule.[382] They include dividends, royalties, interest and other incomes.[383] However, there are exceptions to these rules. Dividend is taxed as business profit if a beneficial owner of a dividend is a resident of contracting state, carrying on business in other contracting state in which the company is paying dividend is resident through permanent establishment situated therein and holding in respect of which dividends are paid is effectively connected with permanent establishment.[384] Likewise, interest is taxed as business profit of permanent establishment if beneficial owner of interest is a resident of a contracting state in which the interest arises through permanent establishment situated there in. Debt claim in respect of kind of interest to be paid is effectively connected with such permanent establishment.[385] Royalties are also taxed as business profit of permanent establishment "if the beneficial owner of the royalties is a resident of contracting state in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the

[379] Ibid, para 66.
[380] Ibid,para 66.
[381] Ibid, para 44.
[382] Article 7(6) of the UN Model 2011 and Article 7(4) of the OECD model2010.
[383] See Articles 10, 11, 12 and 21 (2) of the UN model 2011 and Articles 10, 11, 12, and 21(2) OECD model 2010.
[384] Article 10 (4) of UN model 2011 and Article 10(4) of the OECD model 2010.
[385] Articles 11(4) of UN model 2011 and Article 11(4) of the OECD model2010 .

royalties are paid is effectively connected with such permanent establishment."[386] Unlike the OECD, the UN model extends the business profit to include profit that arises from performance of personal services from a fixed base and that dividend, royalties or interest is effectively connected to permanent establishment or fixed base.[387]

In addition, both OECD and UN models tax other business incomes as business profits of permanent establishment if "the recipient of such income, is a resident of a contracting country, carries on business in the other contracting country through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment."[388] Nevertheless, scholars submit that such exception is merely an application of general international and domestic interpretation rule of '*generalia specialibus non delegant,'* meaning that a subsequent general provision does not repeal or override an earlier specific provision.[389] Similarly commentators posit that the rule is in conformity with practice generally adhered to in bilateral conventions.

Thus, it is submitted that before taxing business profit of the PE, it is important to establish whether the business profit falls within the ambit of Article 7 of both models or not. Failure to establish the business profit may cause dispute to countries that tax permanent establishment on source basis. However, interest royalties and other incomes may either be taxed separately or as a business profit according to tax

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[386] Article 12 (3) of the OECD model 2010 and Article 12(4) of UN model2011.
[387] Articles 10 (4), 11(4) and 12(4).
[388] Article 21(2) of the UN model 2011 and Article 21(2) of OECD model 2010.
[389] Olivier an Honiball note 12 p.91 , see also *Khumalo v Director General of Cooperation and DvP* [1991] 158 A *; Sappi v ICT Canda 1992 3 SA 306 (A).* South Africa.

laws of contracting states. Where the business profit of permanent establishment falls within the ambit of Article 7, source country should tax profit attributable to permanent establishment at arm's length principle as if the permanent establishment is independent.

An overview of international transfer pricing as enshrined under the UN and OECD models reveals that they have special characteristics, which provide uniform bench mark rules between developed and developing countries. The paramount characteristic of such model is international character, which implies that all transactions of goods and services made between associated MNCs must be made at arm's length price. Such models have solved difficulties caused by multiplicity of laws, which associated MNCs may face in various countries they operate. This is the case, in particular, on when different laws become applicable in respect of different aspects of the transaction. Accordingly, it meets the needs for international transactions by taking into account costs of production of goods or services together with involvement of the permanent establishment and agents. Therefore, the models provide uniform rules aiming at ensuring the same results wherever applied, as rightly stated that,

> *"An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in different places in a similar manner. However this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may have an incentive to avoid taxation through transfer pricing manipulation."*[390]

[390]UN Commentary para 1.4.6.

3.7 Methods to Arrive at Arm's Length Price

As pointed in preceding discussions, both UN and OECD models set a principle that transactions between associated parties should be made at arm's length price. Yet, both models are silent on methods to arrive at arm's length price. It is in this context that both UN and OCED establish specific transfer pricing Guidelines to provide for methods to arrive at arm's length price. These are United Nations Practical Manual on Transfer pricing for Developing Countries of 2013 (UN Guidelines)[391] and The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of 2010 **(**OECD Guidelines). The UN Guidelines is the first efforts by United Nations to develop concrete Guidelines for handling transfer pricing issues.

The manual came into force in 2013 and it was preceded by regional instrument made to regulate transfer pricing issues, namely, OECD Guidelines first published in 1995 and USA transfer pricing regulations.[392] It is important to note that the UN Guidelines is largely influenced by OECD Guidelines because Article 9 (1) and (2) of UN Model was reproduced from OECD model except Article 9(3).[393] [394] The UN

[391] For purpose of this work UN guideline will be used.

[392] UN guideline para 1.3.2.

[393] It is important to note that, article 9 of OECD and Article 9 UN model provides bases for transfer pricing methods. Thus, methods to arrive at arms' length enshrined under OECD Guidelines are same as those enshrined under UN Guidelines. For this reason UN Guidelines will be examined more in this discussion as was specific made for developing countries. The OECD citation will be made where necessary.

[394] Notably, The UN Guidelines have received little attention by developing countries.his is partly due to complexity involved in comparability analysis and the process to arrive at arm's length price. Partly, most of investors in developing countries are from OECD countries that prefer their laws to be applied., the UN Guidelines came after OECD, which have been in place since 1995. To the contrary, the OECD Guidelines received more attention because they are applied by both developed and developing countries. Additionally, the content of UN model and Guidelines are replica of OECD model with minor alterations to suit developing countries' requirements. From

Guidelines contains 10 chapters. The main objectives of UN Guidelines are as follows: first, to provide benchmark of transfer pricing upon which national transfer pricing legislation of member countries should incorporate.[395] Second, is to offer developing countries a basis for informed method at a practical level on arriving at arm's length price by taking into account their development level.[396]

The scope and application of the UN Guidelines is limited to associate MNCs operating across countries in determining arm's length price. The Guidelines may also apply to Advance Pricing Agreement (APA) between the tax payer and revenue authorities.[397] In terms of UN Guidelines, "the rationale for the arm's length principle is that the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities."[398] To arrive at arm's length price, both OECD and UN Guidelines provide five methods that are not used in any hierarchal manner but rather, depend on circumstances of particular transactions.

The methods are comparable uncontrolled price, resale price method, and cost resale method commonly known as traditional methods. Other methods are transactional net margin method and profit split method commonly known as transactional profit methods.[399] However, selection of a method depends on strengths and weaknesses of

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practical point of view, the OECD model prevails over UN model because OECD favours resident-base taxation, which is in favour of the MNCs.

[395] See chapter 3 of UN model.
[396] Ibid.
[397] Ibid, chapter 9.
[398] Chapter 1 of UN Guidelines para 1.4.5.
[399] Chapter 6 of UN Guidelines para 6.1.3.1.

each method, the nature of the controlled transaction; availability of reliable information (in particular, on uncontrolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions.[400] The starting point of selecting the method is to understand the nature of transaction between associated MNCs through functional analysis, which entails analysis of performed function, risk assumed and asset used.

3.7.1 Comparable Uncontrolled Price (CUP)

The method compares price of goods and services of associated MNCs' transactions to the price charged for goods and services of independent corporations in comparable circumstances.[401] The comparison may be made between one associated corporation and with an independent corporation commonly known as internal comparison. Similarly, it can be made between independent corporations commonly known as external comparables.[402] In making comparison, required information encompasses prices for internal and external comparables. The transaction of associated MNCs is considered comparable to transaction of independent transactions if there are no differences in the transaction that will materially affect the price.[403]

In other words, if there are differences between the said transactions but do not affect the price for transactions they are deemed to be comparable. Comparability will also be accepted if a reasonable accurate adjustment can be performed between

[400] Ibid, para 6.1.2.1.
[401] Ibid, para 6.2.1.1.
[402] Ibid, para 6.2.1.4.
[403] Ibid, para 6.2.2.1.

transactions of associated MNCs and independent corporations.[404] Reasonable adjustment is rational if it is made based on type and quality of the product, delivery terms, volume of sales and related discounts together with product characteristics, contractual terms, risk incurred and geographical factors.[405] Where reasonable adjustment is not possible, it is envisaged that tax authorities should rely on other methods.[406]

In determining the degree of comparability, the UN Guidelines require the following factors to be considered: characteristics of the property or service provided contractual terms, economic circumstances, and business strategies. Function performed, risk assumed and asset used must be taken into account for functional analysis purposes.[407] The CUP method is direct measure of the arm's length principle because it is two sided analysis reflecting different two parties to the transaction. The method can be used instantly in transaction(s) involving commodity products.[408] However, the CUP method may be affected by difficulties in finding comparables from independent corporations because the method requires certain standards of comparability to be attained.[409]

3.7.2 Resale Price Method (RPM)

This method compares profit margins on price of goods and services between associated MNCs and profit margin of sales by associated parties to an unrelated

[404] Ibid.
[405] Ibid, para 6.2.2.5.
[406] Ibid, para 6.2.2.7.
[407] Ibid.
[408] Ibid, para 6.2.3.1.
[409] For details of standard of comparability required in CUP method, see chapter 5 of UN guideline 2013.

company. The prices of goods and services obtained from associated MNCs are resold to an independent corporation. To determine an arm's length price, resale price is reduced by resale gross profit margin after taking into account function performed and the remaining amount is deemed to be a transfer price of associated parties.[410] In other words, there must be two associated MNCs selling goods or services from each other at a price deemed to be not at arm's length price. The second embodies associated resale goods or services to an independent corporation with a certain gross profit margin. The gross profit margin obtained is then compared with the gross profit by an independent corporation in similar circumstance. Once the gross profit margin of associated MNCs is found to be similar to that of the independent corporation, the gross profit margin is then added to initial price between associated MNCs to achieve transfer price.

In comparing gross profit margin between associated MNCs and an independent corporation, consistency of accounting is required such that in its absence, it renders application of RPM be difficult.[411] In determining the arm's length profit earned by associated MNCs, two methods are employed, namely, transaction and functional comparison. The former entails transactions between related parties compared with transactions of an Independent Corporation. The latter entails comparison of function performed, asset used and risk incurred between associated MNCs and an independent corporation.[412] Under RPM, the transaction of associated MNCs is considered comparable to transaction of independent transactions if there are no

[410] Chapter 6 of UN Guidelines, para 6.2.7.2.
[411] Ibid.
[412] Ibid. para 6.2.8.2.

differences in the transactions which will materially affect the gross profit margin.[413] Presence of minor differences is not an issue. Comparability is also accepted if reasonable accurate adjustment can be performed between transactions of associated MNCs and independent corporations to eliminate the effect of such differences.[414]

However, the Guidelines is silent on what is deemed to reasonable adjustment while applying RPM. Functions performed between associated MNCs are considered comparable with functions of the Independent Corporation if the following is taken it to account: Performed functions must have less effect on price than cost of performing function, substantial gross profit margin should not be added in the resale price, an exclusive right of reseller to resale goods should be taken into account and consideration of accounting practices applies to reseller as well as an independent corporation.[415]

The RPM is reliable in situation when demands are not affected by price fluctuation and can be used without forcing distributors to inappropriately make profit.[416] However, in applying this method, it is difficult to find comparables of gross profit margin from independent corporations due to inconstancy of accounting practices between associated and independent corporations. Moreover, it is one sided because it relies on one party in transfer pricing analysis.[417] In terms of UN Guidelines, the RPM can be used where the CUP method is not applicable where sales companies do

[413] Ibid. para 6.2.9.1.
[414] Ibid.
[415] Ibid. 6.2.9.6.
[416] Ibid, para 6.2.9.10.1.
[417] Ibid, para 6.2.10. 2.

not own valuable intangible properties and where reliable comparison can be available.[418]

3.7.3 Cost Plus Method (CPM)

Cost plus Method (CPM) is the third method that involves cost of production of goods or services transferred or provided between associated MNCs. The CPM compares the gross profit mark-up earned by the tested party with the gross profit mark-ups earned by comparable companies."[419] While taking into account performed functions, risk assumed and the market condition, an appropriate mark up is added to the transaction between associates to make an appropriate gross profit.[420] Comparison is then made between profit mark-up of associated MNC and that of the Independent Corporation. Thus, transfer price between associates is the cost of goods sold plus arm's length profit mark-up. In determining the arm's length mark up, two methods are employed, namely, transaction and function comparison.[421] The former entails comparison of gross profit mark up of associates and that of an independent corporation. The latter entails comparison between gross profit mark-up earned by independent companies performing functions and incurred risks to performed functions and risks incurred by the associated MNCs.[422] Under CPM, the transaction of associated MNCs is considered comparable to transaction of independent transactions if there are no differences in the transactions that will materially affect

[418] Ibid, para 6.2.11.1.
[419] Ibid, para 6.2.13.2
[420] Ibid.
[421] Ibid.para 6.16.2.
[422] Ibid.

the gross profit markup.[423] Presence of minor differences is not an issue. Comparability will also be accepted if reasonable accurate adjustment can be performed between transactions of associated MNCs and independent corporations to eliminate the effect of such differences.[424] However, like in RPM, the Guidelines are silent on aspects deemed to be reasonable adjustment while applying CPM.

Strength of CPM method is availability of comparables because it is based on internal costs readily available between associated MNCs. The method is useful in the following transactions: sale of tangibles, semi-finished goods and transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler who does not own product intangibles and incurs little risk.[425] However, the weakness of the method is existence of a weak link between the level of costs and market price, which affects gross profit mark ups. It requires consistence of accounting as well as other factors and its absence renders comparable difficult. It focuses only on related party manufacturer and no incentive to control manufacturer's cost.

3.7.4 Profit Split Method

Profit Split Method (PSM) is the fourth method used to determine transfer price between associated MNCs. It is dived in the following two parts: Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM). The TNMM examines the net profit margin relative to an appropriate base (for example, costs, sales and assets) that a taxpayer realizes from a controlled transaction. This is compared to the

[423] Ibid. para 6.2.17.1.
[424] Ibid.
[425] Ibid,para 6.2.20.1 and 2.

net profit margins earned in comparable uncontrolled transactions.[426] The TNMM requires identification and comparison of profit net margin realized by associated MNCs with the gross profit margin realized by independent corporations in comparable circumstances.[427] Comparison may be made between net margins earned by one associated corporation with net margin earned by an independent corporation dealing on comparable circumstances or net margins earned between independent corporations operating in similar circumstances.

This is achieved by comparing transactions or functions performed.[428] Unlike RPM and CPM, in determining arm's length net profit margin, under TNMM profit level indicators[429]based on operating profit,[430] they are used to compare net profit margin of associated MNCs and the net profit of an independent corporation.[431] It is worth noting that under UN Guidelines, net margins cannot be affected easily by transactional differences. The method does not employ complex analysis and it can be used even by one associated party that holds intangibles.[432] However, net margins are easily affected and it is difficult to get reliable information. The profit split method (PSM) requires first, identification of aggregated profit earned by associated MNCs. The aggregated profit is then split among associates based on relative value of each associate's contribution based on performed function(s), assumed risk and

[426] UN and OECD glossaries.
[427] Ibid,para 6.3.2.2.
[428] Ibid,para 6.3.8.1.
[429] Profit level indicator is a measure of company's profitability which explains profitability in relation to sales, costs or assets. See UN guideline glossaries.
[430] Operating profit is a profit from business operation before deduction of interests and taxes.
[431] Chapter 6 of UN Guidelines para 6.3.7.1.
[432] Ibid, para 6.3.11.1.

assets used by each associate.[433] The split profit of an associate is then compared with split profit that would have been anticipated and reflected in an independent transaction made at arm's length. If the profit is in accordance with profit of an independent part, then the profit is said to be at arm's length.[434] The PSM seeks to "eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions."[435] In splitting profit, two methods are employed, namely, contribution analysis and residual analysis. The former entails combined profit of associated MNCs transactions on the basis of operating profit distributed between associates and then compared with the same transaction of independent corporations. The latter involves two steps, first, allocation of sufficient profit to each associated MNC to provide basic arm's length compensation for routine contributions and second, allocation of residual profit, which remains after sufficient profit is allocated between associates based on circumstances of a particular case.[436]

In selecting the most appropriate transfer pricing method and in applying the selected method, the Guidelines require comparability analysis to be performed.[437] Comparability analysis involves two distinct related steps. The first step is to understand economically significant characteristics of the transaction between associates and the role of each part in associated MNCs. This is achieved by analyzing characteristics of the property, function performed, contractual terms,

[433] Ibid, para 6.3.13.3.
[434] Ibid.
[435] UN Guidelines glossaries.
[436] Chapter 6 para 6.3.14.2 of UN Guidelines.
[437] See chapter 5of the UN Guideline.

economic circumstances and business strategies.[438] The second step involves comparison between conditions of associated enterprises' transactions and transactions between independent corporations.[439] In order to understand operations of associated MNCs and roles of parties to associated, the Guidelines require functional analysis to be performed.[440] It involves identification of function performed, assets used and risk assumed.[441]

Comparability conditions between associated and independent parties are regarded comparable if "the economically relevant characteristics of the two transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length results".[442] In absence of comparables practical approach is used to establish degree of comparability so long as it does not affect the arm's length intended."[443] In absence of reliable comparables, the Guidelines set a general rule that, "the transaction is or is not arm's length or arm's length is not applicable to the particular transaction."[444] The UN Guidelines clearly note complexity and expenses involved in making comparability analysis. However, the burden of cost should not be the reason to delusion of comparability standards. It is important to note that the comparison procedure itself is very cumbersome and it gives room for tax payers to conceal some pieces of information. Comparability is based on mathematical accounting methods without legal requirements. This brings uncertainty to application of the law. Comparability analysis adds burden to a tax

[438] Ibid, para 5.1.1 and para 5.1.6.
[439] Ibid, para 5.1.1.
[440] Ibid, para 5.3.2.2.
[441] Ibid, 5.3.4.1.
[442] Ibid,para 5.1.5.
[443] Ibid para 5.1.5. see also OECD Guidelines para 3.35 -3.38.
[444] Ibid, para 5.4.3.2.

payer who is required to apply the selected method to arrive at arm's length rate. In practice, both exercises are long, complicated and cumbersome. It involves a lot of expenses and it imposes serious challenge for tax administrators to establish anomalies in a transaction because they are not involved from the very beginning.

3.8 Transfer Pricing Documentation Requirement

The UN Guidelines also require a taxpayer to prepare sufficient documentation at the time of transfer pricing preparations. The document is regarded sufficient if it contains details demonstrating tax payer's compliance with arm's length principle.[445] The tax authorities are empowered to obtain such document when required. However, the Guidelines require that the documentation should not impose cost and burden to tax payers that are disproportionate to the circumstances.[446] Few questions may arise here. 'What should the tax payer do if the cost of preparation of the document is disproportionate to the circumstances? What should tax authority do when found that the transaction has transfer pricing query, and tax payer did not prepare document due to the cost involved?' The Guidelines is silent on all these questions. In due regard, it may be difficult to implement documentation requirements as enshrined in the Guidelines.

Generally, the burden of proof of documentation lies on the tax authority.[447] However, a taxpayer is required to prove on adequacy of the documents where the domestic law provides so.[448] In handling transfer pricing documents, prudent

[445] Chapter 7 of UN Guideline, para 7.1.1.
[446] Ibid, para 7.2.1.2.
[447] Ibid, para 7.4.1.1.
[448] Ibid, para 7.4.1.2.

business principle should prevail between tax payer and tax authority.[449] Accordingly, both parties are required to exercise good faith through reasonable documents of arm's length principle.[450] It should be noted that the words 'good faith and reasonable' are not measurable in law and their uses are subjective and hence, they do not create certainty in law. In both Guidelines, amount of information from tax payer is limited and rationale behind is that at the time of filling documents, no particular query would have been raised by the tax authority. Thus, it is burdensome to prepare documents for purpose of showing appropriateness of transfer pricing determination only.[451] It is interesting to note that the UN Guidelines do not give its position but rather, reproduced OECD Guidelines on preparation of documentation. If arriving at arm's length price requires full analysis, which needs to be recorded, why should the Guidelines limit information? Limitation provided in the Guidelines may create room for a tax payer to conceal relevant information of transfer pricing. There are also provisions for regulation of penalties to the taxpayer for failure to comply with document requirements. The Guidelines require that the taxpayer should be penalized for underpaying due tax and for non-compliance with document requirements.[452] The penalty may be of civil or criminal nature, depending on circumstances of the case.[453] However, in terms of UN Guidelines," it is unfair to impose sizable penalties on taxpayer exerted reasonable efforts in good faith to undertake a sound transfer pricing analysis to ascertain arm's length price."[454] Undoubtedly, this requirement limits domestic laws to impose serious penalties on

[449] Ibid, para 7.2.1.2.
[450] Ibid,para 7.4.1.5.
[451] Ibid, para 7.4.2.7, see also para 5.15 of the OECD Guidelines.
[452] UN Guidelines Para 7.4.3.1.
[453] Ibid, para 7.4.3.3.
[454] Ibid, para 7.4.3.4.

tax payer on mentioned offences. In this context, the Guidelines may give loophole to the tax payer not to comply.

3.9 Transfer Pricing Audits and Risk Assessment

Concerns that associated MNCs take advantage of complexities in arriving at arm's length price to manipulate prices have subjected them to audits by revenue authorities. The purpose is to increase tax revenue and future compliance with a view of protecting tax base.[455] Generally, transfer pricing audits are time and resources intensive to revenue authorities such that long and complicated procedures must be followed to identify risks. Risk identification and assessment are important steps in ensuring that the most appropriated cases are selected for audit. However, sometimes, even effective risk identification, assessment tools and processes may not always guarantee successes in audit.[456] The reason is that details available at risk assessment stage may not be conclusive evidence regarding the arm's length nature of profits or prices.

Identification of transfer pricing risks depends on available data and accessible data from the taxpayer.[457] Once the data are obtained, the revenue authority has to identify categories of risks. Such risks arise from intergroup transactions that may include intentional profit shifting through new business structures, restructuring, incorrect functional classification, use of incorrect methods, thin capitalization and

[455] Chapter 8 of UN Guidelines para 8.1.2.
[456] Ibid, para 8.3.1.1.
[457] Ibid, paras 8.3.1.2 to 8.3.1.5.

unintentional profit shifting.[458] In identifying transfer pricing risks, the Guidelines require transactions, jurisdiction and risk approach to be used.[459] In the mentioned processes, source of information primarily should be provided by the taxpayer. Publicly available information such as news paper, website and data bases may also be used.[460] The revenue authorities are also required to consider risk indicators such as consistent and continuous losses by MNCs, lower effective tax rates for associates in low tax countries and low profit in host country, while high profits are made in another country where associates operate. Existence of centralized supply chain companies in low tax country must be considered.[461] Special procedures need to be followed in assessing the transfer pricing risk.

Accordingly, risk assessment tools must be used and findings should be provided.[462] The examination team should include economist, lawyer, external examiner and computer audit specialist.[463] The transfer pricing risks examination is subject to limitation of time as regulated by domestic law.[464] To establish whether or not there is actual risk between associated MNCs, the revenue authority must understand taxpayers' businesses. In this context, revenue authorities are required to understand taxpayers' operations and their associates plus their roles played in a transaction under the audit.[465] This is sought to be achieved by going through a long list of

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[458] Ibid, paras 8.3.2.2 to 8.3.2.3. The categorization of risks is done with a view of helping revenue authorities to detect possible value of profit shifting and establish time and resource required to audit the risk.
[459] Ibid, para 8.3.3.1.
[460] UN Guidelines chapter 8 , para 8.3.4.2.
[461] Ibid, para 8.3.5.
[462] Ibid, paras 8.3.7 to 8.3.8.
[463] Ibid, paras 8.4.1.1 to 8.4.1.5. These personnel have to perform different duties according to their areas of specialization.
[464] Ibid, para 8.4.7.
[465] Ibid, para 8.5.2.1.

documents.[466] Where it is found that arm's length principle was not followed by the taxpayer, adjustment may be done by the examination team and the taxpayer will be informed accordingly.[467] Where the taxpayer is dissatisfied with such adjustments, settlement opportunities are available between the taxpayer and examination team or appeal officer, depending on countries' laws.[468] Once all these are done, the audit case is assumed to be complete and properly documented for future reference and should be closed.[469]

3.10 Transfer Pricing Dispute Avoidance and Resolution

Complexity involved in arriving at arm's length price provides potentials for disputes between taxpayer and revenue authorities. In this context, it is necessary to avoid transfer pricing dispute before it happens and when it does, the proper dispute resolution mechanisms should be followed. The purpose is to facilitate efficient and equitable determination and collection of tax revenue at the same time avoiding double taxation.[470]Transfer pricing dispute may be avoided by using tax treaty provisions, either bilateral or multilateral and Mutual Agreement Procedures (MAP). [471] Transfer pricing dispute resolution involves use of mutual agreement procedure (MAP) and Advance Pricing Agreement (APA). The purpose of MAP is to provide effective means for reconciling differing treaty positions of contracting countries in avoiding double taxation.[472]" APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g., method, comparables and

[466] Ibid, para 8.5.2.2.
[467] Ibid, para 8.7.6 to 8.7.7.
[468] Ibid, para 8.7.9.1. and 8.9.1.2. for details on transfer pricing dispute see discussion bellow and UN Guidelines chapter 9.
[469] Ibid, para 8.8.1.
[470] Chapter 9 of UN Guidelines para 9.1.2.1.
[471] Ibid, paras 9.4.1.1 to 9.4.1.5.
[472] Ibid, para 9.6.1.

appropriate adjustments thereto, critical assumptions as to future events) for determination of the transfer pricing for those transactions over a fixed period of time".[473] An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises and one or more tax administrations. The APA process comes about as a supplement to traditional judicial administrative and treaty mechanism for resolving transfer pricing issues. Such APA is applied where there is considerable problem in establishing the manner in which arm's length principle should be applied and results that may lead to double taxation.[474] The APA is a procedural process involving mutual agreements between a taxpayer and tax authorities.[475] These agreements are contracts usually for multiple years between a taxpayer and at least one tax authority specifying the pricing method that the taxpayer will apply to its related company transactions. In essence, the APA follows same transfer pricing methods to arrive at arm's length price.

The only difference is that APA contract is entered before the actual transaction between associated parties. Accordingly, the APA does not depart from the arm's length principle. Key objective of APA is to eliminate double taxation that may be caused by uncertainty about acceptability of the applied method. Other related objectives of APA are to facilitate principled, practical and cooperative negotiations; to resolve transfer pricing issues expeditiously and prospectively; to use resources of the taxpayer and the tax administration more efficiently; and to provide a measure of

[473] See OECD and UN Guidelines glossaries.
[474] Para 4.123 of the OECD Guidelines.
[475] The APAs may be unilateral, bilateral of multilateral. The bilateral and multilateral are agreements between MNC and two or more revenue authorities.[475] Unilateral APA exists where there is agreement between revenue authorities in country where it operates without including revenue authority of other country.

predictability for the taxpayer.[476] The main advantage of APA is to allow revenue authorities to obtain much as information as possible from the taxpayer about transactions between associated parties. That may be useful in detecting risk that may exist between associated MNCs. To ensure that the Guidelines are complied with, it calls for every member countries to build transfer pricing capability. This is sought to be achieved by establishing transfer pricing units in tax authorities. The Guidelines set eight key features that transfer pricing unit should contain. They include the following: the relationship between tax policy and tax administration; the need for evaluation of current capabilities and gaps to be filled; the need for a clear vision, a mission and a culture that reflects them; Organizational structure; Approaches taken to build team's capability; need for effective and efficient business processes; advantages of staged approaches to reaching long-term goals; and need for monitoring to assess effectiveness and for fine tuning.[477]

Examination of the UN Guidelines reveals that the main aim of the UN Guidelines is to provide practical solution(s) for developing countries on how to arrive at transfer price between associated MNCs based on arm's length principle. Thus, establishment of the UN Guidelines intended to bring uniformity in determining transfer price among developing countries. Since the UN Guidelines are specifically designed for developing countries,[478] it takes into account development level of these countries. It provide basis upon which transfer prices may be arrived at and hence, it bring certainty to both associated MNCs and tax administrators in determining arms'

[476] Brem M., Globalization, multinationals and tax base allocation: Advance Pricing Agreements as Shifts in international tax policies?, IIMA Working Paper, no. 2005-12-01. P.7.
[477] Chapter for of UN Guidelines , para 4.1.1.
[478] See title of the UN Guidelines.

length price.. Notably, transfer pricing methods take in to account transfer pricing theories and counteract them. For example, the economic theory and accounting theory require transfer price to be compared with market price, if available.[479] This is in line with CUP method, which requires comparability of market price. Similarly, economic theory and accounting theory harmonize well with RPM in establishing the profit margin for purpose of calculating transfer price in absence of market price. Cost plus method (CPM) works well with mathematical programming theory in identifying cost of goods or services provide for the purpose of establishing transfer price.[480] The UN Guidelines were established on the basis of the UN model with the view of providing practical application on transfer pricing issues for developing countries. It is surprising to note that the UN Model is made for both developing and developed countries, while the UN Guidelines are made for developing countries only.[481] It is unclear when developed countries implementing UN Guidelines will use UN Guidelines or OECD Guidelines. It is not disputed that UN Guidelines borrowed a lot from OECD and there are various issues specifically focused on developing countries, which are quite different from OECD.[482] Clarity of the law is necessary for its implementation. However, the UN Guidelines, in some instances, lack consistence and clarity such that they leave much to be desired.

From practical point of view, the transactions referred in UN Guidelines are of goods or services.[483] Additionally, theories of transfer pricing were methods are derived, in

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[479] See discussion in chapter 2.
[480] Ibid.
[481] See titles of UN Model 2011 and UN Guidelines 2013.
[482] See discussion in UN Model in particular Article 7 on taxation of profit from business income and article 9(3).
[483] Reference can also made to CISG of 1980 which governs international sales of goods and service. Also to domestic laws which clearly defines goods.

a kind, referring to transactions of goods or services and not property.[484] In the same spirit, chapters one and two of the UN Guidelines use the word ’goods’ consistently. To the contrary, chapter six of the Guidelines consistently uses the word ‘property’ to infer transactions carried out between associated or independent corporations for property.[485] The problem is that neither the UN Guidelines nor UN model defines the term property for transfer pricing purposes. Ordinarily, goods and property have different meaning. Property means “anything that is owned by a person or entity.” Property is divided into two types: "real property," which is any interest in land, real estate, growing plants or the improvements on it, and "personal property" (sometimes called "personality"), which is everything else."[486] Furthermore, the UN Guidelines define the term ‘mispricing’ to mean a short-term to pricing, which is not in accordance with arm’s length standard.

In addition, mispricing in not intended to imply existence of tax avoidance or evasion motive behind a particular transactions.[487] This definition is against spirit of the law, which requires curbing manipulation of transfer pricing by associated MNCs achieved through mispricing. Although the UN Guidelines provide for circumstances upon which mispricing is not necessarily tax avoidance or tax evasion, advanced reasons do not outweigh the spirit of the law to deter manipulation of transfer pricing. The UN Guidelines enshrine the notion of good faith in various provisions requiring both associated MNCs as tax payers and revenue authorities to exercise,

[484] See chapter 2 of UN Guidelines.
[485] See chapter 6 of UN Guidelines.
[486] See legal dictionary available at Legal-dictionary.thefreedictionary.com/individuality.
[487] See foreword of UN Guidelines p iv.

thought or practice good faith when determining arm's length transfer price.[488] There is a possibility for both tax payers and tax administrators to have different approaches to the notion of good faith. What is considered to be good faith by a tax payer may not be considered the same by the revenue authority. The problem is that the UN Guidelines does not provide any guidance as to how broad in scope the duty of good faith should be and the extent to which it should govern the relationship between the tax payer and tax administrators. Since no compromise was reached, the notion of good faith under the UN Guidelines remains vague.

3.11 Conclusion

The review of international transfer pricing under international law leads to the following conclusions: First, the OECD and UN models expressly spell transfer pricing principles, which offer strong normative roots for transfer pricing laws of regional and individual countries. The norms can be well established from international taxation provisions of such regional and countries' domestic transfer pricing laws. To the country level, frequent reference to arm's length principle for transaction between associated MNCs is made in ant-avoidance provisions. Similarly, courts of law have been referring to arm's length principle in determining transfer pricing matters. This affirms acceptance and recognition of arm's length principle. Second, there is no single approach in application of methods to arrive at arms' length price. Each method is applied depending on circumstances of a particular case.

[488] See para 3.6.11 where tax payer and tax administrators to exercise good faith in determination of transfer pricing regardless of who bears the burden of proof. Para 6.1.2.6 good faith in absence of comparables, para 7.4.1.5 good faith in relation to documentation and para 7.4.3.3 on imposing punishment when a tax payer exercised reasonable efforts to ascertain arms' length price.

Notably, uncertainty and complications involved in arriving at arm's length rate give potentials for manipulation of transfer price between associated MNCs. Accordingly, risk identification and audit assessment for transfer pricing examination by revenue authorities are long as well as complicated processes, requiring resources and time. Such processes which depend to a great extent, on information from taxpayers may render detection of risks futile. Third, although UN model is made for developing countries it has not escaped from the influence of OECD model because developing countries are dominantly relying on OECD model. Forth, both OECD and UN models provide a uniform basis for solving the problem of international economic double taxation primarily to encourage investment by preventing double taxation. Most importantly, the international instruments do not take in to account transfer in extractive sector which is likely to be a big concern for EAC countries.

CHAPTER FOUR

TRANSFER PRICING REGULATORY FRAMEWORK IN EAST AFRICAN COMMUNITY

4.1 Introduction

An increase in foreign investments caused by trade and investment has enhanced challenges for international transfer pricing in EAC. International trade and investment in EAC are largely caused by trade liberalization and investment that have direct impact on transfer pricing. This chapter examines various arrangements of international trade and foreign investments in which EAC countries have been involved. It considers the extent of implications of international transfer pricing to EAC countries. The first part surveys socio- economic and political context of EAC countries. The rationale for looking in socio-economic context is that transfer pricing is not independent from economic and political forces. The second part covers linkage between trade and foreign investment as well as international transfer pricing. The third part comprises liberalization of economy and its impact on transfer pricing regulation in the region. The forth part reviews transfer pricing laws and standards as enshrined in regional instruments. It consequently argues that international trade and investment through such arrangements effectively pull international transfer pricing framework in EAC countries towards international stance and away from its local context.

4.2 An Overview of East African Community

The EAC is an intergovernmental cooperation of United Republic of Tanzania, Kenya, Uganda, Rwanda and Burundi. The United Republic of Tanzania, Uganda

and Kenya are founding members of the East African Community (EAC).[489] The Treaty establishing the East African Community (The Treaty) was signed by heads of governments of the founding partner states on November 30th, 1999, in Arusha Tanzania and came in to force in July, 2000.[490] The EAC was formally launched on January 15th, 2001. Rwanda and Burundi acceded to the Treaty and became full members in July, 2007 and hence, increased membership of the community from three to five countries. The EAC is located between 5030"N, 120S, 28045"E and 410 50" E, with total area of 1.817.7 thousand kilometer squares.[491] The EAC has recorded population of 145 million in 2013.[492] Politically, EAC states have presidential system of government where the President is both the head of state and government.

The history of EAC cooperation can be traced back in 1917 when Custom Union between Kenya and Uganda was established by colonialist.[493] That was followed by the East African High Commission of 1948 to 1961.[494] The objective of the Commission was to administer certain inter territorial services including tax

[489] The Foundation of the East African Community is traceable to:- The Establishment of Permanent Tripartite Commission for East African Cooperation in 1993, and the Treaty for establishment of the East African Community, 1999. See also Shivji, I.G., "The Rule of Law and Ujamaa in the Ideological Formation of Tanzania, Social Legal studies, Vol. 4, London and New Delhi, SAGE, 1995 p. 148.

[490] Shivji I.G.et al., Constitution and Legal System of Tanzania: A Civics Source Book, Mkuki na Nyota Publication, Dar es salaam, 2004, p.136. See also, Ojienda T.O., *Understanding the East Africa Court of Justice*, The East African Lawyer, Issue No. 4, 2003, p.17 – 18.

[491] East African Community Facts and Figures 2013, p.14.

[492] Ibid p.17, see also, East African Investment Guide 2013, p.2.

[493] East African Investment Code 2013.p.1, See also, Shivji et al., note 490, the then Tanganyika joined on the custom union on 1927. The three founding partners of the EAC have many features in common though they have always been separate and independent entities from colonial period to post independent era. They have all once been British colonies with basically underdeveloped agricultural economies. Rwanda and Burundi have also common features as they both colonized by French and Belgium. These common features made it possible for both colonial and postcolonial governments to establish political and economic integration through which their common goals could be achieved. It goes without saying that the goals of political and economic integration differed between the colonial and post colonial periods.

[494] East African (High Commission),1947.

matters.[495] During colonialism, the economies of Kenya, Mainland Tanzania (then Tanganyika) and Uganda were integrated by the British colonialists so as to serve interests of the colonial power (Britain). Under that system, Kenya received more investment from Britain than Mainland Tanzania and Uganda.[496] Historically, this is explained by the fact that Kenya, unlike Mainland Tanzania and Uganda, was a settler and crown colony in which not only many British settlers stayed but also they meant to stay forever. Hence, they felt assured to invest more in Kenya than in Mainland Tanzania and Uganda. To implement the goal of attracting more investments in Kenya than Mainland Tanzania and Uganda, the British colonialists used the law as a tool for that purpose. By using their colonial legislature, the British colonialists made some laws that influenced the pattern on investment in East African countries.

During colonial period, the main source of revenue was the colonial government. In managing tax issues, the High Commission enacted East African (Income Tax Management) Act.[497] The Act synchronized all EAC countries' tax legislation but excluded tax rates and allowances.[498] In 1958, East African Income (Management) Act[499] was enacted. The Act repealed and replaced the 1952 Act. In terms of 1958 Act, tax was levied on residents of East Africa on their incomes derived from sources within East Africa. Incomes from sources outside the region were taxed to the extent

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[495] Ibid.
[496] Kahama C.G et al., The Challenge for Tanzania's Economy, Tanzania Publish House, Dar es Salaam, 1994, p. 17.
[497] No. 8 of 1952.
[498] Third schedule of the Order in Council.
[499] No. 10 of 1958.

that they were remitted and received in East Africa.[500] Although colonialism was essential an expansion of MNCs from developed countries, transfer pricing issues were not a concern.

In 1961, 1962 and 1963, Mainland Tanzania, Uganda and Kenya gained their independence, respectively. After independence, there arose competition over management of economic issues where Mainland Tanzania and Uganda felt that they stood to lose more than they gained. Consequently, the East African High Commission failed and resulted into tension within the East African countries.[501] To address the problem, the East African Common Services Organization (EACSO) was formed in 1961 by Agreement.[502] Emphasis under the EASCO still laid on economic benefits from cooperation by focusing much on investments. However, the cooperation collapsed in 1967 due to failure to agree in setting up EAC federation.[503] During that period, tax matters were still regulated by Act Number 10 of 1958. In 1967, East African Cooperation was formed.[504] The 1967 Treaty aimed at bringing about even economic development among the partner counties.[505] Like in previous cooperation, Act Number 10, continued to be applied on tax matters until 1971when it was replaced by East African Income (Management) Act of 1971.[506] The desire of having investments and create even economic development always existed within the community.

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[500] Luoga, note 10. p.13.
[501] Shivji, et al., note 490 p.135.
[502] Ibid.
[503] Ibid.
[504] East African Cooperation Treaty, 1967. Unfortunately the cooperation collapsed in 1977.
[505] Article 2(1) of the Treaty of the East African Cooperation, 1967.
[506] Cap 24 of the Community laws.

The existing EAC aims at widening and deepening cooperation among the partner states through development of policies and programmes in various fields for their mutual benefits with the view to achieve economic integration, among other things.[507] In order to achieve the said objectives, the Treaty requires the partner countries to take measures to ensure rationalization and harmonization of the investments[508] with the view of promoting the community as a single investment area.[509] In the implementation process, the partner states established the East Africa Community Custom Union (EACCU),[510] aiming at enhancing foreign investment in the community.[511] Article 5 of the Treaty stipulates objectives of the community to include attaining, widening and deepening cooperation among the partner states. This is to be achieved by development of policies and programmes in various fields with a view of achieving economic, social and political integration. The treaty provides that,-

> *"Community organs, Institutions, laws shall take precedence over similar national ones on matters pertaining to implementation of the treaty".*[512] *In pursuance to the provision above, the partner countries undertake to make necessary legal instruments to confer precedence of community organs, institutions and laws over similar national ones*."[513]

It means that partner states are obliged to ensure not only domestication of the Treaty within their countries' laws, but also they should ensure timely implementation of its

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[507] Article 5 of the Treaty for Establishment of EAC 1999.
[508] Ibid, Article 8(d).
[509] Ibid, Article 80 (f).
[510] Ibid, Article 2 and 75.
[511] Article 3(c) of the Protocol for the establishment of EACCU.
[512] Article 8(4) of Treaty for Establishment of EAC, 1999.
[513] Ibid, Article 8 (5).

projection and general adherence to its provisions by instituting all mechanisms and programmes that relate to cooperation to enhance economic integration.

4.3 Linkage between Trade and Foreign Investment and International Transfer Pricing

The desire to make EAC as a single investment area and efforts to implement such desires enhanced an increase in trade as well as investments in the region. Increases in such investments are from within and outside the EAC countries. Investments and, in particular, foreign investments have been seen as a key drive that has been inducing EAC countries to increasingly involve their economies in regional as well as global levels. Such EAC countries have been taking various steps to facilitate foreign investment mostly from developed countries.[514] This is sought to be achieved by changing domestic laws and policies by adopting bilateral treaties with countries where investments are sourced or with their trading partners. Such bilateral treaties may be tax agreements, investment treaties or trade agreements.

Facilitation of trade and investment in EAC countries is a result of implementation of liberalization policies of multilateral institutions such as International Monetary Fund (IMF) and the World Bank (WB). Such institutions required developing countries to involve their economies in free market economy. Accordingly, increasingly sophisticated and powerful technological as well as legal regulatory environments, especially in developing countries enhanced interaction of economies between developed and developing countries like EAC. This is achieved by

[514] The EU, US, United Arab Emirates and emerging economies like India and China are major trading partners.

removing international trade barriers, which resulted in smoothing movement of goods and services between countries. In due regard, big cooperation from developed and emerging economy countries expanded their economic activities to EAC countries by established associated entities.[515] Arguably, most foreign investments in EAC countries are not completely new but rather, they are mere part of large corporations operating from countries where they are sourced.

The increase in MNCs in EAC would mean an increase in transfer pricing practices in the region. In this context, benefits from MNCs are two-fold. First, the difference between countries' tax laws provides potentials for MNCs to avoid tax on their worldwide income. This is achieved by using legal loop holes that exists in countries tax laws setting up prices within corporation without necessarily considering arm's length principle as required by the law. Since the aim of MNCs is to maximize profit, such situation may create a room to under or overprice goods and services transacted within corporation.[516] Second, it provides potentials for reallocation of market shares through off shore companies with the view of reducing operation costs and maximizes profit.[517] Such situation creates room for MNCs to shift profit from high to low tax countries or to countries where a parent company operates. Consequently, countries involved fall in a risk of losing their right share of tax through manipulation of transfer pricing.Globalization of MNCs has enhanced the role of transfer pricing legislation in facilitation of trade and investment in the world.

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[515] See discussion in chapter para 2.4

[516] There are other reasons which motivate MNCs to manipulate transfer pricing. These include managerial, markets and government policy. For more details see Cobham A. et al., note 37 p. 6.

[517] Lanzi R. and Miroudot S., Intra-firm Trade: Patterns, Determinant and Policy Implication. OECD Trade Policy working paper No. 114, 2010, p.22. See also, chapter two on theories for establishment of MNCs.

This is evidenced by bilateral tax treaties concluded in the past to regulate international transfer pricing arising between associated MNCs across countries.[518] The undertaking view is of four-fold. First, absence of transfer pricing law may render host countries in which MNCs operate to lose their right share of tax. Second, ineffective transfer pricing system of law may create loophole for MNCs to avoid tax beyond legal requirement(s). Hence, in case of conflict between revenue authorities and MNCs as tax payers, it may render MNCs to be inadequately protected. Third, in absence of proper transfer pricing law, both tax administrators and MNCs may have limited reference when dealing with transfer pricing challenges. Fourth, absence of proper transfer pricing law may discourage foreign investors to developing countries like EAC.[519] It is in this context such that it is important to consider involvement of EAC in facilitation of MNCs' activities influence international transfer pricing regulations in the region.

4.4 Liberalization of Economy and its Implications to Transfer Pricing Regulation in EAC

The EAC countries have experienced major economic reforms for more than three decades. Such reforms caused growth of economy in the region as a result of liberalization policy implemented under auspices of multilateral institutions, namely, IMF and WB. Such institutions required EAC countries to privatize state owned and controlled enterprises together with liberalization of import and export prices of

[518] See OECD and UN model tax conventions and UN and OECD Guidelines on transfer pricing matters.

[519] Transfer pricing is one of double tax avoidance measure, Tax treaty models normally enshrines arms' length principle and other standards which are important in regulating transfer pricing. Developing countries have always put in a dilemma of pleasing capital importers countries that their laws are capable to protect foreign investment.

commodities including capital flows. In order to achieve liberalization objectives, such institutions provided policy and legal infrastructures, which EAC countries had to follow while reforming their economies. Implementation of such reforms was a condition to attract foreign investments for developing countries.[520] Consequently, developing countries formulated policies and laws to attract more foreign investments in their respective countries.[521] The result was that EAC countries had to depend and participate in private sector, in particular, foreign investment.

Existing EAC liberalized its economy by formulating policies and laws to facilitate high investments as well as trade in the region. Establishment of EACCU and East African Community Common Market (EACCM) protocols is some steps taken by EAC to liberalize their economy and make the region as single investment area. Such step facilitated higher investment flow between member countries and beyond the region. This is achieved through removal of trade and investment barriers within the EAC. Facilitation of investment is enhanced through intra – trade on mutual arrangement basis.[522] This is achieved through removal of non-tariff barriers,[523] creation of common external tariff [524] and elimination of internal tariff [525] and provision of anti-dumping measures.[526] Accordingly, promotion of efficiency in production within EAC [527] through fair competition has improved investment of the region. Furthermore, enhanced domestic, cross border and foreign investments

[520] See UN Model preamble.
[521] For example in 1992, Tanzania formulated parastatal sector reform policy followed by establishment of the Parastatal Sector Reform Commission PSRC) as specific institution to deal with matters of privatization.
[522] Article 3 (a) of the EACCU.
[523] Ibid, Article 13.
[524] Article 12 of the EACCU.
[525] Ibid, Article 10.
[526] Ibid, Article 16.
[527] Ibid, Article 3 (b).

through simplified customs procedure,[528] tax incentive on capital goods and zero tariffs on primary raw materials have brought positive changes to EAC. Moreover, promotion of economic development and diversification of industries[529] have played an important role in increasing investment in the region. Presence of ready market with population of almost 150 million made possible through implementation of EACCM attracted more investments in the region. Establishment of joint institutions on border control, which plays an important role to deter smuggling, illegal cross border transactions and control of transit goods has increased operation of associated MNCs originating from within EAC.[530] Presence of such MNCs essentially means an increase in transfer prices practices from within and beyond the community.

Apart from establishment of EACCU, establishment of East African Community Investment Model code[531] (Investment model) significantly played a great role in facilitation of investment in the region. The investment Model aims at harmonizing investment laws in the region thereby reducing harmful investment competition between member countries. Globalization of investment and trade has made EAC member countries to take proactive measures to improve regional investment climate. This is sought to be achieved by pursuing open, liberal and transparent investment policies to contribute to their economic progress principally through the private sector led development.[532] In this context, investors both local and foreign

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[528] Ibid, Article 3 (c).
[529] Ibid, Article 3(d).
[530] See for example Bahresa Group of companies which has branches in Uganda, Rwanda, Burundi, Malawi, Mozambique and South Africa. For more details see www.bakhresa.com ; Kenya Seed Company having subsidiaries companies in Uganda and Tanzania, see www.kenyaseed.com; and Nakumatt Holding supermarket with branches in Tanzania and Uganda, see www.nakumatt.net .
[531] 2006.
[532] Preamble of the East Africa model Investment code, 2006.

are ensured of right to private ownership establishment.[533] Most importantly, the investment code provides tax incentive for investors investing in export processing zones, manufacturing under bond, free trade zones and technology parks. These incentives include;,

> "*10 years corporate tax holiday and 25% tax thereafter,10 years withholding tax holiday, duty and value added tax (VAT) exemption, on raw materials, machinery, equipment and other inputs, stamp duty exemption,100% investment deduction on capital expenditure within 20 years, complete exemption from dividend tax, duty and tax free import of goods from domestic tariff area, duty free import of two motor vehicles for use of business enterprise allowed under certain conditions, exemption of income tax on interest on borrowed capital, relief from double taxation subject to bilateral agreements, exemption of income tax on salaries of foreign technicians for 3 years subject to certain conditions and exemption from property tax for 10 years.*"[534]

Arguably, the EAC investment code, which regulates investors, may provide potentials for transfer pricing manipulation by allowing huge tax incentives to investors. Facilitation of investment in EAC also has impact on attracting foreign investments in the region. The EAC has entered in economic partnership with other regional blocks such as Economic Partnership Agreement (EPA) with European Union (EU), Trade and Investment Framework Agreement (TIFA) with USA, and COMESA-EAC and SADC Tripartite free trade area and trade cooperation with China and India.[535] Entering in economic partnership with EU means that EAC have opened room for 18 developed countries.[536] Such kind of relations has potential in attracting MNCs from EU to invest in the EAC countries and therefore, increase transfer pricing practices in the region.

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[533] Article 5(1) of the East the East Africa Model Investment Code, 2006.
[534] Ibid, Annex 1 which is made pursuance to Article 17 of the Investment code 2006.
[535] See EAC website.
[536] See EAC – EU Economic Partnership Agreement.

The EPA, for example, covers trade in goods and development. It adheres to non-discrimination principles on imports and exports.[537] Accordingly, it contributes to eradicate non–tariff barrier in intra EAC trade.[538] The main export from EAC to EU is dominated by coffee, cut flowers, minerals, fish and vegetables.[539] The imports to EAC from EU are mainly machinery and mechanical appliance, equipment and parts, vehicle and pharmaceutical products.[540] Although EU may be seen to be supporting the EAC, in real sense, the trade relation may have impact on tax matters. Imported machinery and equipment from EU may enjoy exemptions as capital goods. The trend of export between EAC and EU from 2012 to 2013 shows that EU imported more than EAC exported to EU.[541] Such kind of partnership intensifies involvement of MNCs' operations in EAC, which potentially exposes EAC to the potential effect of international transfer pricing. Likewise, expansion of a common market within EAC and tripartite preferential free trade area of EAC–COMESA and SADC provides a potential market for foreign investments.

Foreign investments in EAC countries are also from other African countries like South Africa and Mauritius.[542] For example, in 2012, South Africa and Mauritius were leading investors in Tanzania. Mauritius is a tax haven country and provides potentials for transfer pricing manipulation including profit shifting from EAC. In this context, foreign MNCs stand to benefit more than local MNCs. This is because local MNCs are able to invest within the region and very few have invested in

[537] See for example Article 128 of the EPA.
[538] Ibid, Article 19.
[539] See http://ec.europa.eu/trade/policy/countries-and-regions/regions/eac/ . Accessed 20 May 2015
[540] Ibid.
[541] Ibid.
[542] TIC, Tanzania Investment report 2012,

comparative African advanced economies like South Africa and Mauritius.[543] To the contrary, MNCs from such countries have invested heavily in the region. Likewise, EAC MNCs are lacking capacity to invest in their counter partners like EU, USA and China. For example, it is a reported that intra-trade within EAC states is 3.8 billion US dollars, while international trade volume with EAC is 33 billion US dollars.[544] The EAC exports volume is 11 billion UD dollars while import volume is 26 billion US dollars and investment flow is 1.7 billion US dollars.[545] From these statistics, it is clear that EAC trades more internationally than intra-region. The rate of investment is also high, which means that more MNCs are carrying out business in the region and therefore, transfer pricing is highly practiced.

Prosperity of the economy of any country or regional integration requires sufficient tax revenue collected by revenue authorities from tax payers. Such tax authorities and tax payers are influenced as well as governed by the law, which, as part of the ideological superstructure, must inevitably not lag behind economic changes in any society. Tax laws, in particular, constitute the legal regime that applies to local and foreign investments for promoting economic development of a country or region. The primary role of tax law is to encourage and regulate taxation in various sectors of the economy. Thus, tax laws play a great role in success or failure of effective tax collection of countries. As far as EAC countries are concerned, transfer pricing standards were introduced after liberalization of the economy.[546] To a significant

[543] Except for few companies like Bakhresa Group of companies.
[544] East African Investment Guide 2014 p.2.
[545] Ibid.
[546] Tanzania introduced transfer pricing law in 2004 and its transfer pricing regulation on 2014, Kenya 1995 and its regulation on 2006, and Rwanda 2005, Uganda transfer pricing regulation came in 2011, Burundi 2009.

extent, domestic laws have tended to incorporate arm's length principle and other standards contained in the model conventions.[547] This is in line with the requirement of multinational institutions as rightly pointed out that,

> *''A drafting issue for the domestic [tax] law is that the arm's length principle should be provided for both branches and subsidiaries. This is most easily done by using language similar to that found in tax treaties. Such an approach ensures that there is a basis in domestic law for making transfer pricing adjustments. In many countries, it is not clear whether tax treaties on their own would provide a sufficient basis for such adjustments, and, in any event, it is necessary to have the rules in the case of residents of countries with which there is no tax treaty in force. Using statutory language based on treaties has the added advantage of giving a clear signal that the country intends to follow international norms.''*[548]

Introduction of transfer pricing provision in EAC countries was mainly to avoid double taxation and allocate taxing rights to countries where MNCs operate. Accordingly, this was done with a view to attract more foreign investors in their respective countries so as to keep up pace with requirement of international taxation norms. Additionally, by abiding by these standards, it is believed that governments provide potentials in obtaining the right share of tax arising from MNCs' transactions for countries' economic development. Arguably, foreign investments have been seen as major means of obtaining huge taxes that will help governments to enhance economy and provide public services.[549] Accordingly, importation of transfer pricing standards from developed countries significantly limits options available to

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[547] See for example, section 33 of Tanzania Income Tax Act, 2004, section 18 of Kenya Income Tax Act, cap 470 of the laws of Kenya and Article 30 of the law No. 16 of 2005 of Rwanda. See also Article 9 of the Agreement Between the Government of the Republic of South Africa and the Government of the United Republic of Tanzania for the avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income.

[548] Vann R., 'International Aspects of Income Tax, in *Tax Law Design and Drafting'*, in V. Thuronyi (ed.), Vol.2, International Monetary Fund, 1998, P. 782.

[549] See for example, the role of President Kikwete of Tanzania in encouraging foreign investors.

EAC countries as tax policy choices seem not to be influenced by countries' economic structure and administrative capacity.

With ongoing discovery of natural resources and implementation of the policy of making EAC as the single investment area supported by liberalization of market, involvement of MNCs' operations is likely to increase. Most likely, such MNCs are from developed countries. There is an emerging pattern of MNCs from emerging economies such as China and India as well as among developing countries like Nigeria, South Africa and Mauritius.[550] Consequently, arm's length principle is becoming highly applicable. Growing of MNCs' activities seems to be derived from their desire to obtain profit and reduce overall corporations' tax liability.

Such desire reflects objectives for which MNCs are established[551] and in the magnitude of Bilateral Investment Treaties (BITs) concluded by EAC countries with their trade partners.[552] Although the argument for having BITs and Double Tax Treaties (DTAs) is to attract more foreign investments in the region, it is questionable whether or not tax losses caused by loopholes in such treaties can be compensated by the increase in volume of MNCs investments in the region. It is common knowledge that attraction of foreign investment and protection of the same is another thing. There is consensus from scholars and investors that investing in Africa generally is unsafe because of weakness in adherence to the rule of law and that investors are insufficiently protected in Africa.[553] The investors are of the view

[550] See the SADC, COMESA and EAC tax tripartite treaty of the said regions.
[551] See discussion in chapter two above.
[552] For example recently Tanzania has concluded BITs with several countries like China and Morocco
[553] Hicks G., BITs for Africa, Centre for International studies, 6 June 2014, available at http:csis.org Accessed September 2014, see also, Leo B., Where are BITs? How US Bilateral Investments

that developing countries like EAC are lacking proper tax laws, in particular, transfer pricing to protect their business profits. Hence, home countries of MNCs had to find a way of protecting and capturing profits that may arise out of MNCs' operations across countries. It is generally accepted under international taxation principle that countries have the right to tax income either on source or resident bases. Thus, countries, which host investments, have the right to tax on source, while countries where investments are sourced, they tax on resident basis.

Equally important, another great concern for foreign investors is payment of double tax for their investments, which seems to increase transaction costs that need to be avoided. Likewise, a host country may require effective mechanisms for exchange of information between countries in relation to economic activities of MNCs for tax purposes before acceptance of investment. It is in this context that home countries of MNCs negotiated and concluded Double Tax agreements with EAC countries.[554]

From investors' countries, DTAs are seen mainly as means to protect and capture their profits and partly as means to remedy local institutions' deficiency together with governance.[555] It is within this context that transfer pricing standards have been enshrined in EAC DTAs. Such standards were seen as a condition to avoid double tax to investors so as to obtain intended profit at the same time facilitating more capital imports by MNCs in the region. From EAC countries' perspective, the

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Treaties with Africa can Promote Development', Centre for Global Development, August 2010, available at http://www.cgdv.org. Accessed on 1st September 2014.

[554] Number of DTAs is signed between EAC countries and Developed countries. For example Tanzania has signed DTA with Canada, Denmark, Finland, Italy, Norway, Switzerland and Sweden. Kenya has signed DTA with Norway, German, Denmark and Canada.

[555] Ginsburg T, *International Substitutes for Domestic Institutions: Bilateral investments and Governance*, Int'l Rev& Econ, 2005 p.107.

conclusion of such DTAs seems to connote the following: first, as means to attract more foreign investors in the region.[556] Such desire seems to be derived from the notion that foreign investment plays an important role in generating tax for economic development, among other things.[557] By signing DTAs, EAC countries will be in a position to obtain the right share of tax from MNCs' profits.

Second, it is a way to impress foreign investors that EAC countries are not unsafe destination.[558] Third, it is as a mechanism for exchange of information between countries in relation to economic activities of MNCs in case of tax dispute for purpose of tax compliance. This was seen important because developing countries like EAC are seen as having weak tax law and administrative capacity in regulating international tax.[559]

The increase in DTAs involving EAC countries plays an important role in promoting MNCs' operations, in general. The EAC countries are becoming interdependent and connected to MNCs' operations, but they face challenge of reflecting in their tax regimes global standards in dealing with international transfer pricing. Transactions of MNCs through transfer pricing impose challenges for EAC countries to align transfer pricing laws so as to abide by their desire to attract more MNCs to countries with which they signed DTAs. The fact that liberalization of economy was

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[556] McGauran, K., note 30, p.5 See also, Neumayer E., *Do Double Taxation Treaties Increase Foreign Direct Investment to the Developing Countries?*, Journal of Development Studies. 43 (8) 2007, pp 1501-1519 available at http://ssrn .com/ abstract=766064, p.2; Accessed September 2013. See also Ahmed S.A.S and Giafri R.N.M., *The Role of Double Taxation Treaties on Attraction of Foreign Direct Investment: A Review of Literature*. Research Journal of accounting, ISSN 2222-2847online Vol 6, no 12, 2015.

[557] Like importation of technology, employment opportunities etc.

[558] Masot V., *Bilateral Investment Treaties and a Possibility Multilateral Framework on Investment and WTO; Are Poor Countries Caught in Between*? 20 NWJ Int'l L &Bus (2005 -2006) pp 95 and 114.

[559] Mclure, Jr., C.E., note 36.

influenced by multilateral institutions is highly influenced by policies, rules and programmes of developed countries' standards.[560] Consequently, such rules, policies and programmes suitable for developed countries' economies and administrative capacity were imported in EAC countries.

On the basis of the importation, EAC countries formulated policies and laws, to a great, extent reflect requirements of foreign investments. Arguably, laws, programmes and standards on transfer pricing were not set and implemented to reflect specific needs including administrative capacity of EAC in handling transfer pricing intricacies. To this extent EAC countries were opened for potential transfer pricing challenges. Such countries may consider foreign investment as one of the means to obtain taxes necessary for economic and citizens' development. However, EAC countries laws are may be ineffective and inefficient in capturing their tax potentials that may arise out of international transactions by MNCs.

For example, it is estimated that developing countries capture only 40 percent of their potentials and lose US dollars 160 billion a year through international transfer pricing manipulations.[561] Arguably, the desire for attraction of foreign investment has put EAC countries to institute transfer pricing laws, which reflect MNCs' desires, a situation, which may preclude them from making proper analysis of consequences that may be caused by application of the arm's length principle.

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[560] Kelley T.A., *Exporting Western Law to the Developing World: The Troubling Case of Niger'* 7 Global Jurist (Frontiers) Article 8, 2007 available at http://wwwbepress.com/gj/vol7/issu3/art8. Accessed 2nd December 2014.

[561] International Tax Compact, "Benefits of computerized integrated system for Taxation", Tax case study, Bonn Feb 2011.

4.5 International Transfer Pricing Regime in East African Community

4.5.1 The EAC Treaty

The EAC treaty has nothing explicit related to transfer pricing between associated MNCs. However, it contains provisions upon which transfer pricing laws can be inferred and form basis for transfer pricing laws. Article 5 of the EAC Treaty stipulates objectives of the community to include attaining, widening, and deepening cooperation among the partner states. From economic and tax perspective, the treaty provides for cooperation in investment and industrial development.[562] To achieve such requirement, the EAC treaty necessitates harmonization and rationalization of investment of tax incentives with a view of promoting EAC as a single investment area.[563] Accordingly, it requires avoidance of double taxation for investments across borders[564] and harmonization of tax policies with a view of removing tax distortions so as to bring about efficient resource allocation within the region.[565] In addition, the treaty allows free movement of capital so as to encourage cross–border trade and financing instrument.[566]

This is to be achieved by developing policies, laws, institutions and programmes in various fields with a view to attain economic, social and political integration. Accordingly, the EAC Treaty requires "community organs, institutions, laws to take precedence over similar national ones on matters pertaining to implementation of

[562] Article 79.
[563] Article 80(f).
[564] Article 80(h).
[565] Article 83(e).
[566] Articles 80 - 87 respectively.

the EAC treaty."[567] Pursuant to this provision, the partner countries are required to undertake necessary legal instruments to confer precedence of community organs, institutions and laws over similar national ones.[568] This means that the partner states are obliged to ensure not only domestication of the EAC treaty within their domestic laws, but also ensure timely implementation of its projection and general adherence to its provisions by instituting all mechanisms, laws and programmes that relate to cooperation to enhance economic integration. It is within this ambit the EAC countries have entered in Agreement for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income (EAC DTA). The EAC DTA contains arm's length principle and other standards of transfer pricing as enshrined in model conventions. Examination of standards and principles contained in the EAC DTA including clauses demonstrates the extent to which EAC countries have bound themselves in obligation that potentially affect as well as shape their policy choices in transfer pricing regulations.

4.5.2 EAC Agreement on Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income 2011 (EAC DTA)

The East African Community Double Taxation Agreement (EAC DTA) is a multilateral treaty for avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income.[569] Such taxes, which the EAC DTA applies, are taxes chargeable in accordance with provisions of the income tax laws of member

[567] Article 8(4) of the Treaty for the Establishment East African Community, 1999.
[568] Ibid,Article 8(5).
[569] Article 2 of the EAC DTA. It was established on 2010 and came in to force on 2011.

countries.[570] The treaty seeks to eliminate double taxation among countries by imposing an obligation on the resident state to give credit to source country against the resident country's tax on income or exempt the income from tax. The parties to the treaty are the Republics of Kenya, Uganda, Burundi, Rwanda as well as the United Republic of Tanzania and it is applicable to residents or one of the residents of contracting countries.[571] In context of transfer pricing, when stakeholders need to establish whether or not the prices are made at arm's length, the EAC DTA provides for requirements that need to be followed while setting transfer price between associated MNCs operating within the region. Such provisions are discussed in the next sub-sections.

4.5.2.1 Arms' Length Principle in EAC Context

Arm's length principle is a corner stone of regulating transfer pricing between associated MNCs enshrined under the EAC DTA.[572] The principle provides that,

> *"... and in either case conditions are made or imposed between the enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any income which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the income of that enterprise and taxed accordingly*."[573]

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[570] Ibid, Article 2(3). These laws are Income Tax Act, Cap 470 RE 2014 of the laws of Kenya, Income Tax Act Cap 332 RE 2008 , of Tanzania, Income Tax Act, Cap 340 of the Laws of Uganda, Rwanda Law no 16/2005 of 18/08/2005 and law no 17/2005 and Burundi Income Tax act of 2008.

[571] Ibid, Article 1.

[572] Ibid, Article 9(1) (b).

[573] Article 9(1) para 1 of EAC DTA. It is worth noting that, the wording of Article 9 (1) para 1 are identical with wording of Article 9(1) of OECD and Article 9(1) UN model, except that, the EAC DTA uses the word 'income' and the OECD and UN model uses the word 'profit'. However, for purpose of transfer pricing, Article 7 of EAC DTA uses the word profit throughout for transfer pricing purposes.

The principle requires that transfer of goods and services between associated enterprises should be made at market price like those would have been made between independent parties.[574] In context of this principle, the enterprise is regarded as associate of another if it participates directly or indirectly in either management or control or capital of an enterprise of another contracting state.[575] Or the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting states.[576]

Notwithstanding such requirement, there are no clear guidelines under circumstances a person is said to control the other for transfer pricing purposes. However, scholars posit that the notion 'control' should be used in its broader sense to include sufficient degree of control in relation to participation in management whether or not legally enforceable, directly or indirectly, whether horizontal or vertically.[577] However, in practice, the degree of control is different from member countries. For example, the threshold for control in Kenya for transfer pricing purposes is 25 percent of the share holding or voting power in the entity.[578] To the contrary, threshold control in Tanzania is 50 percent or more of the rights to income or capital or voting power through one or more corporations.[579] Generally, the arm's length principle applies to taxation of income to persons who are residents of one or any of the other

[574] Article 9(1) (b) of the EAC DTA.
[575] Ibid, Article 9(1) (a).
[576] Ibid, Article 9(1) (b).
[577] Blank M. et al., note 589 p.128.
[578] paragraph 32(1) of part IV of the second schedule of ITA CAP 470 RE 2014. For more details see discussion in chapter seven at para 7.3.2.1.
[579] Ibid, Section 3 (i) (bb). For more details see discussion on chapter six at para 6.4.3.2.

contracting states.[580] It means that for arm's length to apply, associated enterprises must be in different states. For that reason, associated parties operating within a country are excluded from the ambit of EAC DTA. The provision also excludes foreign controlled companies for transfer pricing purposes. In context of EAC countries, the purpose of arm's length principle is first, to secure appropriate tax base in each country where MNCs operate; second, to avoid economic double taxation and to attract foreign investors as well as cross border trade to the region.[581]

In essence, transfer pricing rules are avoidance rules aiming at elimination of double tax and encourage foreign investors in the region. The principle applies only when transfer price between associated MNCs is not at arm's length because of their special relations between them. It is in this context that Article 9(1) empowers revenue authorities of contracting states to adjust transfer pricing in accordance with arm's length principle. However, the EAC DTA is silent on modalities of adjustment for purpose of obtaining arm's length price. To the contrary, the EAC DTA clearly provides for corresponding adjustments with a view of elimination of double taxation.

The arm's length principle requires adjustment where one contracting state includes in the income of enterprises of the other state arm's length profits, which have been

[580] Ibid, Article 1. This means that non EAC enterprise related to an enterprise of EAC shall be subject the EAC DTA. This is important as EAC is not trading within its member states only; it also trades with other third countries including those in other regional communities such as COMESA and SADC. Similarly, foreign direct investments among EAC member countries are becoming increasingly important. Just like other regional integration such as ECOWAS[580] and European Union (EU) who have established specific transfer pricing laws to keep pace with requirement of raising revenue from profit of associated MNCs.

[581] Blank M. et al., The Double Taxation Avoidance Agreement of the EAC hand book, p.125.

charged in other state prices.[582] To this extent, the state, which made such inclusion, shall make an appropriate adjustment to the amount of the tax charged therein on that income. The adjustment can be made through deduction[583] or exemption[584] methods. However, corresponding adjustment cannot be made if it is time bared according to countries' laws of limitations,[585] except where there are fraud, default and neglect.[586] Likewise, where there is judgment duly made by judicial, administrative or other legal proceedings, adjustment of income of enterprises cannot be made.[587]

4.5.2.2 Resident Principle in EAC Context

In context of EAC, for arm's length to apply there must be a transaction between residents associated MNCs between contracting countries. A corporation is regarded a resident if it is incorporated under the laws of that state or if place of effective management is situated therein or any other criterion of similar nature.[588] Where the corporation has two or more contracting countries, the resident of such corporation is regarded to be where effective management is situated.[589] However, the EAC DTA is silent on meaning of 'effective management.' The income tax laws, which are referred to are also silent on meaning of effective management.[590] There is serious concern with determination of a residence of a company by using phrase 'effective

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[582] Article 9(2) of EAC DTA
[583] Ibid, Article 24(1).
[584] Ibid, Article 24(2).
[585] Ibid, Article 9 (3).
[586] Ibid, Article 9(4).
[587] Ibid, Article 9 (5).
[588] Ibid, Article 4(1). This article clearly excludes any person who is liable to tax in respect only of income from sources in that state.
[589] Ibid, Article 4 (3).
[590] See for example section 10 of ITA, Cap 340 of the laws of Uganda, Section 66 of ITA, Cap 332 RE 2008 of Tanzania and Section 2 (1) of ITA Cap 470 RE 2014 of the laws of Kenya.

management' to determine tax liability of MNCs. Van de Merwe, for example, argues that the phrase "effective management" is ambiguous because it ether refers to nature of management or level of management and management decision.[591] It is difficult to apply because each case is determined according to circumstances of a particular case.[592] On level of management, it is not clear at what level of management can residence of a company be determined, either at the place where activities are managed or at the place where actually broader, strategic decision are taking place.[593] He further posits that in determining residence of a company by using effective management, the following questions arise:- "who manages the company? At what management level is it important to determine residence? What is the nature of effective management? Is there any guidance to be instituted from management and control? Can there be more than one place of effective management?"[594]

Arguably, the notion of effective management is relevant to traditional trade where decision makers of companies used to meet physically at a particular place.[595] With the modern technology development in communications, decision makers of the companies are using video conference, electronic mails (e-mails), phone and the like. Furthermore, an idea of residence as a central key on principles and policies in relation to international taxation of foreign investment seems to be both outdated and

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[591] Van de merwe B.A., *Residence of A Company: Meaning of effective Management*, South Africa Mercantile Law Journal, 2002, pp79-92, p.81.
[592] Ibid.
[593] Ibid.
[594] Ibid 79.
[595] Oguttu A. W., *Resolving Double Taxation: The Concept of 'Effective Management' Analyzed from South African Perspective*, XLI No 1 The Comparative and International Law Journal of Southern Africa, 2008, pp 80-104p.86.

unstable.[596] Likewise, Kirsch points out that there is no substance connection between corporate tax residence and corporate economic attributes in a global economy.[597]Avi Yonah concludes that charging tax on residence basis is not very meaningful.[598] Scholars further argue that taxation on residence basis is easy and vulnerable to tax manipulations, in particular, for MNCs in shifting profit from one country to another.[599] The issue is, 'what will happen if profit of a whole company is generated by subsidiary of company X in country C but the such subsidiary is managed wholly in country Y? In context of transfer pricing, it creates room for manipulation of prices where the profit will be made in another country and therefore, the tax base in which subsidiary company operates may be eroded.

4.5.2.3 Permanent Establishment in EAC Context

In determining taxing rights of residents of associated MNCs and whether or not the corporation has presence in contracting countries, permanent establishment concept is employed. The East African Community Double Taxation Agreement (EAC DTA) defines permanent establishment as a fixed place of business through which

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[596] Graetz, M. J. and O'Hear, M. M., The Original Intent of U.S. International Taxation, Faculty Scholarship Series. Paper 1620, 1997, P.1066, available at http://digitalcommons.law.yale.edu/fss_papers/1620.Accessed 30th th August 2014.

[597] Kirsch M. S., Taxing Citizens in a Global Economy, Scholarly Works**,** 2007 Paper 547, p.480-483. available at http://scholarship.law.nd.edu/law_faculty_scholarship/547 Accessed 30th December 2014.

[598] Avi-Yonah R. S., International Tax as International Law, University of Michigan Law, Public Law Research Paper No. 41; Michigan Law and Economics Research Paper No. 04-007, 2004. Available at SSRN: http://ssrn.com/abstract=516382 or http://dx.doi.org/10.2139/ssrn.516382 , Accessed 30th December 2014

[599]Graetz, M.J., *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*,54 Tax Law .Review , 2001 p.261 and 320, Kirsch note 95, Kleinbard E.D., *The Lessons of Stateless Income*, 65 Tax Law Review 2011, p.99, Tillinghast D.R., *A Matter of Definition: 'Foreign 'and 'Domestic' Taxpayers,*'2 International Tax & Business Law, 1984, pp239, 267, Avi-Yonah, R.S Tax Competition and the Trend Onward Territoriality, University of Michigan Public Law Research Paper No. 297, 3 2012, available a*t* http://papers.ssrn. 2191251. Accessed 20TH December 2014

the business of enterprises is wholly or partially carried out.[600] Such permanent establishment includes place of management, a branch, an office, a factory, a workshop, a warehouse for storage facilities for others, a mine, a gas or an oil well, a quarry or any other place of extraction of natural resources.[601] Permanent establishment also encompasses a building site or construction, installations other than mines and natural resources, assembly or supervisory activities, which last for more than six months.[602] Furnishing of services and consultancy services through employee as well as other persons engaged if such activities continue for the same connected project for a period of aggregated more than six months within any twelve months constitutes a permanent establishment.[603]

For an insurance company, permanent establishment exists in a country where it collects premium or insured risks are situated.[604] Likewise, permanent establishment also can be formed if a person habitually exercises a general authority in the first-mentioned country to conclude contracts in the name of the enterprise, unless his activities are limited to purchase of goods or merchandise for the enterprise; or maintains in the first mentioned country a stock of goods or merchandise belonging to the enterprise from which he regularly delivers goods or merchandise on behalf of the enterprise.[605] The EAC DTA clearly excludes activities of preparatory or auxiliary character to form permanent establishment.[606] Likewise, permanent establishment cannot exist if it carries on business through broker, general

[600] Article 5 (1) of the EAC DTA.
[601] Ibid, Article 5 (2) (a) to (h).
[602] Ibid, Article 5 (3) (a).
[603] Ibid Article 5 (3) (b).
[604] Ibid, Article 5 (6).
[605] Ibid, Article 5 (a) and (b).
[606] Ibid, Article 5 (4) (a) to (f).

commission agent acting on the ordinary cause of their business.[607] From the fore discussions, it is clear that the concept of permanent establishment as a tax payer in the host country presupposes physical existence. However, with development of modern technology where communication is enhanced, it makes the physical requirement of permanent establishment as enshrined in EAC DTA to be applicable to physical permanent establishment only. It means that an existing requirement of existence of permanence as enshrined leaves out electronic transactions by MNCs. Consequently, MNCs may take advantage of the situation by conducting their international transactions through electronic means.[608] By using internet, MNCs are able to transfer goods and services between themselves all over the world without being easily interfered with revenue authorities of countries where transactions occurred.

4.5.2.4 Business Profit for Transfer Pricing Purposes

The EAC DTA sets a general rule that profit of enterprises should be taxed in the country where it is situated.[609] However, there are exceptions to this rule. Where an enterprise operates in another country through permanent establishment, it requires business profit attributable to permanent establishment to be taxed in the country where it is situated.[610] Article 7(2) requires each permanent establishment situated in contracting states to be taxed on attributable profit obtained under arm's length

[607] Ibid, Article 5 (7).

[608] Commonly known as e-commerce, which is defined as processes of carrying out commercial activities through electronics means by using internet where by voice, data and images take place in cyber space with little or no physical activities in absence of geographical boundaries. For more detail see Doernberg R and Hinnekens L., Electronic Commerce and International Taxation, 1999, p.3.

[609] Article 7(1) of EAC DTA.

[610] Ibid.

rate.[611] It means that any attributable profit between associated enterprises operating through permanent establishment relied on internal agreement will be subject to adjustment by revenue authorities in accordance with arm's length principle. In determining attributable profit amount, the EAC DTA sets a general rule that expenses incurred for business purpose, executive and general administrative cost should be deducted in the country where the permanent establishment is situated or somewhere else.[612] Accordingly, it prohibits any deductions, which are not allowed as deduction under laws of the country where the permanent establishment is situated.[613]

However, in determining profits of permanent establishment, amounts charged by head office of the corporation or any of its offices by way of royalties or fees in return for use of certain rights are not taken in to account except for banking enterprises.[614] Such loop holes may provide potentials for associated MNCs to manipulate prices. The agreement also excludes profit obtained by mere purchase of goods or merchandise by permanent establishment[615] Moreover, the EAC DTA requires that methods used to determine the profits attributable to the PE should be used on yearly basis unless there is sufficient reason to depart.[616] The rationale behind is to limit contracting states to change methods used so as to create certainty and consistency. However, the rule does not prevent contracting states to impose additional requirements in preventing duplications of accounting methods. EAC

[611] Ibid, Article 7(2).
[612] Ibid, Article 7(3) (a).
[613] Ibid.
[614] Ibid, Article 7(3) (b).
[615]Ibid, Article 7(5).
[616] Ibid, Article 7(6).

DTA clearly excludes business profits dealt separately in other provisions as a general rule.[617] They include dividend, interest, royalties and other incomes.[618] However, there are exceptions to this rule. In terms of dividend, where a beneficial owner of a dividend is a resident of the contracting state, carrying on business in other contracting state in which the company is paying dividend is resident through permanent establishment situated therein and holding in respect of which the dividends are paid is effectively connected with permanent establishment, Article 7 shall apply.[619] The EAC DTA defines the term dividend to mean income from shares or other rights, not being debt claims, participating in profits as well as income from other corporate rights subjected to the same taxation treatment like income from shares by laws of the contracting state of which the company making a distribution is a resident.[620]

Likewise, interest is taxed as business profit of permanent establishment if the beneficial owner of interest is a resident of a contracting state in which the interest arises through permanent establishment situated there in and the debt claim in respect of which the interest paid is effectively connected with it.[621] The term interest is defined to mean income from debt claims of every kind whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profit, and, in particular, income from government securities as well as income from bonds or debentures including premiums and prizes attaching to such securities, bonds and

[617] Ibid, Article 7(7).
[618] Ibid, Articles 10, 11, 12 and 23 respectively.
[619] Ibid, Article 10(4).
[620] Article 10 (3).
[621] Ibid, Article 11 (5).

debentures.[622] Accordingly, royalties are taxed as business profit of permanent establishment "if the beneficial owner of the royalties is a resident of contracting state in which the royalties arise through a PE situated therein and the right or property in respect of which the royalties are paid is effectively connected with such PE."[623]

4.6 Methods to Arrive at Arm's Length Price

The EAC DTA is silent on methods to arrive at arm's length price. Generally, such methods are enshrined under domestic transfer pricing regulations of contracting states.[624]These are comparable uncontrolled price, resale price method, cost plus method and profit split method.[625] Notably, the handbook is for training purposes for officials working in revenue authorities and Ministry of Finance of respective countries.[626] The purpose is to bring uniform application and interpretation of the DTA in all EAC partner states. This means that there are no transfer pricing guidelines at community level. Therefore, countries have discretion to make their own guidelines in determining arm's length price.

Likewise, the EAC DTA is silent on comparability aspect. However, in context of EAC DTA practical point of view, it is not necessary that comparables should be

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[622] Ibid, Article 11(4).
[623] Ibid, Article 12 (4).
[624] Income Tax (Transfer Pricing Rules) 2014 of Tanzania, Income Tax (Transfer Pricing) 2006 of Kenya, and Income Tax (Transfer Pricing) 2011 of Uganda respectively. For details of methods of countries under study see chapter six and seven respectively.
[625] Rule 5 (1) (a,b,c,d,and e) of Income Tax (Transfer Pricing Rules) 2014 of Tanzania, Rule 7 (a, b,c,d,and e) of Income Tax (Transfer Pricing) 2006 of Kenya; See also, Blank M. et al., Double Taxation Avoidance Agreement of EAC handbook, W.B. Druckerei GmbH, Hochheim am Main, Germany, p.123.
[626] Ibid, p.ix.

identical.[627] Thus, the comparability aspect is based on none of the differences that can materially affect the price or reasonable accurate adjustment that can be made.[628] Adjustments arising out of comparability may result in different arm's length price. It may be more or less the same with price between related parties. From practical point of view, different ranges of prices are allowed as transfer prices provided they are within the range of price compared.[629] Comparability analysis is based on OECD Guidelines because the EAC DTA is based on the OECD model. Consequently, domestic transfer pricing regulations are interpreted in line with OECD Guidelines. For example, Rule 9 of Income Tax (Transfer Pricing Rules) of 2014 of Tanzania clearly requires such rules to be interpreted in line with OECD and UN models. To the contrary, such requirement does not exist in Kenyan transfer pricing law. In addition, issues related to documentation requirement and transfer pricing audits are regulated by individual countries' domestic laws. While the EAC aims at bringing uniform interpretation within its member states, lack of clear transfer pricing Guidelines of the community may impede such desire from being obtained.

4.7 Transfer Pricing Dispute Resolution Mechanism in EAC

MNCs' operations in various countries have not been very smooth. While struggling to obtain profit in a cause of their businesses, they found engaging in dispute with tax authorities. It is common knowledge that tax avoidance is lawful and the tax payer is allowed to arrange tax affairs to minimize tax liability. However, MNCs have taken

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[627] This can be inferred from Income transfer pricing regulations of member states which requires adjustment to be made on comparables provided do not affect the expected arm's length price. See discussion in chapter 6 at para 6.4.3.2; See also Blank M. et al., note 633 p.146.

[628] Ibid.

[629] An interview with TRA officials. See also Income Tax (Transfer Pricing Rules) 2014 of Tanzania.For more details see discussion on chapter 6 at para 6.4.3.2

advantage of loopholes that are found in law to avoid tax beyond legal requirements. Accordingly, MNCs have been manipulating transfer prices by using the same laws either by over- or under- pricing goods and services transacted between them. To this extent, tax revenue of the host countries where MNCs operate comes in to play by auditing accounts of a particular company to establish such manipulation. When the revenue authority is satisfied that there is existence of any special arrangement, which amounts to manipulation of prices, the revenue authority makes adjustment to such prices by reflecting arm's length price. Thus, transfer pricing cases happen when the revenue authority is claiming its right share of tax, which it believes to be lost because the arm's length was not taken in account by MNCs, while MNCs claim that the arm's length principle was adhered to and no tax needs to be adjusted.

Generally, the EAC DTA does not provide specific transfer pricing dispute resolution mechanism. In case of any dispute arising out of this agreement, the person may take the matter to the competent authority within two years from the first date of notification. The person can take the matter for two reasons only. First, if it is being taxed not in accordance with the agreement and second, if a person is not handled according to nondiscrimination principle.[630] Arguably, there are no special provisions or guidelines in handling transfer pricing. Each country is handling such disputes according to its domestic transfer pricing laws.

[630] Article 26 of EAC DTA.

4.8 Conclusion

The preceding analyses lead to conclusion that EAC instruments provide arms' length principle in regulating transactions between associated parties. Currently the arms' length principle has been explained and applied in the context of OECD model. This is partly because such principle is derived from OECD model. It was imported to developing countries including EAC through liberalization of economy policies as a way of attracting foreign investors. Essentially, transfer pricing laws of EAC is a replica of OECD and UN models with slight modification. The EAC instruments do not take in to account issues related to extractive sector which its impact to transfer pricing manipulation is big.

Accordingly, rules related to taxation on source basis are weak compared to residence principle. Moreover, the instruments do not provide limitation of benefits provisions to limit other person to benefit from treaty. There is potential for such DTA to impose some problems in relation to transfer price manipulation like those caused by such models. This is because legislators seem to have failed to recognize and draw attention on growing legal challenges of international transfer pricing emerging from an increase in foreign associated MNCs' investments.

Accordingly, they have failed to make appropriate choices commensurate to the local context while taking in to account international transfer pricing standards in crafting domestic laws. The significant challenge in crafting transfer pricing laws commensurate with the local context is affected by desire of EAC countries to attract more foreign investors with a view of obtaining more tax, among other things. As a result, legislators have been enacting laws and policies, which attract more foreign

investors without taking in to account risks that may be associated with such steps, in particular, transfer pricing issues. Apart from desire to attract foreign investment, constant pressure from developed countries to follow international transfer pricing standards as a benchmark in reforming local transfer pricing laws has greatly influenced legislators to adopt such standards.

The five partners of the EAC, to date, have different provisions of law governing transfer pricing in their respective countries as discussed in this chapter. Each state, through its investment laws, appears to be competing with others to attract more strategic investors to supply its internal market.[631] It is clear that EAC member states, while showing interest in economic cooperation, they do not seem to be taking measures towards a common transfer pricing regime. The essence of the matter is that transfer pricing laws of the partner states are of wide variety, lacking coordination even clarity in some cases. Although arm's principle has been enshrined in various countries' anti- avoidance legislation its application is limited to certain transactions only. Furthermore, in EAC, issues of transfer pricing have not largely been tested in the court of law.[632] Arguably, EAC countries would need effective transfer pricing regime to contribute towards facilitation of foreign investment in the regional. The main concern is to find the best and appropriate approach commensurate with the level of economic development of EAC countries. Linked with this concern is relatively lack of capacity for EAC countries to invest across

[631] See discussion in chapter six and seven below.
[632] See for example Tanzania, Burundi Uganda and Rwanda. Only Kenya tested transfer pricing case as was in Unilever Kenya Limited v Commissioner of Income Tax, Income Tax case No. 753 of 2003 of the High Court of Kenya.

borders in particular, in developed countries [633] Yet, EAC countries have been involved in massive investment and market liberalization measures in promoting foreign investment such that they may be regarded as reaffirmation of their support for global approach of transfer pricing standards. Whilst the argument inherited from such focus might be valid, the implication arising from implementation of foreign investment facilitation arrangements may suggest a different conclusion. EAC tax administrators may sometimes find that complying with international accepted standards of transfer pricing as often developed at OECD level may put them to the disadvantage.[634] Consequently, it may be difficult for them to object the global approach in international transfer pricing regulations, which have enclosed standards that have already been accepted.

[633] UNCTAD, World Investment Report 2014, pp. 37-39. It is stated that Kenya has crossed to Asia countries.

[634] Ali-Nakyea A. et al., *International Transfer Pricing in Developing Countries*, International Transfer Pricing
Journal, 2013 (Volume 20), No. 6 November/ December 2013 pp 395 to 399 p. 395.

CHAPTER FIVE

AGRESSIVE TAX PLANNING AND TRANSFER PRICING MANIPULATION IN EAST AFRICA

5.1 Introduction

Traditionally, international transfer pricing law has evolved as tax avoidance legislation with respect to intercompany transactions by MNCs. The rationale is to allocate taxing rights and avoid double taxation for MNCs operating in more than one country. From developing countries' perspective such as EAC, transfer pricing laws were developed as means to promote greater inflow of foreign investments.[635] Hence, policies and laws are made to reflect such objective.[636] The tax avoidance laws on transfer pricing are mainly based on arm's length principle, which OECD and UN have agreed upon as international standards for transactions between MNCs. This has been reflected in domestic tax laws and multitude of DTAs concluded between countries on income and capital. However, underlying policies, approaches and interpretations seem to vary from countries to countries and in some instances it is unclear.[637]

This chapter invokes theoretical aspect of transfer pricing standards in considering the way associated MNCs have been using such standards to manipulate transfer

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[635] Para 4 of the UN model 2011, see also, United Nations Trade and Development, the 2002 Monetary Consensus Conference on Trade and Development , available at United Nations 2002, A/CONF/198/11 .

[636] See chapter one above.

[637] Riedel N et al., The Increasing Importance of Transfer Pricing Regulations: a worldwide overview, Oxford University Centre for Business Taxation Said Business School, Park End Street, Oxford.OX1 1HP p. 6.

pricing under the auspices of tax avoidance. Use of transfer pricing standards and principles through aggressive tax planning to facilitate manipulation of transfer pricing is discussed. It is argued that existing transfer pricing standards provide potentials for associated MNCs to manipulate transfer prices. The BEPS Action plan, which came to rescue failure of existing transfer pricing standards is reviewed and analyzed. The chapter concludes by showing that the existing international efforts through BEPS action plan to curb transfer pricing manipulation essentially are not departing from arm's length principle.

5.2 Relationship between Tax Treaties and International Transfer Pricing

The increase of MNCs' operations in the globe and desire to attract foreign investments has brought enormous policy challenges with regard to international taxation. Such operations have put countries on how to allocate taxing rights on income generated out of MNCs' transactions in countries where they operate. Difference in tax laws between countries, which were normally exploited by MNCs to avoid tax beyond legal requirement, is another challenge. Ordinarily, countries have the right to tax income arising within the country.[638] In this context, foreign investment in the host country in which income is attributable to permanent establishment initially derived would have the first right in taxing such income.

Consequently, the home country of foreign investor would be left with no taxing or residual taxing rights.[639] Consistent with this there is no contractual obligation

[638] This is according to territorial principle of international law.
[639] Michael L., *The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current points of Differences and Recent Development*, Asia – Pacific Tax Bulletin, January /February 2009, p.4.

between the foreign investor and the host country to enforce taxing rights in the investor's country in case of tax dispute. If the resident country would use unilateral exemption system to prevent double taxation, no tax would be collected on income derived from the source country. Likewise, if unilateral credit system is used it would only collect tax to the extent if any, that its tax rate exceeds that of the source country.[640] Thus, the DTAs came in to play to capture taxes having foreign elements, which countries are unable to capture. Consequently, it necessitated countries to change unilateral and domestic laws to adopt double tax agreements (DTAs) to capture such tax. The OECD and UN conventions are tax treaties made as models upon which countries refer when crafting their transfer pricing laws. Both UN and OECD models present an important form of technical assistance upon which existing and future bilateral tax treaties commonly known as double tax agreements (DTAs) are based.[641] From developed countries' perspective, the conclusion of tax treaties between them is seen as an important aspect to trade and investment.[642] Developed countries were also investing in developing countries felt that the then existing tax treaties between them were not working well to developing countries as rightly pointed out by Fiscal Committee of the Organization for Economic Co-operation and Development that,

> "*Existing treaties between industrialized countries sometimes require the country of residence to give up revenue. More often, however, it is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the*

[640] Ibid. See also Mc Gauran K., note 30, p.11.
[641] Economic and Social Council resolution 1541 (XLIX).
[642] OECD., Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee, Paris, 1965, para 163.

> *revenue sacrifice would be one-sided. But there are many provisions in existing tax conventions that have a valid place in conventions between capital-exporting and developing countries too.''*[643]

Developed countries also were of view that tax treaties could benefit developing countries in a way they do to developed countries.[644] It is in this context that UN Economic and Social Council set an *ad hoc* group of experts and tax administrators to formulate tax treaty guidelines[645] between developed and developing countries. The result was that the UN model as model convention for developing countries came in to play. From developing countries' conclusion of DTAs, it is seen as means to attract foreign investments and to avoid double taxation.[646]

Generally, DTAs are enabled by substantive laws of a particular country.[647] By signing DTAs, states invariably give up some taxing rights, the extent of which is subject to lengthy and complex treaty negotiations with another state whereby mutual investment takes place.[648] Contracting countries expect equal rights on apportionment of tax that arises from international transactions. This is possible if both countries have more or less the same level of investment.

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[643] Ibid, para 163 and 164.

[644] Ibid, para 163. On its opinion Fiscal Committee of the Organization for Economic Co-operation and Development stated that "the traditional tax conventions have not commended themselves to developing countries". Therefore there was a need to help developing countries to develop tax treaty guideline. see para 164.

[645] Economic and Social Council of the United Nations, Resolution 1273 (XLIII) adopted on 4 August 1967. From Africa, Ghana, Tunisia and Sudan were members to the ad hoc group. These efforts were influenced by developed countries.

[646] see for example DTA between Denmark and Tanzania for avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, 1976 which came in to force 1st January, 1977, see also Agreement between Canada and United Republic of Tanzania for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, 1996 which came in to force 29th August 1997.

[647] See for example section 41 of ITA Cap 470 RE 2014.

[648] Mc Gauran, note 30p.12

Accordingly, the invariably given up taxing rights may be offset by reduction in administrative burden in investment and hence, accrue revenue for both countries.[649] The situation is different when DTA is signed by two countries with different investment levels, particularly between developed and developing countries. The developing countries most likely are mere capital importers and therefore, trading off taxing rights might not be the same. This is because home countries where investments are sourced retain taxing rights on profits earned by their corporations in host countries through resident principle. Since countries have given up some taxing rights, it is not easy for developing countries like EAC to offset such taxing rights.

The situation becomes worse when developing countries signed DTA with tax haven countries[650] whereby there is possibility for MNCs to use for treaty shopping purposes.[651] The fact that arm's length is enshrined in model tax conventions in which countries have adopted in their respective countries, DTAs and domestic laws provide a direct link with transfer pricing. Accordingly, other standards that link with determination of arm's length price are also enshrined in the convention models. Application of such standards provides potential challenges in applying arm's length principle to curb transfer pricing manipulation.

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[649] Ibid.

[650] See DTA between Tanzania and Switzerland, Uganda and Netherlands.

[651] Treaty shopping is a "graphic expression used to describe act of resident of a third country taking advantage of a fiscal treaty between two contracting states" see *Union of India and Azadi Bachao Andolan* [2003] SC 56ITR India P. 113; In EAC for example, Uganda has DTA with Netherlands which is regarded as tax haven country, there is possibility of MNCs to set conduit entities for purpose of enjoying favorable terms of the treaty resulting in profit shifting through transfer pricing.

5.3 International Transfer Pricing Standards and its Link to Price Manipulation

Although every DTA has a particular language, several standards are shared between majorities of double tax instruments. Standards that are commonly found in DTAs include allocation of taxing rights between contracting countries, defining persons who are entitled benefits of treaty, tax avoidance and relevant tax principles between contracting countries, exchange of information, mutual agreement, non-discrimination and anti-treaty shopping provisions.[652] Although such standards are not expressly addressing transfer prices, they provide basis upon which both tax authorities and MNCs consider when dealing with transfer prices. Accordingly, they are the same standards and laws that may be used by MNCs under the umbrella of tax avoidance to manipulate transfer prices. The following part examines principles and standards as they link and implicate international transfer pricing manipulation.[653]

5.3.1 Application of Arm's Length Principle

The EAC countries have included arm's length principle in their DTAs and domestic laws.[654] The principle is premised in comparability of transactions between associated and independent parties based on their economic or financial relations. The principle requires transactions between associated MNCs to be delineated first and then compared to an independent transaction. This is achieved by using functional analysis through relevant economic factors. Methods to arrive at arm's

[652] See OECD and UN models. For more details see chapter 3.
[653] This particular part is discussed in context of EAC.
[654] See article 9 of DTA between Tanzania and Canada, Kenya and UK, Uganda and Netherland, EAC double tax agreement.

length are employed in making such comparison.[655] Where it is established that a delineated transaction is more or less the same with transaction of independent parties, then transfer price between associated parties is said to be arm's length price. The fact that arm's length principle is based on comparability; arguably, in absence of comparables it may render application of arm's length inapplicable. In due regard, associated MNCs may take advantage of the situation. For example, it is common knowledge that in developing countries like EAC countries, most investors import technology on their area of investment. It is likely that such technology may miss comparables.

Apart from comparables, there is no requirement for hierarchal application of methods to arrive at arm's length price and the taxpayer is at liberty to choose any method that deems fit for its transaction. The problem is that the taxpayer may choose a method that may favour its interest even if other methods could be highly appropriate for such transaction.[656] Accordingly, the interplay between arm's length principle and other standards that provide bases for transfer pricing provide potentials for transfer pricing manipulation.

5.3.2 Allocation of Taxing Rights

The DTAs that EAC countries have concluded specify standards for allocation of taxing rights for MNCs' income operating in contracting countries.[657] The standards require that source country to tax active income only if they are attributable to

[655] For more details on methods to arrive at arm's length price see discussion on chapter 2.

[656] In practice however, CUP is regarded as a traditional methods and associated parties ought to use that method first before embarking to other methods.

[657] Cooper J. et al., Transfer Pricing and Developing Economies: A handbook for Policy Makers and Practitioners, Directions in Development. Washington, DC: World Bank. doi:10.1596/978-1-46480969-9. License: Creative Commons Attribution CC BY 3.0 IGO, 2016, p.35.

permanent establishment.[658] This means that a permanent establishment cannot pay corporate tax in the host country. The right to tax passive incomes such as dividends, interest and royalties is completely removed from source country unless there is permanent establishment with a specified rate that the source country can impose tax.[659] Such standards also set limits upon which a source country can tax passive income. For example, both DTAs between Canada and Tanzania and UK and Kenya require source country to tax passive income amount, which does not exceed 15 percent of gross amount of such income.[660] The requirement that business profit in context of transfer pricing be taxed on resident basis and limited right to tax passive income by source country entails that MNCs are entitled more taxing rights than source country. This implies that EAC as source countries are denied their right share of tax, which could be obtained from MNCs' transactions. Arguably, this is the effect of OECD based DTAs because such standards were set to reflect developed countries, in particular, OECD members' interests in reducing source based taxation of capital exporting enterprises.[661]

In context of transfer pricing, allocation of taxing rights is done by using arm's length principle. Such principle requires business profit of associated enterprises to be taxed separately at a market price as if they are independent parties.[662] Such allocation is made by adjusting business profits believed not to be taxed under arm's

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[658] Article 7(1) of DTA between Canada and Tanzania; see also Article 8(1) of the DTA between UK and Kenya.

[659] Ibid, Articles 10 (1), 11(1) and 12(1), see also, Articles 11 (1), 12 (1) and 13 (1) of DTA between UK and Kenya.

[660] Ibid, Article 10 (2) (a), 11 (2) and 12 (2), see also Article 11 (1) (b), 12 (2) and 13(2) of DTA between UK and Kenya.

[661] McGauran, K., note 30 p.14.

[662] Article 9 of DTA between of Canada and Tanzania and Article 10 of DTA between UK and Kenya. For more details on arm's length principle see chapter 3.

length principle. Thus, a source country will potentially be expected to align its transfer pricing law in a manner that is in line with DTAs. To import such principle may mean to protect profits of MNCs. The right to tax passive income on resident basis as enshrined in EAC countries' DTAs gives room for MNCs to manipulate transfer prices that may arise out of passive income such as interest. For example, for MNCs to establish and manage their activities, they require equity or debt capital.

When a new subsidiary company is established, the parent company may finance working capital in short-term until it starts making profit. Such capital may be equity, which increases the credit base of the company or loan and shows in the debt column of the company's account such that it will have to be paid with interest.[663] In context of transfer pricing, when determining arm's length interest, the rate of interest on loan, capital amount of the loan, the currency and the credit worthiness of the borrower must be considered.[664] When a company is having higher level of debt capital than equity, it is said to be thin capitalized.

The result is that profits from the new subsidiary may be repatriated to repay debt at an interest rate higher than arm's length price. Consequently, the EAC countries may lose their share of tax because such an income may be shifted from one entity to another in form of interest payable on loan amount.[665]

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[663] Cobham, A., et al, note 37. p. 5.
[664] Ibid,
[665] Although substantive laws of countries provide for thin capitalization ratios, the interpretation of treaty prevails over countries law and therefore there is little host country could do.

The DTAs also require that any other income not dealt with in other articles of such DTA be taxed only by resident country.[666] Basically, the principle extends more taxing rights to resident than source country. Arguably, such principle would work well if both contracting countries have more or less some level of economic development with reciprocal investments. In this context, both contracting countries stand to benefit from such income that may arise and not deal with other provisions of the particular DTA.[667] To the contrary, EAC countries are having low level of economic development and therefore, they have no capacity to invest in developed countries that they signed DTAs. It means that EAC countries stand to lose more tax than developed countries. Implementation of such principle would mean that associated MNCs, in context of transfer pricing, may allow permanent establishment to take advantage to generate incomes not covered by particular DTA such that they would be taxed on resident basis only. It implies that tax rights as allocated in DTAs potentially play a role of shifting taxing rights from source country to resident country of an investor or to tax haven countries.[668]

5.3.3 Qualification for DTA Benefits

Normally, DTAs provide persons entitled to benefit from such agreements with a view of ensuring that taxing rights are allocated accordingly. EAC countries' DTAs have concluded and adopted meaning of legal persons for purpose of enjoying treaty benefits. DTAs grant benefits to residents of both contracting countries who are

[666] Article 22(1) of DTA between Canada and Tanzania; see also Article 24 of DTA between UK and Kenya.

[667] This requirement may work well within EAC because the level of economic and investment is more or less equal.

[668] Busse M., et al The relationship between double taxation treaties and foreign direct investment.2010, p.5 available at http://www.researchgate.net/publication/210417692 assessed30th June 2015.

liable for tax therein by reason of domicile, residence, place of effective management, place of incorporation or any other criterion of similar nature.[669] Accordingly, domestic laws have also adopted the same meaning.[670] In context of such definition, a corporation is a resident of that state if it is incorporated or where the place of effective management is situated.[671] Furthermore, the definition of residence includes any other "criterion of similar nature" in determining residence of a corporation for treaty benefits and allocation of tax rights. This definition is open-ended because it has potential to cover other legal entities, depending on MNCs' activities. The broad definition of residence is influenced by the character of MNCs' operations operating across countries. It is argued that qualification of corporation as a residence by way of 'effective management' and any other 'criterion of similar nature' may create room for taking a variety of legal entities that evolve in response to creativity of MNCs' activities in profit maximization. It may include special purpose entities[672] or companies, which have no physical activities in a particular

[669] Article 4 of the DTA between Tanzania and Canada.
[670] Section 66 4 (a) and (b) ITA RE 2008.
[671] See article 3 (a) and (b) of DTA between Tanzania and Canada. For meaning of effective management See discussion chapter 3.
[672] The OECD definition of SPEs is as follows: "Multinational enterprises (MNEs) often diversify their investments geographically through various organizational structures. These may include certain types of Special Purpose Entities. Examples are financing subsidiaries, conduits, holding companies, shell companies, shelf companies and brass-plate companies. Although there is no universal definition of SPEs, they do share a number of features. They are all legal entities that have little or no employment, or operations, or physical presence in the jurisdiction in which they are created by their parent enterprises which are typically located in other jurisdictions (economies). They are often used as devices to raise capital or to hold assets and liabilities and usually do not undertake significant production. An enterprise is usually considered as an SPE if it meets the following criteria: *(i)* The enterprise is a legal entity, a. Formally registered with a national authority; and b. subject to fiscal and other legal obligations of the economy in which it is resident. *(ii)* The enterprise is ultimately controlled by a non-resident parent, directly or indirectly. *(iii)* The enterprise has no or few employees, little or no production in the host economy and little or no physical presence. *(iv)*Almost all the assets and liabilities of the enterprise represent investments in or from other countries. *(v)* The core business of the enterprise consists of group financing or holding activities, that is – viewed from the perspective of the compiler in a given country – the channeling of funds from non-residents to other non-residents. However, in its daily activities,

country, but may qualify for benefits under DTAs.[673]Accordingly, such DTAs do not provide any test to qualify a corporation or any other legal entity to treaty benefits. For example, requirement that the corporation must itself carry on business in a whole or part in the country of residence or the corporation must not be merely an investment holding company not carrying business at all.[674] The implication of this is that it not only broadens the scope within which resident corporations may be created but also it widens obligation of the source (host) country in dealing with transfer pricing issues between associated MNCs.

The importance of such criterion is that the EAC becomes vulnerable to transfer pricing issues in the following scenarios: Firstly, there is potential for the host country to lose right share of tax because more taxing rights are on residence basis of MNCs. Accordingly, EAC countries have no reciprocal investments with developed countries that they signed DTA and hence, they do not have corporation, which can be taxed on residence basis to benefit them. Secondly, MNCs have capacity to establish special purpose entities that may be used to shift profit obtained from transfer pricing manipulation. Accordingly, MNCs have large networks of DTAs that they may use treaty shopping[675] advantage and make difficult for host country to

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managing and directing plays only a minor role." See the 4th Edition of the OECD Benchmark Definition of Foreign Direct Investment.

[673] Although interpretation of DTA require adherence of Vienna Convention that in case of conflict, provisions of treaty need to be interpreted in good faith, and that provision of treaty prevails in case of conflict. Conduit entities may fall within DTA because of any other criterion notion embodied in DTAs. This is so because in interpreting provision of treaty, definition of particular treaty prevails over other methods of interpretation. Again, notion of 'good faith' as enshrined in DTAs is vague and not measurable. See Vogel, K., note 262.

[674] Ward D.A., Access to Tax Treaty Benefits, Advisory Panel on Canada, Research Report prepared for Advisory Panel on Canada's System of International Taxation, 2008, p. 4.

[675] Treaty shopping is a "graphic expression used to describe act of resident of a third country taking advantage of a fiscal treaty between two contracting states" see Union of India and *Azadi Bachao Andolan* (2003) SC 56ITR INDIA P. 113.

implement anti-treaty measures. Thirdly, in case of transfer pricing dispute, it may be difficult for EAC to conduct audit and obtain comparables for functional analysis purposes. Generally, the broad definition of residence of a corporation provides potential for manipulation of transfer prices between associated MNCs. Such potentials are exacerbated by the fact that EAC tax authorities have low administrative capacity to handle transfer pricing issues.[676] Hence, MNCs stand to benefit more on residence principle than the source country.

5.3.4 Exchange of Information and Administrative Cooperation

Exchange of information is another principal enshrined in EAC countries' DTAs.[677] The essence of this principle is that tax revenue of contracting countries should be able to obtain information on financial and economic activities of their residents, either corporations or individuals operating across countries for purpose of enforcing tax compliance. This principle offers foundation for assistance, cooperation and coordination in resolving enforceability of international tax problems between contracting countries. However, exchange of information for tax purposes is not automatic and it can only be obtained upon request. Yet, the country, which information is requested from is not treated to be under obligation to do so.[678] From EAC countries' perspective, tax transparency prays an important role because manipulation of transfer prices by MNCs is an obstacle in obtaining their right share of tax. Thus, use of this principle could be useful for EAC countries. The gist of the matter is that arm's length principle requires analysis of various data used by a

[676] Absence of transfer pricing cases in some of EAC countries may be taken as evidence.
[677] Article 30 of DTA between Canada and Tanzania.
[678] Article 30 of DTA between Tanzania and Canada.

taxpayer to establish whether or not the principle was followed. To the contrary, inclusion of exchange information does not ensure detection of manipulation of prices. A mere request of information cannot detect such offences. From legal point of view, strong evidence needs to exist so as to request information from another country. This is because the DTAs do not make exchange of information between contracting countries as mandatory and such situation poses serious difficulties for effective information exchange. Since manipulation of prices is within parameters of tax planning associated with lack of transparency, it means that even initial suspicions are hard to prove in absence of reliable information.[679]

5.3.5 Elimination of Double Taxation

Another important feature of DTAs, which EAC countries have concluded thus far enshrines requirement for elimination of double taxation.[680] It was the original role of double tax treaties.[681] The methods are credit and exemptions. Significance of these provisions is that an investor is entitled to be relieved from paying tax on income, which he has paid in a home country. Arguably, this would require reciprocity of investment from both contracting countries. Since EAC countries are unlikely to have investment in developed countries, they stand not to benefit from such relief. However, most double tax relief has been solved partly through domestic legislation provided through credit and exemption.[682] As the resident country is given

[679] McGauran, K . note 30 p.19.
[680] Article 24 of the DTA between Canada and Tanzania, see also article 26 of DTA UK and Kenya.
[681] League of Nations, Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations, League of Nations document no. F.212, Geneva: League of Nations, February 7, 1925.
[682] Article 24 of EAC DTA. See also McIntyre M.J., legal Structure of Tax Treaties, 2003 revised edition 2010 p.2 available atwww.iatj.net/.../**LegalStructureofTaxTreaties**.-M.McI, Accessed

more taxing right, it is also obliged to avoid double taxation. The credit method entails the resident remaining liable in the country of residence on his or her worldwide income. Any lowering of tax rates in the source state is calculated against the resident state's tax rate, leading to one tax rate for the investor. In context of transfer pricing, however, significant problems of double taxation still exist. It happens when revenue authorities make adjustment in arriving at arm's length price on the income, which might be already paid tax in another country. Accordingly, given the complexities involved in arriving at arm's length price, there is a danger of MNCs not to pay tax on either country.

Thus, it is submitted that arm's length and other transfer pricing standards as enshrined in EAC countries' DTAs and in tax convention models are vulnerable to transfer pricing manipulation between associated MNCs. Yet, EAC countries are still embracing such standards. The embracement may be inferred due to fear from discouraging investments, which have been seen as important means to develop their economies.[683] Recall, such standards as enshrined in EAC countries' DTAs are based on OECD model.[684] Accordingly, investors from OECD countries prefer OECD model to be applicable because it favours residence principle. Given lack of reciprocal investment from EAC countries, there is no equal bargaining power when negotiating with such countries.[685] The effect of OECD model lock in provides potentials for EAC countries to incorporate international norms of transfer pricing,

1.May 2015, stating that, "tax treaty to day seems reaffirming the operation of the credit or exemption system that most countries have unilaterally adopted to prevent double tax".

[683] See discussion chapter 4.

[684] See article 9 of DTA between Tanzania and Canada, Kenya and UK, Uganda and Netherland, EAC double tax agreement.

[685] In this context EAC countries are likely to face pressure from their investors' home countries to embrace OECD transfer pricing standards.

which, to a great extent, remains unenforceable.[686] This is evidenced by either few or absence of transfer pricing cases in EAC. For example, to date there is no transfer pricing case that has been decided in Tanzania, but only in Kenya few cases including one land mark case of Unilever.[687] Thus, policy makers and legislators fall in dilemma of interaction of competing considerations of the need for raising tax revenue and the need for attracting foreign investments. The UN model, which is made for developing countries provides for, to a lager extent, but not exclusive right for countries to tax on source basis. As indicated before, one purpose of the UN model is to help developing countries in their tax treaty negotiations with developed countries.[688] However, more that 80 percent of its provisions are adopted from OECD model, save for few provisions, which are either new or are highly brood. For example, the definition of permanent establishment under the UN model is broader than the OECD model.[689] The UN model also provides limited force of attraction rule that aims to deter manipulation of permanent establishment attribution rules. Likewise, the UN definition of royalties is broader than the OECD model.[690]

Although the UN model is made for developing countries, it failed to solve the existing dilemma. The failure of UN model to solve such dilemma is caused by the following reasons: Firstly, evolution and changes of UN Model have always been

[686] "Many developing countries have included in their tax legislation some of the measures requested by the OECD Report on Harmful Tax Competition, e.g. transfer-pricing regulations based on OECD guideline" See also, OECD note 22.
[687] An interview with TRA officials in Tanzania and KRA Kenya.
[688] Resolution 1273 (XLIII*)* of the Economic and Social Council of the United Nations.
[689] See art. 5 of UN model, on 12 months period.
[690] Article 12(3) of UN model.

towards increasingly similarity with the OECD model.[691] Consequently, the OECD model has capacity to induce or destroy other models like the UN model. Secondly, there is lack of global international tax instrument, which is above all other convention models capable to regulate both developed and developing countries. Thirdly, EAC countries may be lacking political power and influence on treaty negotiation(s) with developed countries.

5.4 International Tax Planning and its Linkage to Transfer Pricing Manipulation

Apart from tax treaties in playing a significant role in transfer pricing manipulation, activities of tax advisers under auspices of tax planning significantly contribute to manipulation of transfer prices by MNCs. It is common knowledge that before starting business, normally, MNCs seek advice from tax advisers on how best they can position their investments to minimize tax payment in a certain country.[692] The main preoccupation is to see that MNCs minimize tax liability in their world wide incomes. This is sought to be achieved by evaluating tax implications of various investments and their strategies.[693] Such responsibility is attained through contracts between MNCs and tax advisers in regard to tax arrangements of their businesses across countries. Since tax arrangements are done within auspices of tax avoidance, they have a direct impact on transfer pricing manipulations. This part focuses on how

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[691] Kosters B., *The United Nations Model Tax Convention and its Recent Developments*, 4 Asia-Pacific Tax Bulletin 7, 2004 arguing that ''The 2001 UN model made some changes to the 1980 version of the UN model and with regards to the text, the bulk of the changes were made with a view to bring the UN model more in line with the OECD Model'') See also Baistrocchi E., *The use and interpretation of tax treaties in the emerging world: Theory and implications,* in British Tax Review, 2008 Issue 4,p.374.

[692] This is in line with the transaction cost theory for establishment of MNCs. It should be noted that the common tax advisers are KPMG, Ernest and Young, PWC and Delloite among others.

[693] Interview with KPMG Tanzania office and Paulclaim accounting firmDar es Salaam.

tax avoidance provisions are used by associated MNCs to manipulate prices by avoiding tax beyond legal requirements. This may be useful for EAC legislators in developing appropriate responses to transfer pricing manipulation problem.

It is common knowledge that every person, whether an individual or legal person, has duty to pay tax on taxable income according to laws of the particular country. The taxpayer ought to interpret provisions of tax legislation with the view of complying with law requirements. Unlike other laws, tax legislation are notoriously susceptible to different interpretations. Consequently, doubt may arise about the exact tax results from a transaction as well as freedom of contract that enables a choice in the legal form of a transaction or an entity.[694] To create certainty in such situation, the law allows tax payers to take advantage of the law if such law does not create liability to pay tax or to arrange its affairs to pay less tax, which is commonly known as tax avoidance. Generally, tax avoidance is lawful and allowed for three related reasons: Firstly, tax payers are entitled to follow onerous interpretation of ambiguous tax legislation. Secondly, taxpayers may exercise freedom of contract and commerce to opt for legally permissible arrangement(s) of affairs and can take in account options, which are cost-effective including the least onerous tax burden. Thirdly, government designs tax laws that offer a lower tax burden to taxpayers in defined circumstances.[695] It is within this ambit that tax planning comes in to play to allow taxpayer exercise freedom of contract and commerce in arranging tax affairs with a view of minimizing tax burden. In essence, tax avoidance places an obligation

[694] Hattingh J., Anti Avoidance Rules, a paper presented at first African tax symposium, Victoria falls Zambia, 18-19 May 2015.
[695] Ibid.

to taxpayers to plan their tax affairs while taking incentive of the law without infringing the spirit of the law and legislators' intention.

Tax planning "is a process of taking into consideration all relevant factors in light of the material non-tax matters for the purpose of determining whether or not and if so, when, how and with whom to enter into and conduct transactions, operations including relationships with the object of keeping the tax burden falling on taxable events and persons as low as possible while attaining the desired business plus other objectives."[696] Tax planning is lawful and is allowed under the law of different countries under tax avoidance rules.[697] Both tax avoidance and tax planning are arrangements, which aim at lawful reduction of tax liability of the tax payer. However, the former entails securing loopholes in tax laws and minimize its tax liability within parameters of the law,[698] while the latter not only secures loopholes but also ensures compliance with tax obligation to avoid penal provisions.[699] However, "tax planning may reach a point beyond which it cannot be tolerated within a legal system intended to conform to principles of justice",[700] commonly known as aggressive tax planning or aggressive tax avoidance.[701]

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[696] Duhia N.M.F., Advance Tax Practice 1, A Paper Presented at Tanganyika law Society Tax Law Practice Training 22nd -25th July 2014 Beach Comber Dar es salaam. The objectives of tax planning are minimization of tax liability or realization of tax savings or the elimination of tax liability altogether but within the legal requirements. Accordingly it ensures availability funds to meet any tax obligations and to minimize litigation thereby saving time, hardships and costs.

[697] See for example section 23 of ITA Cap 470 R.E 2014; see also CA: Canada Revenue Agency, *Tax Avoidance*, available at http://www.cra-arc.gc.ca/gncy/lrt/vvw-eng.html, Accessed 20 August 2015.

[698] See OECD, *Glossary of Tax Terms*, available at: http://www.oecd.org/ctp/glossaryoftaxterms.htm#E Accessed 2015 which defines tax avoidance as arrangement of a taxpayer's affairs that is intended to reduce his tax liability. Although the arrangement could be legal (i.e. in line with "the letter of the law"), it is usually in contradiction with the intent of the law it purports to follow (i.e. against "the spirit of the law").

[699] Ibid.

[700] Vogel K., note 262, p 117.

[701] For the purpose of this work aggressive tax planning is used.

Generally, there is no clear demarcation between aggressive tax planning and tax avoidance. However, MNCs usually use schemes that fall between tax evasion and tax avoidance and take advantage of variation of laws between countries.[702] Sometimes the distinction between aggressive tax planning and tax avoidance can be made by courts.[703] It is submitted that tax avoidance is the one that results in benefits that are intended by the legislatures. To the contrary, aggressive tax planning is one that results in benefits that are not intended by the law and infringes the spirit of the law together with purpose of the legislator.[704] However, it can be argued that the difference between lawful avoidance and aggressive tax planning can be inferred from the taxpayers' intentions. If there is malice aforethought, it may amount to unlawful avoidance. If there is no intention then, it amounts to lawful avoidance. The link between aggressive tax planning and MNCs is that the former arranges associated MNCs' affairs such that profits are earned where they are taxed at the lowest possible rates and expenses are incurred where their deductions yield the greatest tax relief.[705]

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[702] Hattingh J., note 694. Tax evasion is an illegal act of not paying taxes intentionally. This is done either by under reporting business income, deliberately underpaying taxes owed. In most countries tax evasion is a criminal offence.

[703] In *IRC v Willoughby* [1997] STC 995, 2004, The House of Lords described aggressive tax avoidance "as a course of action designed to conflict or defeat the evident intention of parliament". Merks P., Tax Evasion, Tax Avoidance and Tax Planning, *34 Intertax 5* 2006, p. 281.

[704] Ogazón Juárez L.G., and Hamzaoui R., '*Common strategies Against Tax Avoidance: A Global Overview*,' in Madalina Cotrut, International Tax Structures in the BEPS Era: An Analysis of Anti – Abuse Measures, ed. IBFD e book, 2015 p.4 describes aggressive tax planning as arrangements that "push the limits" of acceptable tax planning and would fall into the realm of tax avoidance. Similarly, tax avoidance exists where a taxpayer seeks to obtain a tax advantage by means of sham or artificial transactions, considering that the law could not have intended to grant a tax advantage in such way.

[705] Arnold B.J. and Wilson J.R., Aggressive International Tax Planning by Multinational Corporations: The Canadian Context and Possible Responses, School of Public Policy, University of Calgary, SSP Research Papers, Vol.7 Issue 29, September 2014. p.17.

5.4.1 Transfer Pricing Manipulation Schemes

As stated before, aggressive international tax planning is done by tax advisers. The obligation of such advisers is to ensure that MNCs exploit difference in gaps in the relevant countries' tax laws as well as create opportunity to reduce, defer or eliminate MNCs' overall tax liability. The implication is that tax advisers always look out for new schemes and new ways to exploit weaknesses of the law. They promote tax avoidance schemes to their clients that are sometimes not legally available. The said advisers may advise MNCs in complex strategies and contrived structures that may not reflect the substance of their business and instead, they would be designed to avoid tax.[706] Such avoidance schemes are often informal arrangements created to obtain tax benefits of the client by reducing their tax liability, while they contravene intention of legislators that give benefits to tax advisers.[707] The interplay between associated MNCs, tax haven, tax arbitrage, qualified and experienced lawyers and accountants and less aggressive transfer pricing laws is a key to obtaining such objective. However, not all tax planning amounts to transfer pricing manipulation. One of the objectives of aggressive tax planning is minimization of taxation in a foreign operating or source country to high tax jurisdiction either by shifting gross profit via trading structures or reducing net profit by maximizing deductions at the taxpayer level.[708] Aggressive tax planning provides for a direct link with international transfer pricing in that tax avoidance schemes, which do not reflect substance of associated MNCs' businesses involve

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[706] House of Commons Committee of Public Accounts, Tax avoidance: the Role of Large Accountancy Firms (follow-up), Thirty- Eighth Report of Session 2014 -15, January 2015 p.4.

[707] Australia Taxation Office, Tax Planning, available at https://www.ato.gov.au/General/Tax-planning. Accessed 20th December 2015.

[708] OECD note 246.

transactions between associated MNCs uses transfer pricing. To achieve this objective, various avoidance schemes are used by associated MNCs to manipulate transfer prices. The schemes depend on the transaction used. The common transaction involves tangible goods, intangibles, services and intra-group financing.[709]

5.4.1.1 Under or over- Pricing of Prices and Invoices

This scheme involves over- or under- pricing of prices or invoice of goods transferred between associated companies with a view of shifting profit. For example, in 2012, it was discovered that Resolute Goldmine Tanzania Limited was selling gold at US$530 per ounce to an associated company outside Tanzania. At that time, market price of the gold was US$1,200 per ounce.[710] The tax lost from such scheme was substantial amount of royalties for the use of the mine. Over-invoicing entails that invoices for goods transferred between associated parties do not reflect the actual amount of transferred goods. For example, in 2011, it was established that India reported to import 120,000 tons of cashew nuts from Tanzania. However, an export company from Tanzania reported to have exported 80,000 tons.[711] Through such scheme, export tax and corporate tax for 40,000 tons that were not charged were lost. Such over-invoicing was also noted on fuel transactions imported in Tanzania, which had import duty exception for mining in companies.[712] Notably, such miss

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[709] Price Waterhouse Coopers, *International Transfer Pricing*, 2008.

[710] Bomani Mining Review Report of 2008 and Masha Mining review report of 2006.

[711] Kataraihya L., Tanzania Transfer Pricing Regulations 2014, A Global perspective, A Changing Role of Professional Accountants and related Tax policies, A paper presented at NBAA Accountants Annual Conference 2014, AICC, Arusha, Tanzania.

[712] Muganyizi T. K., Research Report 1: Mining Sector Taxation in Tanzania," International Centre for Tax and Development (Brighton, UK: Institute of Development Studies, August 2012), 20, http://www.ictd.ac/sites/default/files/ICTD%20Research%20 Report%201_0.pdf p.26 accessed July 2015

invoicing was from tax haven countries, namely, Switzerland and Singapore. Tanzania, for example, lost more than 19.69 Pound Sterling between 2005 and 2007 as a result of bilateral trade mispricing with the EU and USA.[713] A study by Global Financial integrity reveals that African countries such as Tanzania, Ghana, Kenya, Uganda and Mozambique collectively lost US$ 14.39 billion between 2002 and 2011.[714]

5.4.1.2 Thin Capitalization

This scheme entails use of interest rate obtained from intra-financing between associated MNCs. Generally, interest on debt is deductable by the debtor for tax purposes but dividend on shares is not. This distinction creates strong preference for MNCs to use debt financing so as to reduce tax in source countries where their subsidiaries carry on business, while dividends received by resident company from subsidiaries are often exempted from resident country's tax.[715] The manipulation can be done by using three ways: first, MNCs from tax haven may finance a related company in a high tax country. The amount of interest deductable in the high tax country is overpriced and repatriated to pay loan in a low tax country. In that way, MNCs benefit further. Second, there is potential for overpricing of interest due to exchange rate risks claimed in strong currency. Third, the company may thin its capital by having a large amount of debt to equity ratio. For example, in 2007, Geita

[713] Christian Aid, the Missing Millions; the Cost of Tax Dodging to Developing Countries Supported by Scottish Government, Christian aid report 2009, p.3.

[714] Clough C. et al., Hiding in Plain Sight: Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011, Global Financial Integrity Report 2014, p.

[715] Wilson J.R, Aggressive International Tax planning by Multinational corporations p. 18, see also, Cobham A. et al., note 37.

Gold Mine had 125,970:1 of debt to equity ratio. Consequently, Tanzania lost US$830 from 2001 to 2007.[716]

5.4.1.3 Use of Intellectual Property Rights

This scheme involves the right to use intellectual property rights such as trade mark, technological knowhow and marketing intangibles. From practical point of view, most MNCs operating in EAC hold intellectual property rights, which are licensed associated companies for annual royalty payment. For example, Tanzania Breweries Company limited (TBL) is a subsidiary of SABMiller, the largest breweries company, which uses intellectual rights of parent company SABmiller Plc. However, the trademark owned by the parent company for African brands are registered in the Netherland where there no or minimal royalty taxes are paid.[717] For TBL to use trade mark, it must pay the parent company. The TBL may treat royalty charges as expenses that qualify for tax relief in Tanzania while the income in the hand of the parent company attracts no or low tax rate in the Netherlands.

5.4.1.4 Use of Special Conduit Entities

The scheme entails establishment of entities, which may be incorporated in tax haven countries where corporate tax rates are very low, for example, Mauritius corporate tax rate is 15 percent.[718]In this context, MNCs may take advantage by registering their corporations in countries where corporate tax is low. For example, MultiChoice

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[716] Boman Report note.

[717]Hearson M. and Brook, note10. See also, Sikka P. and Willmott, H., The Tax Avoidance Industry: Accountancy Firms on the Make, Critical Perspectives on International Business, Vol. 9 Iss: 4, pp.415 – 443 available at www.tax.mpg.de/.../Paper_Prem_Sikka p. 30, Accessed 30th December 2015; See also, Arnold B.J., and Wilson J.R, note 705 pp18 and.26.

[718] Section 44 and schedule 1 of the first schedule of Mauritius Income Tax, consolidated 2016.

Tanzania is a permanent establishment of MultiChoice Africa which is wholly-owned by Naspers Group registered in Mauritius. MNCs may take advantage on the way various tax avoidance rules interact and develop a scheme that may reduce their tax liability. This may be achieved by developing special transfer pricing programmes to suit certain MNCs transactions either by increasing or reducing the transfer prices for such particular circumstances. In World Com, a USA giant telecommunication company increased its profit by adopting intangible creating asset transfer pricing programme called the asset 'management foresight' and registered in low tax country, which, in turn, licensed to other associates for annual royalty payment.[719]

5.4.1.5 Use of Management Fee

This scheme entails use of management fee and other costs to avoid tax. In this context, MNCs may register management in a country where management fee is low compared to where operations of the company are taking place. For example, SABmiller Plc registered Bevman service Management Company in Switzerland where the tax in Management Company is charged at a lower rate than elsewhere. Assuming that the company is responsible in managing its subsidiary in Tanzania, for that reason, the TBL has to pay Bevman fee for the services received. Arguably, MNCs potentially have opportunities to escape tax with respect to international investment rather than domestic investment.[720]

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[719] OECD, Base Erosion and Profit shifting, 2013, p. 9. See also *Tullow Oil v Uganda Revenue Authority* , TAT App no.40 of 2011 Uganda Tax Appeal Tribunal 1(16 June 2014);where Tullow oil used disposal of mineral licensing rights to avoid tax. In *Zain International BV v Commisioner General and URA*, HCT 2011 where Zain used disposal of telecommunication shares to avoid tax.

[720] Rego S.O., Tax Avoidance Activities of U.S. Multinational Corporations (July 11, 2002) p. 2 available at http://ssrn.com/abstract=320343, Accessed 26th december2015; See also Leblang S., International Double No taxation. Tax Notes International 7/20/1998, 181-183., p.81.

Accordingly, MNCs with more extensive international operations have lower worldwide effective tax rates.[721] Aggressive tax planning reduces the present value of tax payments and generally, it increases after tax rate of return to investors' corporation.[722] Such planning affects effective tax rate of MNCs in two ways: First, it creates temporary or permanent book tax differences between a corporation's pretax income and taxable incomes. In order to obtain an effective tax rate, pretax income is divided to taxable income. In this context, the effective tax rate is reduced because of various deductions on taxable income while pre-tax remains the same.[723] Because of aggressive tax planning by MNCs, it is estimated that US$365 shifted from developing to developed countries due to transfer pricing manipulations.[724] As already noted, aggressive tax planning by MNCs is done by tax advisers. In running their activities, normally, tax advisers have their code of conduct in which they refer while doing their businesses. Such codes of conduct does little more than shroud the way tax advisers exploit flaws in international tax law avoidance schemes for their clients.[725] Tax advisers are also responsible for preparation of MNCs' group transfer pricing policy. Group transfer pricing policy records transfer pricing practices that yield arm's length results in specific circumstances. Accordingly, such policy may

[721] Ibid.
[722] Ibid.
[723] Ibid.p.7. Effective tax rate is the average rate at which an individual or corporation is taxed. The effective tax rate for a corporation is the average rate at which its pre-tax profits are taxed. For corporations, the effective tax rate is computed by dividing total tax expenses of the corporation's earnings before taxes. The effective tax rate is the net rate a taxpayer pays if all forms of taxes are included and divided by taxable income. See investopedia dictionary online. It should be noted that, tax system of each country sets out different rate of tax at different level of income. For example, see first schedule of ITA Cap332 RE2008 of Tanzania. Secondly MNCs frequently use foreign operation to avoid income taxation and ETR capture this type of tax avoidance. In this context the company is said to have effective planning because it has reduced ETR on taxable income while maintaining their financial accounting income. This is in line with theories for existence of MNC and accounting transfer pricing theory.
[724]Action note10Action Aid.,p.6
[725] For example research done by House of Commons reveals that PWC code of conduct has that problem. See House of Commons Report p. 3 note 89.

also provide room for transfer pricing manipulation by not crafting their policy according to arm's length principle as required by the law.[726]

The problem with tax advisers is that they are also government advisers and receive government contracts. Accordingly, normally, governments seek assistance in auditing their accounts.[727] The effect of this is that it may be difficult to challenge and discipline their activities. On top of that, some countries like Tanzania do not have regulatory authorities for regulating Accounting firms. Scholars argue that big tax advisers have established international structures and they are present in OECD meetings. They may become potential in frustrating development of accounting standards that can expose corporate tax avoidance schemes.[728] Accordingly, the big firms control formulation of audit standards at international federation of standards.[729] Generally, it can be argued aggressive tax planning has given MNCs power to exploit opportunities for avoiding tax through transfer pricing on profits arising from MNCs activities.

Arguably, existing international transfer pricing standards potentially provide room for MNCs to manipulate transfer prices. The interplay between aggressive tax planning and complexities surrounding arriving at arm's length price exacerbate the problem. Manipulation of prices has caused enormous profit shifts from countries where economic activities of MNCs take place and consequently, they affect tax base

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[726] For example, in Unilever case The KRA provided evidence that Unilever group transfer pricing policy is offending the provision of sect. 18 of Kenyan income tax Act. See Unilever case p.12.
[727] Interview with officials Ministry of Finance Dar es Salaam and KPMG officials Dar es salaam Tanzania.
[728] Sikka P. and WillmottH., note 741, p.34.
[729] Ibid.

of host countries. Arm's length principle, which is a corner stone in regulating transfer prices between associated MNCs, ought to provide a concrete solution to existing problem. However, such principle is not providing a complete solution. The problem has irked both developed and developing countries. It is in this context that the OECD and G20 countries came up with another plan to complement the existing arm's length principle and other transfer pricing standards that seem to fail. As a result, the Base Erosion and Profit Shifting Action Plan (BEPS Action Plan) was established. The next part examines BEPS Action Plan in curbing transfer pricing manipulation by MNCs.

5.5 Transfer Pricing in Context of Base Erosion and Profit Shifting Action Plan 2013

5.5.1 Background to BEPS Action Plan

The incentive provided by international transfer pricing standards to MNCs and the role played by aggressive tax planning using both international treaties and domestic tax laws, significantly have brought challenges in curbing manipulation of transfer prices. Accordingly, the existing arm's length principle, which seems not effective enough to catch all spheres of transfer pricing manipulations, has caused serious profit shifting and base erosion in host countries.[730] The problem has irked both developing and developed countries. However, concerns on tax base erosion between developed and developing countries are different. In developed countries, there is a symmetric level of investments and therefore, the impact of base erosion may be

[730] Base erosion and profit shifting is defined as "tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid." See Ogazón Juárez L.G., and Hamzaoui R., note 704 p. 3.

more or less the same. Accordingly, the tax revenue authorities of such countries are more sophisticated to counter aggressive planning. To the contrary, developing countries such as EAC, for a long time, have been capital importers and thus, the impact of base erosion goes one way only. The BEPS was adopted by OECD and G20 countries in response to the growing volume of base erosion and profit shifting by MNCs. The BEPS Action Plan came as a measure to ensure that profit by MNCs are taxed where economic activities generating that profit are performed or where the value of intangible is created. The objective of BEPS action plan is,

> "*To complement existing standards that are designed to prevent double taxation with instruments that prevent double non-taxation in areas previously not covered by international standards and that address cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.*"[731]

The motive for aggressive tax planning has been caused by both domestic law and tax treaties, which provide room to be manipulated by taxpayers. Consequently, such planning has changed the way MNCs have been carrying on their businesses. In due regard, MNCs have been keen to follow aggressive tax planning to keep pace with the theory of their establishment.[732] The situation has been exacerbated by globalization, development of technology as well as communication and raise of digital economy, which affected the physical elements' presence of PE for tax purposes.[733] The digital economy, in particular, has caused a large amount of money

[731] OECD, BEPS Action plan 3.
[732] Taking advantage of favourable conditions and cost minimization.
[733] See discussion on chapter 3.

to be extracted without paying any tax in either country they operate.[734] Hence, various host countries' tax bases have been eroded through transfer pricing enabled by digital economy. Although various countries have anti-avoidance tax rules, unfortunately, the existing anti avoidance rules, in particular, arm's length principle seems not sufficient enough to curb base erosion and profit shifting to keep pace with changes caused by aggressive tax planning.[735] To address those challenges, the OECD and G20 countries adopted BEPS Action Plan as a viable solution.[736] These efforts are reaffirmation by both OECD and G20 countries that existing arm's length principle on which the current rules are based present significant problems in curbing transfer pricing manipulation.

5.5.2 An Overview of BEPS Action Plan

The BEPS Action Plan contains 15 Actions that need to be implemented as follows: Action 1, addresses tax challenges of the digital economy, Action 2 deals with neutralization of effects of hybrid mismatch arrangements. Action 3 requires strengthen CFC rules and Action 4 requires limitation of base erosion via interest deductions and other financial payments. Action 5 requires counter harmful tax practices more effectively by taking into account transparency and substance. Action 6, requires prevention of treaty abuse; Action 7 requires prevention of artificial avoidance of PE status and Action 8, 9 as well as 10 require assurance of transfer

[734] Ogazón Juárez L.G. and Hamzaoui R. note 704.

[735] A s rightly pointed out by OECD BEPS 2013 that, "taxation is at core of countries' sovereign, when countries design their tax rules , may not take in to account other countries rules and when such domestic rules are applied may lead to gaps or friction. Accordingly, international rules that are developed to such friction and gaps seems failed to filling such gaps and fictions. Moreover, the existing international and domestic tax rules revealed weaknesses that create room for base erosion and profit shifting. See background of Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013.

[736] Individual countries and economic blocks such as EC and US have taken such initiatives.

pricing outcomes in line with value creation in relation to intangibles, risks and capital including other high-risk transactions. Action 11 requires establishment of methodologies to collect and analyze data on BEPS address it. Action 12 requires taxpayers to disclose their aggressive tax planning arrangements. Action 13 requires re-examination of transfer pricing documentation. Action 14 requires countries to make dispute resolution mechanisms more effective and Action 15 requires development of a multilateral instrument.[737]

The BEPS Action Plan holistically touches associated MNCs' operations, in one way or another, and where issues transfer pricing may feature indirectly. However, the most direct provisions in context of transfer pricing are Actions 8, 9, 10, and 13. For purpose of this work, Actions 4, 6, and 7 were considered.[738] Implementation of BEPS Action Plan measures is not uniform such that some require an immediate action, for example, revise guidance on transfer pricing. Other measures require changes to bilateral tax treaties and other measures require domestic law implementation.[739] In transfer pricing context, implementation requires countries to comply with existing transfer pricing standards as administered by OECD and UN models. It is important to note that the BEPS Action Plan is a soft law and therefore, it is not binding to non-members like EAC.

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[737] OECD., Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013. The BEPS plan 15 actions were developed by OECD for both developed and developing countries. However, concerns of tax base erosion between developed and developing countries is different. In developed countries there is symmetric level of investments and therefore the impact of base erosion may be more or less the same. Accordingly, the tax revenue authorities of such countries are more sophisticated to counter aggressive tax planning. To the contrary, developing countries for a long time have been capital importers and thus the impact of base erosion goes one way only.

[738] Action 4, 6 and 7 presents important aspects that form bases of determination of transfer price.

[739] OECD question and facts.

5.5.3 Guideline in Applying arm's Length Principle in the Context of BEPS Action Plan

The desire to align transfer pricing outcomes with value creation to counter manipulation of transfer prices manipulation has necessitated the need to improve application of arm's length principle. The fact that arm's length principle is a corner stone for setting transfer pricing between associated MNCs, the principle is strengthened to ensure that outcomes of transfer pricing are in line with value creation. To keep pace with rules, measures and principles as enshrined in BEPS Action Plan, specific guideline were developed by OECD in applying arm's length pricing in context of BEPS. The guideline covers eight areas and is examined in detail because they are corner stone of any transfer pricing analysis for both revenue authorities and associated MNCs. It worth noting that arm's length guideline in BEPS context is replacing Chapter I Section D of the OECD guideline for transfer pricing 2010.[740]

5.5.3.1 Identifying Commercial or Financial Relations

As stated before, comparability analysis is the corner stone for arm's length principle to apply. To run comparability analysis, the guide requires two important aspects to be taken in to account. First, identification of commercial or financial relations and conditions including economically relevant circumstances attached to those relations so as to delineate transaction of associated MNCs. Second, an undertaking to compare conditions and economically relevant circumstances of accurately

[740] OECD/ G20 Base Erosion and profit Shifting Project, Final Report, 2015 p.15. It should be noted that at the time when this work was written the document was not on published and therefore reference is made to OECD/G20 G20 Base Erosion and profit Shifting Project, Final Report, 2015.

delineated transactions of associated MNCs with conditions together with economically relevant circumstances of comparable transactions between independent corporations.[741] Identification of commercial or financial relations and conditions together with economically relevant circumstances requires the following be done: First, to understand broadly, the industry or sector in which the MNE group operates[742] and factors affecting business performance.[743] The understanding may be derived from particulars of group of MNCs under analysis, which normally contains information on factors affecting their performance.[744] For revenue authority, such information may be found in the master file submitted to them in accordance with requirement of Action 13.[745] Second, identification of operations of each MNC within that group followed by analyses of activities of each MNC and then identification of their commercial or financial relations between associates as expressed in their transactions.[746] This is done so as to delineate actual transactions between associates.

In delineating accurate transaction, the guide requires economically relevant circumstances in which transactions taking place should be considered.[747] They include the following: first, contractual terms of the transaction. Second, functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of

[741] Ibid, para 1.33.
[742] The business may be mining, pharmaceutical, luxury goods, manufacturing industry, telecommunication to mention few.
[743] OECD/ G20 note 765 para 134.
[744] Ibid.
[745] BEPS action plan for more details on Action 6 measures see discussion below.
[746] OECD/ G20 Base Erosion and profit Shifting Project, Final Report, 2015. p.15 para 1.35.
[747] Ibid.

value by the MNC group to which the parties belong, the circumstance surrounding the transactions and industry practices; third, characteristics of property transferred or services provided; fourth, economic circumstances of parties and the market in which the parties operate; and fifth, business strategies pursued by the parties.[748]

5.5.3.2 The Contractual Terms of the Transaction

These are terms of contract concluded between associates of group of MNC. They provide terms upon which goods and services between them are transferred. Such terms may include responsibilities of each division, obligations and rights, assumption of identified risks, and pricing arrangements. Such information is useful because it provides for starting point of delineating transaction between them and their intention at the time of concluding their contract.[749] Where the terms of contract do not provide sufficient information for transfer pricing analysis, the guide requires that resort should be made to actual conduct of the associates of the particular MNC.[750] In terms of the guide, the actual conduct of the parties should be established by analyzing other categories of economic relevance of commercial or financial relations.[751] However, it is unclear about methods to be employed in analyzing conduct of the parties by using other relevant economic patterns.

When it is established that characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associates, the transaction reflected in the actual conduct of the parties should prevail in delineating

[748] Ibid p. 16 para 1.36.
[749] Ibid,p.18, para 1.42.
[750] Ibid, para 1.43.
[751] For details of other economic relevance category see note 772 above.

the actual transaction of associates.[752] Where there are material differences between contractual terms and the conduct of the associated MNCs in their relations, functions they actually performed, the assets actually used and risks actually assumed in the context of the contractual terms should be used to determine the factual substance as well as accurately delineate the actual transaction.[753] Where there has been a change in terms of a transaction, the guide requires examination of circumstances surrounding the change. That should be done in order to establish whether or not original transaction has been replaced through a new transaction with effect from the date of change or whether or not the change reflects into intentions of parties in the original transaction.[754]

5.5.3.3 Function Analysis

In determining arm's length price functional analysis is important in establishing economically significant activities including responsibilities, asset used and risk assumed by parties to the transaction. Accordingly, risk analysis is corner stone of functional analysis for arm's length price purposes. Therefore, functional analysis is useful in delineating transaction between associates for the purpose of comparing with transaction of an independent corporation. The analysis focuses on aspects parties actually do and capability they provide in generating value of a group as a whole together with the contribution of each associate.[755] The capability of each associate is important in identifying economically relevant commercial or financial relations and as such, capability affects options that are realistically available.

[752] OECD/ G20 Base Erosion and profit Shifting Project, Final Report, 2015 p.18 para.1.45
[753] Ibid, para 1.46.
[754] Ibid, para 1.47.
[755] Ibid, p. 20 para 149.

Accordingly, such capability is used in comparing a similar situation in arm's length arrangements.[756]

In analyzing risk assumed in commercial or financial relations, the guide provides the following six steps that need to be followed: Step one involves identification of economic risks with specificity.[757] This entails definition and categories of transfer pricing. The guide defines risk in a transfer pricing context as an effect of uncertainty on the objectives of the business.[758] Transfer pricing risks are categorized according to source, which gives rise to such risks. They include strategic risks or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and hazard risks.[759]

Step two entails determination on how specific, economically significant risks are contractually assumed by the associated enterprises under terms of the transaction. Contractual assumption of risk embodies risk clearly identified in the contract between associated parties and the party assuming such risk. It provides clear evidence of a commitment to assume risk prior to materialization of risk outcomes. Such evidence forms an important part for revenue authorities' transfer pricing analysis of risk analysis in commercial and financial relations, which may occur years after conclusion of such contract.[760] However, not every contractual exchange of potentially higher but riskier income for lower but less risky income between

[756] Ibid, p.21 para 1.53.
[757] Ibid, p. 22 para 1.60.
[758] Ibid, p.25 para 1.71
[759] Ibid, p.27 para 1.71
[760] Ibid, p.28 para 1.77 to 1.78.

associated enterprises is automatically arm's length.[761] Accordingly, the pricing adopted in the contractual arrangements alone does not determine which party assumes risk.[762]

Step three entails function analysis in relation to identification of associate(s), which control,[763] manage[764] and perform risk mitigation function and have financial capacity to assume the risk, and the associate encountered outcomes of such risks.[765] Step four entails interpreting information obtained in steps 2 and 3 as well as determine whether or not contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analyzing whether the associated parties follow the contractual terms; and whether the party assuming risk, as analyzed exercises control over the risk and has the financial capacity[766] to assume the risk.[767] This is sought to be achieved by analyzing whether or not the associate follows contractual terms and whether or not the associate actually has financial capacity to manage as well as control the risk.[768] Where or not it is established that conduct of both parties is consistent with contractual obligations, the

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[761] ibid p. 29 para 1.80.
[762] Ibid p.29 para para 1.81.
[763] Control over risk is defined as "(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function". See Ibid, p.23 para 1.65.
[764] The guidance defines risk management as "(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation." see ibid, p.22 para 1.61
[765] Ibid p. 29 para 1.82
[766] Is access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes. see p. 23 para 1.64 .
[767] Ibid, p. 23 para 1.64.
[768] ibid p.31 para 1.86 to para 1.87.

analysis is said to be complete.[769] Where it is established that the conduct of the associated parties is inconsistent with contractual terms in relation to risks, which are economically significant, such terms may be used by third party for pricing purposes between them. The assumption of risk should be determined according to the actual conduct of the associates.[770] Where the associate party assuming risk is not controlling the risk, further risk analysis should be taken by using step five.[771] In establishing whether or not the party assuming risk controls that risk, the guide requires the identified risk between associated MNCs be compared with risk of independent parties' transaction as a control test.[772]

Step five entails allocation of risk between associates to MNCs. Under this step, where analyses one to four establish that the party assuming risk is not controlling that risk, then the risk should be allocated to the associate, which actually controls and manages the risk.[773] Where more than one associate controls the risk and have finance capacity to assume the risk, the risk should be allocated to associates who have the most control of risk.[774] In circumstances where no associate parties are identified as controls and have capacity to assume the risk, rigorous analysis of the facts and circumstances of the independent parties' case will be performed for the purpose of identifying reasons for such situation. Based on that assessment, the revenue authorities will determine what adjustments to the transaction needed for the

[769] Ibid p.31 para 1.87 Here step 5 may be skipped and step six may be considered.
[770] Ibid p.31 para 1.88.
[771] ibid p.32 para1.90.
[772] Ibid, p.32 para 1.97.
[773] Ibid, p.33 para 1.98.
[774] Ibid.

transaction to result in an arm's length price.[775] Step six entails pricing of the transaction by taking into account consequences of risk allocation. This step, essentially, entails the relationship between performed functions and corresponding allocation of returns of the associates in an MNC. The guide sets a general rule that an assumed risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated.[776] Thus, a taxpayer who assumes and mitigates a risk will be entitled to greater anticipated remuneration than the taxpayer that only assumes a risk or only mitigates, but does not do both.[777] The guidance provides that associates, which have financial capacity to assume risk but do not perform any relevant economic activities and do not exercise control over the financial risk will not be allocated any excess profits as well as will not be entitled to any more than a risk-free return.[778]

The guidance sets another general rule that, "a functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises."[779] Thus, the associate party assuming the risk for transfer pricing purposes needs to control risk and has financial capacity to assume the risk. However, for enterprises to have control over risk, an enterprise is not required to perform the risk mitigation activities itself, but it is required to be actively involved in the decision process when outsourcing these

[775] Ibid, p.35 para 1.99.
[776] Ibid p.34 para 1.100.
[777] Ibid.
[778] Ibid p.34 para 103.
[779] Ibid, p.21 para 1.56.

activities.[780] Nevertheless, the guidance does not provide any guideline on how taxpayers and revenue authorities will allocate risks in practical stances. Such situation may render application of arm's length principle difficult to implement.

5.5.3.4 Characteristics of Property or Services

The guidance requires characteristics of property and services to be considered in delineating controlled transaction for comparison purposes.

> "*In the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.*"[781]

However, characteristics of service and property may be given more or less weight, depending on the method used to arrive at arm's length. Expressly, more weight is given to CUP method than other methods.[782] This factor is subjective because it depends on the method applied in transfer pricing analysis. Accordingly, lack of an hierarchal requirement in applying arm's length methods contradicts with this guidance.[783] This situation may provide room to MNCs to select a method that would not necessarily consider characteristics of the property or services. Furthermore, the guide clearly acknowledges that practically, comparability for methods based on gross or net profit indicators often put more emphasis on functional similarities than

[780] ibid p.23 para 1.65.
[781] Ibid, p.35 para 1.107.
[782] ibid, p. 35 para 108.
[783] According to tax models the taxpayer is at liberty to choose any methods deemed to fit in determining arms length price.

on product similarities.[784] Arguably, the guide acknowledges difficulties involved in comparing characteristics of property and services and thus, there is a danger of setting rules, which are not implementable.

5.5.3.5 Economic Circumstances

Economic circumstances are compared for purpose of determining whether or not differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate effects of such differences. In terms of the guide, relevant economic circumstances for transfer pricing purposes include, but they are not limited to, the following,

> *"Geographical location, the size of the market, the extent of competition in the markets and the relative competitive positions of the buyers and sellers, the availability of substitute goods and services, the levels of supply and demand in the market as a whole and in particular regions, if relevant, consumer purchasing power, the nature and extent of government regulation of the market, costs of production, including the costs of land, labour, and capital, transport costs, the level of the market (e.g. retail or wholesale), and the date and time of transactions."*[785]

Where economic circumstances between associated MNCs and independent corporations are more or less the same, such situations are comparable.[786] Where economic circumstances are found to be significantly different, the guide is silent on recourse to be taken by the MNCs or revenue authorities. Such situation may provide advantage to MNCs to manipulate prices because they are not bound to make comparison in absence of comparability situation.

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[784] Ibid, p.35 para 108.
[785] Ibid, p.36 para 1.110.
[786] Ibid, p. 37 para 113.

5.5.3.6 Business Strategies

Business strategies are also considered when determining comparability of controlled and uncontrolled transactions. Business strategies in context of transfer pricing include, but they are not limited to, innovation and new product development, degree of diversification, risk aversion, assessment of political changes and input of existing and planned labour laws together with duration of arrangements[787] and market penetration schemes.[788] Generally, a taxpayer is required to follow business strategy that distinguishes it from potential comparables. To establish whether taxpayer actually followed business strategy, the conduct of the parties and the cost of business strategy should be taken in to account. The taxpayer is deemed to follow business strategy if he produces a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement.[789] This is possible only if the taxpayer is in a position to foresee such expectations.[790] However, if such an expected outcome was not foreseeable at the time of the transaction or if the business strategy is unsuccessful but nonetheless is continued beyond what an independent corporation would accept, the arm's length nature of the business strategy may be doubtful and may warrant a transfer pricing adjustment. Certainty of the law is very important for its implementation. Arguably, examination of economic strategies for transfer pricing purposes is based on possibilities and expectation. From practical point of view, it may be difficult for revenue authorities to establish whether a taxpayer was in a position to foresee results of such strategy because a foreseeable element is not measurable. Accordingly, the guide is silent under

[787] Ibid p. 37 para 114.
[788] Ibid para 1.115.
[789] Ibid para 1.118.
[790] Ibid.

circumstances the taxpayer was in a position to see what was coming. Such uncertainties may provide chances to associated MNCs to manipulate prices.

5.5.4 Recognition of the Accurately Delineated Transaction

Delineated transaction between associated parties for transfer pricing purposes is recognized once substance of the commercial or financial relations has been identified by analyzing economically relevant factors. The actual transaction as delineated is used to determine transfer price under the arm's length principle.[791] The general rule is that where the same transaction can be seen between independent parties in comparable circumstances, such transaction should be recognized for transfer pricing purposes.[792] However, there is an exception to this rule. The accurately delineated transaction can be disregarded for transfer pricing purposes if such transaction viewed in its entirety lacks commercial rationality of arrangements between unrelated parties in comparable circumstances. The guide does not clearly set out under what circumstances can accurately delineate transaction can be disregarded but this is inferred from examples provided in the guide.[793]

5.5.5 Losses

The guide also requires losses to be examined for transfer pricing purposes if the associate of MNC continuously makes losses while continuing to carry on with business.[794] The assumption is that an associate cannot continue to make business if it always makes losses. Therefore, there is a way in which associate MNCs benefit

[791] Ibid p. 39 para 1.121.
[792] Ibid, p.39 para 1.122.
[793] Ibid para 1.125 and 1.126.
[794] Para 1.130.

from that business. Hence, only justifiable losses may not be taken in to account for transfer pricing analysis purposes. Thus, both taxpayer and revenue authorities have to analyze justifiable losses that may not be taken in to account for transfer pricing purposes.[795] In terms of guide, the losses are justifiable if they are recurring for a reasonable period and they are made for specific objectives of the business strategy.[796]Accordingly, same types of losses that an independent corporation would have incurred under the arm's length principle. The losses are not justified if in context of business strategy they continue beyond a reasonable period, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent corporation. However, the guide does not provide guideline on period deemed to be reasonable. Again, the term reasonable as used is vague and not measurable such that it provides uncertainty of the law.

5.5.6 Effect of Government Policies

The effect of government policies must be taken into account in evaluating transfer price between associate MNCs as a condition affecting market in a particular country. Sometimes the government makes intervention in the market for policy reasons and actually affects transactions.[797] The affected transaction of associate MNCs should be compared with transaction of independent parties affected by the

[795] Ibid, p. 41 para 1.131 .
[796] Ibid
[797] Ibid, p.41 para 1.132 Such intervention may include "price controls (even price cuts), interest rate controls, and controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate".

same intervention.[798] In determining arm's length price, the revenue authorities are required to adjust arm's length price to account for government intervention. Where the government intervention applies only to transactions between associated MNCs, the guide clearly states that,

> "*There is no simple solution to the problem. Perhaps one way to deal with the issue is to apply the arm's length principle viewing the intervention as a condition affecting the terms of the transaction. Treaties may specifically address the approaches available to the treaty partners where such circumstances exist*."[799]

In essence, the guide acknowledges difficulties involved in applying arm's length principle. Use of words like 'perhaps' suggests probability and failure to provide concrete solution(s) to application of arm's length principle. In addition, the guide is silent on a situation where there is no DTA between countries. It means that the guide provides incomplete solutions in applying arm's length principle. Although both taxpayer and revenue authorities are likely to be affected, the revenue authority stands to lose more than the taxpayer.

5.5.7 Use of Customs Valuations

The guide recognizes that arm's length principle is used by customs administration as comparison of value of imported goods between related seller and buyer. Just like in transfer pricing, special relations that exist between related seller and buyer may affect the value of imported goods for customs evaluation purposes. Thus, customs evaluation may be used by revenue authorities in evaluating the arm's length

[798] Ibid,
[799] Ibid p.42 para 1.134.

character of a controlled transaction transfer price and vice versa.[800] This is possible because customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation, which provide detailed information on circumstances of the transaction.[801] However, it requires cooperation between income tax and customs administration in evaluating transfer prices within the country.

5.5.8 Location Savings and Other Local Market Features

Location savings refer to a situation whereby associated MNCs relocate some of their activities to a place where costs are lower than in location where activities were initially performed. The location savings and other local market features may affect comparability including arm's length prices. With regard to location savings for transfer pricing purposes, it is necessary to determine whether location servings shared between associated MNCs.[802] Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable in the local market are present, such comparables will be sufficient to provide basis upon net location savings should be allocated among associated MNCs.[803] In absence of comparables, allocation should base on analysis of function performed, risks assumed and assets used of the relevant associated MNC. With

[800] Ibid, p.43 para 1.137.
[801] Ibid.
[802] Ibid, p.44 para 1.141, this is sought to be achieved by examining whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.
[803] Ibid p.44 para 1.142.

regard to other local market features,[804] it is necessary to examine data on comparable uncontrolled transactions in that geographic market to establish whether or not a comparability adjustment is required. Where the examined data show that comparable local market features are present then the need for making specific adjustments for local market features would not arise.[805] In absence of reasonable local market comparables, determination of appropriate comparability specific adjustments for features of the local market should be based on underlying facts and circumstances.[806]

The guide requires that in conducting a transfer pricing analysis, intangibles such as contractual rights, government licenses or know-how necessary to exploit that market should be distinguished from tangible local market features.[807] The contractual rights and government licenses may limit access of competitors to a particular market and may affect the manner in which economic consequences of local market features are shared between parties to a particular transaction. In these circumstances, it is necessary to determine each affiliated party's contribution to

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[804] other local market features that may affect comparability include the relevant features that affect Relevant characteristics of the geographic market in which products are sold, purchasing power and product preferences of local households in that market, whether the market is expanding or contracting, degree of competition in the market, relative availability of infrastructure in the market, relative availability of trained and educated workforce, proximity to profitable markets and similar features in a geographic market that create market advantages or disadvantages. See p. 44 para 1.144.

[805] Ibid para 1.145.

[806] "(i) whether a market advantage or disadvantage exists, (ii) the amount of any increase or decrease in revenues, costs or profits, vis-à-vis those of identified comparables from other markets, that are attributable to the local market advantage or disadvantage, (iii) the degree to which benefits or burdens of local market features are passed on to independent customers or suppliers, and (iv) where benefits or burdens attributable to local market features exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such net benefits or burdens between them." See p.44 para1.146.

[807] Ibid p.45 para 1.149.

obtain the license to determine allocation of profit attributable to the license of intangible. In assessing the impact of the government license, contribution by the local member of local market intangibles and other group members of intangibles such as skills, experience, and knowledge should be considered.[808]

5.5.9 Assembled Workforce

Workforce [809] is another factor also affects transfer pricing and is taken into account in a transfer pricing comparability analysis. The guide indicates the need to determine benefits or detriments of the unique assembled workforce with that of independent parties. However, the guide is silent on modalities on how the determination can be done. The guide states that,

> "*where it is possible to determine the benefits or detriments of a unique assembled workforce vis-à-vis the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services.*"[810]

In absence of such possibilities, the associated may take advantage of the situation and affect the arm's length price. Where an assembled workforce is transferred from one associate to another as part of the transaction, time and cost savings should be reflected in the arm's length price charged for the transferred assets.[811] If the transfer of a workforce or a secondee results in the transfer of valuable know-how, then the transfer of that valuable know-how should be valued in accordance with rules on

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[808] Ibid p.45 para 1.150.

[809] Is a situation where by a corporation assembles a uniquely qualified or experienced cadre of employees producing or providing services capable of affecting arms length price

[810] Ibid, p. 46 para 1.152.

[811] Ibid, p.46 para 1.153.

intangibles and an appropriate price should be paid for the right to use the intangibles.[812]

5.5.10 MNC Group Synergies

Associated MNCs may benefit from interactions or synergies amongst group members that would not generally be available to similarly situate independent enterprises. Such synergies may stem from economies of scale, combined or integrated computer and communication systems, integrated management, and elimination of duplicative expenses.[813] Such synergies may be unfavorable if they impose bureaucratic impediments that smaller, nimbler enterprises do not face or as a result of additional burdens and requirements placed on units because they are part of a large organization. Consequently, that smaller unit of associated parties receives incidental benefits.[814] Under such circumstances, no compensation should be paid for incidental benefits received by an MNC group member solely because it is a member of the larger MNC group.[815] Where synergistic benefits and burdens of group membership may arise because of deliberate concert the nature of the advantage or disadvantage, the amount of the benefit or detriment and the manner the benefit or detriment should be allocated among group members must be determined through functional and comparability analysis.[816] If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by group members in proportion to their contribution to

[812] Ibid p.46 para 1.154.
[813] Ibid, p. 47 para 1.157
[814] These are benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit.
[815] Ibid,p.47 para 1.158.
[816] Ibid,p.47 para 1.161.

creation of the synergy.[817] In this context, arguably, revenue authorities must depend on information from the taxpayer and in absence of such information, the said processes cannot be implemented.

The review and analysis of guidance to apply arm's length principle in context of BEPS Action Plan reveal that to arrive at arm's length price, it requires long and complex procedure to follow. That may require sufficient well equipped human resources and other resources to manage such analysis. However, the guidance does not provide conclusive solution in certain areas, which seem to materially affect transfer price between associated MNCs. The principle is subjective because it depends on nature of transaction and available comparables. In some instances, it does not provide practical solution(s) to relevant issues. In other circumstances, the application depends on reasonableness and foresee-ability of certain issues, patterns, which bring uncertainty of the law. Such uncertainty is undesired in law. Therefore, the principle is uncertain and cannot assure countries' right share of taxes arising from associated MNCs. In addition, the guidance admits difficulties involved in arriving at arm's length principle. Although such guidance could be seen as providing room for EAC countries to shape their policies and law in a manner that would take into account international standards and principles, the way they are formulated including complications involved in arriving at arm's length price, in practice, it tends to restrict realization of objective of curbing transfer pricing manipulation.

[817] ibid p.48 para 1.162.

5.6 BEPS Action Plan Measures in Curbing Transfer Pricing Manipulation

The BEPS Action Plan sets a timeframe upon, which measures in form of rules or principles will be developed and used by countries in tackling base erosion as well as profit shifting problems.[818] Thus, OECD and G20 came up with package of measures believed to represent the first substantial renovation of the international tax rules in almost a century.[819] Such measures are expected to render ineffective aggressive tax planning as discussed below. Action four [820] requires countries to design rules to prevent base erosion through use of interest expense. In context of transfer pricing, use of interest techniques is normally practiced by associated MNCs through intra-group financing. In due regard, the OECD developed a fixed ratio rule as a measure to prevent such concern. The rule requires associated MNCs to deduct net interest expense economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA ratio).[821] Given different situations of countries in tackling BEPS, the OECD sets a range of 10 percent to 30 percent to ensure that countries apply a fixed ratio that would be low enough to tackle BEPS.[822] However, currently, the EBITDA is not dealing with banking and insurance sectors because of their specific features and they require specific rules to deal with.

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[818] Annex A of OECD BEPS 2013.

[819] OECD/ G20 Base Erosion and profit Shifting Project, Final Report, 2015 p.2. It should be noted that these measures were a result of the work performed on equal footing between all G20 and OECD countries. Accordingly, European Commission substantially contributed its view throughout the project. In addition other international organization such IMF, WB and UN also contributed to the work. In Africa, Africa Tax Administration Forum also contributed to the project direct through participation on committee of fiscal affairs.

[820] Action 4, of the OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013

[821] OECD/G20 Report p.15.

[822] Ibid.

Action Plan six requires countries to develop rules to prevent arrangements through which a party who is not a resident of one of the two contracting countries of a tax treaty to obtain benefits that the treaty grants to residents of the countries.[823] These arrangements are often implemented by establishing conduit companies for purpose of shifting profit from host countries. In due regard, the three measures have been taken by OECD as follows: first, countries are required to include, in their tax treaty, a clear statement that countries to a tax treaty intend to avoid creating opportunities for non-taxation through avoidance by using treaty shopping arrangements. Second, there has to be inclusion of limitation on benefits rule (LOB) in DTA as specific anti-avoidance rule.

The LOB entails to limit treaty benefits to entities that have sufficient link with its country of residents. Third, there has to be inclusion of principle purpose of test rule (PPT) in DTA as a general ant-avoidance rule based on principal purposes of transaction or arrangements.[824]Where it is established that one of the principal purpose of arrangements or transactions is to obtain treaty benefits, such benefits would be denied, unless such benefits would be in accordance with the object and purpose of provisions of the DTA.[825] The PPT rule is applicable where such transaction or arrangement is not covered by LOB.[826] Action eight requires countries to assure that transfer pricing outcomes are in line with value creation of intangibles.[827] This Action requires countries to develop rules to prevent BEPS by

[823] Action 6 of the OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013.
[824] OECD/G20 Report note 848, p.21-22.
[825] Ibid.
[826] Ibid.
[827] Action 8 of the OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013

moving intangibles among group members. It involves:- (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer as well as use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.[828]

Measures taken in regard to definition of intangible, the word is expanded and thus, "intangible" is intended to address something, which is not a physical asset or a financial asset, capable of being owned or controlled for use in commercial activities, whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.[829] The guidance clearly distinguishes intangible from market conditions or local market circumstances that are incapable of being owned or controlled. The guidance also provides definition of marketing intangibles as,

> "A*n intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, "trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers."*[830]

With regard to allocation of profit by associated MNCs on use or transfer of intangibles, the guidance sets a principle that legal ownership alone of intangibles by associated MNCs does not necessarily generate a right to returns from exploitation of

[828] Ibid.
[829] OECD/G20 Report para 6.6.
[830] Ibid, P.69.

the intangible.[831] In determining the arm's length condition for transactions that involve use or transfer of intangibles and parts dealing with ownership, the guidance requires six steps to be followed. First, it encompasses identifying the intangibles used or transferred in the transaction with specificity and specific economically significant risks associated with the development, enhancement, maintenance, protection, and exploitation of the intangibles. Second, identifying full contractual arrangements with special emphasis on determining legal ownership of intangibles based on terms and conditions of legal arrangements.

Third, identifying parties performing functions, using assets, and assuming risks related to developing, enhancing, maintaining, protecting, and exploiting the intangibles by means of the functional analysis, and, in particular, which parties control any outsourced functions, and control specific, economically significant risks. Fourth, confirming consistency between terms of contractual arrangements and conduct of the parties. Fifth, delineate actual controlled transactions in light of legal ownership, other relevant contractual relations and the conduct of the parties; and sixth, where possible, determine arm's length prices for transactions consistent with each party's contributions of functions performed, assets used, and risks assumed.[832]

In regard to hard-to- value to intangible,[833] the guideline sets the rule that the tax administration can consider *ex post* outcomes as presumptive evidence about

[831] Ibid, p. 65.
[832] Ibid, pp.74 -75.
[833] "The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the

appropriateness of *ex ante* pricing arrangements, based on reliability of information on kind of *ex ante* pricing that has been based.[834] The purpose of this guide is to ensure that transfer pricing analysis is not weakened by information asymmetry between the taxpayer and tax authorities. However, it does not take extra measures to compel MNCs to provide information on time, particularly to developing countries. This is important because developing countries like EAC are vulnerable to manipulation of transfer prices. Accordingly, this approach is very cumbersome and seems not to be realistic for EAC. It is common knowledge that most if not all intangibles, in particular, techno know how used by MNCs in developing countries are developed by them and it may come to countries where the MNC associates operate after a certain couple of years. For a country like Tanzania, it may be difficult to obtain such information. Although this approach may seem to be viable to solve existing intangible transfer pricing, there is danger for EAC legislators to adopt BEPS measures that are not implementable and unrealistic in the economy. Action nine deals with risks and capital.

This Action requires countries to develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to associated MNCs. The guide focuses more on accurately delineating transactions between associated enterprises by examining contractual relations against the actual conduct of the parties through a transfer pricing comparability analysis. The guide sets a principle that allocation of risk should be considered under arm's length principle and that legal ownership of finance risks alone does not create an entitlement to profits. To assume a risk for

intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer. See OECD/G20 Report p.110.

[834] Ibid.

transfer pricing purposes, the associated MNCs need to control the risk and have the financial capacity to assume the risk.[835] The guide defines control over risk as:

> *"(i) The capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function."*[836]

Financial capacity refers to an enterprise's capability to access funding when managing risk as well as absorbing consequences of risk in the event of an unfavourable outcome.[837]

Action ten requires countries to develop rules to prevent BEPS by engaging in transactions, which would not or would only very rarely occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify circumstances in which transactions can be re-characterized; (ii) clarify application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.[838] With regard to re characterizing of transaction, the guide provides a principle to re-categorize contractual terms to reflect commercial or financial patterns that actually exist between associated MNCs based on their conduct and economically relevant characteristics of the transaction including options realistically available to the parties.[839]

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[835] OECD/G20 20 P.22.
[836] Ibid.
[837] Ibid.
[838] Action10 of the OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013.
[839] OECD/G20 Base Erosion and Profit Shifting Final Report 2015.pp.17 -18.

In comparing situation with independent parties, the guide suggests to look at contractual terms and actual legal ownership in light of commercial or financial relationship between associated MNCs. Where it is established that the conduct and characteristics, which are economically relevant are inconsistent with a written contract between associated MNCs, the actual transaction should be delineated for transfer pricing purposes in accordance with characteristics of the transaction reflected in the conduct of the parties.[840] Thus, the actual conduct of associated MNCs is a key factor in delineating a transaction and aligning transfer pricing outcome.

With regard to clarifying application of transfer pricing methods, selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNC's global business processes and the manner intangibles interact with other functions, assets, and risks that comprise the global business.[841] In other words, it is especially important to ground comparability and functional analysis on an understanding of the MNCs' global business by identifying all factors that contribute to value creation, which may include borne risks, specific market characteristics, location, business strategies and MNE group synergies.[842] On transfer of intangibles, the selected transfer pricing method selected take into account all relevant factors materially contributing to creation of value, not just intangibles and routine functions.[843]

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[840] Ibid,p.18.
[841] Ibid p. 26.
[842] Ibid, pp.58 -59.
[843] Ibid, p.98 para 6.133.

The revised guidance makes clear that any of the five OECD transfer pricing methods as well as 'alternative methods'[844] might constitute an appropriate transfer pricing method for transactions involving transfers of one or more intangibles.[845] In this respect, the OECD explicitly states that a rule of thumb cannot be used as evidence that a price or apportionment of income is arm's length including an apportionment of income between a licensor and a licensee of intangibles.[846] Whereas it recognizes use of thumb rule, under limited circumstances, transfer pricing methods based on costs may be utilized, particularly where the intangibles are not unique and valuable, for example, development of intangibles used for internal business operations, such as internal software.[847] This implies that transfer pricing methods most likely to prove useful in matters involving intangibles is CUP and transactional profit split method.[848] In clarifying the split profit method in the context of global value chains, the OECD is still working on it. Action thirteen deals with re-examination of transfer pricing documentation. The Action requires countries to develop rules regarding transfer pricing documentation to enhance transparency for tax administration by taking into consideration compliance costs for business.[849] The rules developed include a requirement that MNCs should provide all relevant governments with needed information on their global allocation of income, economic activity and taxes paid among countries according to a common template. Measures

[844] The guideline (report) is silence as to what constitute alternative methods.
[845] OECD/ G20 Base Erosion and profit Shifting Project, Final Report, 2015 p.98 para 6.136. This implies that the transfer pricing methods most likely to prove useful in matters involving intangibles is the transactional profit split method.
[846] OECD/ G20 Base Erosion and profit Shifting Project, Final Report, 2015 p.100 para 6.144.
[847] Ibid, p.100 para 6.143.
[848] Ibid, p. 100 para 6.145.
[849] OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013.

taken by the OECD are a three-tiered standardized approach to transfer pricing documentation to be followed.

First, MNCs are required to provide to tax authorities with high-level information regarding their global business operations and transfer pricing policies in a 'master file' to be available to all relevant tax authorities in countries they operate.[850] Second, detailed transactional transfer pricing documentation should be provided in a 'local file' specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.[851] Third, large MNCs are required to prepare Country-by-Country files containing information on pre-paid tax and paid tax in each country they operate. Such report should also contain their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction.[852]

In enhancing compliance, the guide requires local files and country-by-country to be finalized before due dates for filing tax returns for a relevant fiscal year. However, due to some circumstances, the country-by-country submission time may be extended up to one year.[853] Tax authorities are required to maintain confidentiality of documents availed to them by MNCs.[854] Most important innovation in the guide is that it provides templates for all three kinds of reports.[855] However, the guide

[850] Ibid.14.
[851] Ibid, p.16.
[852] Ibid, p. 1.
[853] Ibid p.17.
[854] Ibid p.18.
[855] Ibid, Annex 1-iv.

excludes associated MNCs with less than 750 million EURs to provide country-by-country reports.[856] Arguably, the enhanced three tier approach might be beneficial for EAC countries but this is subject to improved tax revenue capacity. Accordingly, the threshold of 750 million EURs requirement to report country-by-country pattern is very high and creates potentials to leave out a significant number of associated MNCs to take advantage.

Action seven requires countries to develop changes to the definition of permanent establishment to prevent artificial avoidance of permanent establishment status in relation to BEPS, including through use of commissionaire arrangements and the specific activity exemptions including related profit attribution issues.[857] The measure taken by the OECD is developing a rule that a person is deemed to have PE in the contracting state if he is acting on behalf of enterprises and habitually concludes contract or plays a principal role leading to a conclusion of contracts in the name of the enterprises for transfer of ownership, granting of the right to use or provision of service without material modification by the enterprise.[858] The guide also has clarified on activities that are not deemed to be PE. They include maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise, any other activity, provided that such activity or overall activity is of preparatory or auxiliary nature.[859] Accordingly, it developed anti-fragmentation rule to limit associated MNCs to establish and maintain several fixed places of business separated locally and organizations to be viewed as places of preparatory nature for

[856] Ibid p.10.
[857] Action 7 of the of the OECD Action Plan on Base Erosion and Profit Shifting, OECD Publishing, 2013
[858] OECD/G20 Action 7, p.16.
[859] Ibid.p 29.

purpose of establishing existence of PE for tax purposes.[860] However**,** Action 7 does not make any changes to existing international standards on allocation of taxing rights on international income. From the foregoing, measures and principle under BEPS Action Plan in aligning transfer pricing outcomes with value creation are still based on arm's length principle.

5.7 An Alternative to Arms' Length Principle

Use of arm's length principle as the corner stone for regulating transfer pricing between associated MNCs has been, to a great extent, of benefits to MNCs more than host countries. Both developed and developing countries have been irked by this problem and therefore, thought has been brought to completely depart from such principle. Scholars have suggested that formulary apportionment methods should be applied as alternatives to arm's length principle.[861] OECD member states also advocate for use of formulary apportioned within European Union.[862] African countries also have called upon to adopt formulary apportionment method given weakness of arm's length and lack of comparables prevailing in Africa.[863] The

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[860] Ibid, p.39.

[861] Avi –Yohah R.S. and Clausing K., Reforming Corporate Taxation, in a Global Economy: A Proposal to Adopt Formularly Apportionment, The Brookings Institution, 2007; Picciotto. S., Towards Unitary Taxation of Transnational Corporations, Tax Justice Network 2012, p.1.; Cauzin R., Policy Forum: The End of Transfer Pricing? *Canadian Tax Journal* 2013, 61:1 159 – 78; Meager L., Transfer Pricing Alternatives Needed, Business and Management, 2014; Rectenwald G., *A Proposed Framework for Resolving Transfer Pricing Problem: Allocating the Tax Base of Multinational Entities based on Real Economic Indicators of Benefit and Burden*, Duke Journal of Comparative and International Law, Vol.23:425; Altshuler R. and Geubert H., Formulary *Apportionment: It is Better than the Current System and Are there Better Alternatives?* National Tax Journal, December 2010, 63 (4 part 2), 1145 -1184.

[862] Weiner J.M., Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada (PDF), Working Papers No. 8, Taxation and Customs Union, European Commission, ISSN 1725-7557, 2005. P.247. See also, EU, Towards an internal Market without tax obstacles: A strategy for providing companies with consolidated corporate tax base for their EU worldwide activities, Communication 0582, Brussels 2001 p.15.

[863] Oguttu A.W., A Critical Analysis of what Africa's Response should be to the OECD BEPS Action Plan? A paper presented at 1st Africa Tax Symposium – Zambia, 2015.

argument in fovour of formulary apportionment method is that the arm's length principle is unfit for global economy because it is based on artificial distinct legal entities; it creates artificial tax incentives; very complex; and it does not ensure countries their right share of tax.[864] Notably, to date, formulary apportioned method as an alternative to Arm's length principle has not been adopted as an international standard. However, the method has been widely used in USA MNCs operating with USA and Canada. Formulary apportionment is a method of allocating profit earned by associated MNCs to countries, which the company has tax presence.[865] In this method, associated MNCs are considered to as one unit despite being operating in different countries. In ascertaining the income for tax purposes, the method requires deduction in their worldwide expenses based on global accounting system.

The net income is then distributed among countries in which the MNC has tax presence based on agreed factors and formula. Thereafter, each country applies its

[864] Avi –Yohah R.S. and Clausing K., note 861, p 10.

[865] The existing formulary apportionment originates from USA. This happens when USA congress concerned about double taxation between USA corporations and it PE operating across the USA border. In this context, the USA congress presumed that, PE outside USA was established to milk the income of USA parent corporations. In this context, the USA congress established the first legislation in 1921 requiring multinationals to provide consolidated accounting reports "to make an accurate distribution or apportionment of gains, profits, income, deductions, and capital between or among related business. See, Durst, M. C., and Culbertson, R.E., Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today, *57 Tax Law Review*, 2003, p. 37 and 43.As the time went on, the issue of apportionment of income became serious. In 1928, the USA congress reformulated the 1921 legislation by empowering commissioner to apportion, allocate or distribute gross income or deduction for the purpose of prevention of tax evasion. The provision provides that, "In any case of two or more trades or businesses (whether or not incorporated, whether or not organised in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorised to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such trades or businesses." see Revenue Act of 1928, Pub. L. No. 70-562, ch .852, §45, 45 Stat. 791, 806

tax rate to the income apportioned to it and tax accordingly.[866] The common factors, which ought to be taken into account for establishing a formula is proportion of sales, assets and payroll.[867] However, sales-based formula is preferred because it takes into account complicated issues like intangible. The information ought to be obtained from MNCs' country-by-country report. Advantages of formulary apportionment method include the following: first, the method can align countries' tax systems with global economy. Second, it eliminates tax incentive and possibility of shifting income to tax haven countries. Third, it is simple and easy to apply. Fourth, it provides potential for increase in revenue or enables a tax rate reduction.[868] Critic of formulary apportionment argues that it is vulnerable to double taxation in absence of a common formula. Secondly, it may lead to high compliance cost in absence of common tax accounting rules. Third, differences in currency exchange rates and rules of countries may distort the apportioned income. Fourth, the method does not reflect profit or loss of each entity.[869]

From the foregoing, it is submitted that the approach suggested in applying formulary apportionment is too simple to deal with and basically it does not take into account difference of tax laws of countries. Accordingly, there is no clear guideline in applying formulary apportionment, which ought to be regulated by law.

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[866] Ibid, see a Picciotto. S note 486 p.1.

[867] Avi –Yohah R.S. and Clausing K., note 864, p.12. see also, Mclntyre M.J., Theory and Practice of Combined Report with formulary apportionment, A paper presented at Multistate Tax Commission, December 2009.

[868] Ibid, p.13 -16. See also Rectenwald G., A Proposed Framework for Resolving Transfer Pricing Problem: Allocating the Tax Base of Multinational Entities based on Real Economic Indicators of Benefit and Burden, Duke Journal of Comparative and International Law, Vol.23:425, p.435.

[869] OECD., Review of Comparability and of Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development, July 2010, p. 8- 10.

Additionally, disadvantages of the method outweigh advantages. This might be reasons formulary apportionment has not been adopted widely by countries as an international standard. Consequently, there is no global instrument that regulates the same. The fact that formulary apportionment is based on profit split, it is argued that profit split method can be used to obtain such objective.[870] Likewise, other countries have also modified their transfer rules to suit their interest while based on arm's length principle. For example, Brazil modified its transfer pricing by doing away with comparability factors by using a fixed margin based on mathematical theory.[871] Despite weakness of arms length principle, if other factors remain constant, and available arm's length principle may remain a viable option for regulating transfer pricing across countries. World Bank study has shown that countries have increased their income by using transfer pricing law based on arms' length principle.[872]

5.8 Conclusion

The foregoing examination and analysis suggest that application of international transfer pricing standards as enshrined in various tax treaties and conventions are susceptible to manipulation of transfer prices by MNCs. The weakness of such standards, in particular, arm's length principle has given room for MNCs to take advantage and practice aggressive tax planning. The interplay between transfer pricing standards and aggressive tax planning has caused enormous base erosion in countries where economic activities are taking place. Results are that both developed

[870] Kroppen H. et al., Profit split, the Future for Transfer Pricing? Arms 'Length Principle and Formulary Apportioned Revisited From a theoretical and Practical Perspective, Fundamentals of International Transfer Pricing in law and Economics, in (W Schon and K.A.Konrad) editors, MPI Studies in Tax law and public Finance 1, DOI 10.1007/978-3642-25980-7_13, 2012 p. 268.

[871] See law 9430/96 of Brazil. See also Falcao T., Brazil's Approach to Transfer Pricing: A Viable Alternative to Status Quo? Tax Management Transfer Pricing Report, Vol. 20 no. 20 2/23/ 2012.

[872] Cooper et al., note 657 p.11.

and developing countries faced base erosion and profit shifting impact. International initiatives have been taken to rescue countries from base erosion and profit shifting through transfer pricing by supplementing existing standards. The intention is to ensure that profits are taxed where economic activities generating such profits are performed and where value is created.

However, the BEPS Action plan to a great extent is not taking in to account issues of concern for EAC countries. Notably, measures, rules and principles are still based on arm's length principle, which previously, seemed to fail in such areas. Furthermore, to a great extent, the whole process of arriving at arm's length price is still based on comparability and analysis of various issues. Although tax authorities have been availed with the tool for auditing, the whole procedure is very cumbersome. Accordingly, application of arm's length solutions provided in the guide sometimes, is inconclusive and contains probabilities, which to lead to uncertainty of the law. A plea for use of formulary apportionment has not been well addressed. Countries, which have been embracing such method in their application is limited with countries because the law applicable to such transaction is the same. Absence of a thorough study in handling formulary apportionment as a viable solution to existing problem renders decision to opt for it difficult. Notwithstanding, the weakness of arm's length principle advantage of using it outweigh the disadvantage.

CHAPTER SIX

TRANSFER PRICING LEGISLATION IN TANZANIA

6.1 Introduction

Abolition of socialist ideology in Tanzania and adoption of a free market economy in which trade liberalization is enhanced, increased regional trade and economic links with other countries throughout the world. The result is an increase in MNCs' operations in the country whereby transfer pricing is practiced. However, like other countries of the world, Tanzania faces the problem in relation to the law regulating international transfer pricing in particular. Manipulation of prices by MNCs through transfer pricing causes income tax base erosion and profit shifting problems that have necessitated changes in tax laws governing transfer pricing in many countries. Arm's length principle as a corner stone for transfer pricing between MNCs, and other principles have been enshrined in various domestic tax legislation and DTAs in Tanzania.[873] However, the application of arm's length principle remains largely untested or implemented. This chapter analyses an adequacy of transfer pricing legislation in curbing transfer pricing manipulation in Tanzania.

6.2 An Overview of Social, Economic and Political Context

Tanganyika, now Mainland Tanzania, attained its independence on 9th December, 1961. Economically, it inherited the colonial economy and remained an appendage of the metropolitan economy. The actual situation of the economy of Tanzania immediate after independence is well explained by Rweyemamu that,

[873] Income Tax Act, Cap 332 RE 2008 (ITA), Income Tax transfer pricing Rule 2014,(TP rules) Tanzania Revenue Authority Guidelines, (TRA Guideline)

> *"When Mainland Tanzania became independent on 9th December 1961, it inherited its basic position within the international community from the colonial relationship. In economic terms, this means that a client 'independent' state on the periphery of western capitalism was created. Political independence did not necessarily mean economic independence namely control over economic decision making and the national economy, the establishment of a firm industrial structure leading to self generating and self sustain grown,…on the contrary the institution framework diligently erected by Britain during colonial period ensured Tanzania economic dependence on international capitalism in general and in Britain in particular… Investments, both public and private, were assumed to flow easily from Britain."*[874]

Essentially, the economy of Tanganyika was export economy directly or indirectly integrated in the world of capitalist system via export sector.[875]As a consequence, the government of Tanganyika continued to depend on foreign source of income for development of the country. To solve the problem, the government of Tanzania spelt various laws aimed at attracting both local and foreign investors to participate fully in industrial development sector in the country.[876] They included the Tanganyika Development Act,[877] which established National Development Corporation (NDC). The function of the NDC encompassed to provide loans to African small scale business enterprises, to provide incentive to high risk investment in areas important for the country's development and to enter into joint ventures with foreign private investors.[878] Foreign Investment Protection Act[879] was also established. The

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[874] Rweyemamu J., Underdevelopment and industrialization in Tanzania, 1976, PP 38 -39.

[875] Shivji I.G., Classes struggle in Tanzania, Dar es Salaam, TPH, 1976, P.36.

[876] Maina C.P., Foreign investment in Tanzania, the Mainland and Zanzibar, University of Dar es Salaam, 1994, p. 5.

[877] 1962. The intention of the parliament was to use private sector for industrial and commercial development. However, most industrial opportunities in the country were neither so readily identifiable nor so clearly feasible and attractive to ensure their accomplishment without encouragement. See Kiunsi, note 80 p. 10.

[878] Ghai Y.P., Law in the Political Economy of Public Enterprises, African Perspective, Uppsala Offset Centre AB, 1977, p. 209.

objective of the Act was to encourage foreign investors by providing statutory guarantee on their investments.[880] To enable implementation of the Act, Foreign Investment (Protection) Regulation of 1964 was established.[881] Consequently, dominant sectors were given to private investors as was reflected in the five years development plan.[882] The plan also outlined various incentives for private sector like repatriation of capital and profits, provision of industrial estates, tariff protection for infant industries and investment allowances.[883]

To supplement general guarantees provided in the legislation, the government also concluded bilateral agreements with foreign countries in its efforts to encourage and protect foreign investment. They included, for example, agreement between United States of America and Tanganyika on investment guarantee,[884] the Agreement between Tanzania and Germany on encouragement and reciprocal protection of investment,[885] and the agreement between Tanzania and Swiss Confederation concerning encouragement and reciprocal investment encouragement.[886] From the foregoing, it is submitted that from the beginning of independence, political leaders believed that foreign investment and aid were important catalysts for development.[887]

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[879] Act No 40 of 1963.
[880] Special supplement to the Tanganyika Gazette, Vol XLIV No. 32 of 14th June, 1963 p.8.
[881] Government Notice No. 523 of 1964.
[882] Government of Tanganyika, Development Plan for Tanganyika, 1961 -1962 and 1963 -1964, Dar es salaam Government Printer, 1962, pp 7 -8.
[883] Ibid.
[884] Of 14th November 1963.
[885] Of 30th January, 1965.
[886] Of 3rd May, 1965.
[887] Mapunda B.T., Compensation for Expropriation of Foreign Investments: The Problem of Standards, The LL.M Dissertation, University of Dar es Salaam 1993, p.153.

It was clearly pointed out by the then president Nyerere that, "the government wishes to work with private investors for the development of the Tanganyika."[888]

Notwithstanding, efforts to encourage foreign investors, in 1967, there was dramatic change of laws of investment in Tanzania. In the same year, the country adopted socialism ideology whereby all major means of economy were placed under public ownership and control.[889] Consequently, the law operated to restrict development of private sector while ensuring public sector investment.[890] However, socialism ideology failed due to poor performance and inefficiency of public enterprises, among other things. In 1986, Tanzania embarked on economic recovery programme and liberalized its economy. Implementation of economic reform was part of conditions for financial aid administered by World Bank and other donor community members. That was evidenced by expanded donor support, ranging from public infrastructure building to civil services and governance reforms. For example, there was support of $200 million World Bank credit for Songo Songo natural gas field development project.[891]

The most remarkable development was pronouncement of Zanzibar Resolution, which officially abandoned socialism ideology in Tanzania.[892] The resolution necessitated formation of a new policy and law with a view of attracting foreign investments. That was followed by establishment of Investment and Protection Act

[888] Nyerere J.K., Freedom and Unity, Oxford University Press, 1966, p.209.
[889] This was done following the proclamation of Arusha declaration of 1967.
[890] Kiunsi H.B, note 80 p. 13.
[891] United Nations, An investment Guide to Tanzania, UNCTAD/ITE/IIA/2005/3, 2005, p.13.
[892] United Republic of Tanzania, Investment Promotion policy, Dar es Salaam, Government Printer, 1990.

of 1995, which was repealed and replaced by Tanzania Investment Act.[893] The Act establishes Tanzania Investment Centre (TIC) as agency to coordinate, promote, encourage and facilitate investments in the country,[894] among other things. In enhancing industrial activities, Tanzania also established Export Processing Zone[895] (EPZ) and special economic zone,[896] which also attracted MNCs. Results were an increase in foreign MNCs in the country whereby transfer pricing is practiced. Such MNCs' operations are ranging from mining, [897] manufacturing,[898] telecommunications,[899] and finance undertakings.[900] Others are shipping,[901] tourism and promotion services. Accordingly, the recent discovery of huge gas reserves increased attraction of foreign MNCs in the country.[902] In due regard, it is clear that most MNC investors are subsidiary companies from developed and tax haven countries. [903] In fact, Tanzania leads EAC region in investment inflow.[904]

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[893] 1997.

[894] Section 4 of Tanzania Investment Act, 1997.

[895] Established under Export Processing Act, 2002.

[896] Established under Special Economic Zone Act, 2006.

[897] for example Geita Gold mine (GGM)a part of Anglo Gold Ashanti from South Africa, Songas gas Tanzania limited from party of CDC Group plc from UK, Williamson Diamond Mines part of De Beers Group of South Africa.

[898] for example Carnauld Metal Box Ltd UK, Coca Cola Kwanza Tanzania Ltd from USA, Mbeya Cement Co. Ltd from France, SBC Tanzania Ltd as part of (Pepsi co Inc of USA, Tanzania Cigarette Company, Tanzania Breweries company Ltd and recently Dangote Cement

[899] Such as Vodacom Tanzania Limited, MIC Tanzania Ltd, Airtel Tanzania Limited, Hallow tel and Zantel.

[900] such as KPMG from Switzerland, Standard chartered bank UK, Citi Bank from USA, Barclays Bank from UK, FNB from South Africa.

[901] See for example Maersk Tanzania Ltd from France.

[902] UNACTAD, note 914, p. 34.

[903] The presence of various investment opportunities such as natural resources, cheap labour and market has been important catalyst for MNCs operations in Tanzania. Accordingly, favourable tax laws and political stability have contributed substantially in attracting MNCs operations in the country. See Burhan., A.M., Analysis *of Multinational Corporations (MNCs) in Tanzania*, Scholarly Journal of Business Administration, Vol. 3(1) pp.1-6 January, 2013, p. 1. Available online http:// www.scholarly-journals.com/SJBA ISSN 2276-7126 ©2013 Scholarly-Journals.

[904] UNACTAD, World Investment Report 2015, p. 34. See also BOT, Tanzania Investment Report: Foreign Private Investment, 2013, p.15.The report shows investment inflow trend in Tanzania from 2008 -2012. United States of America, Tanzania Investment Climate Statement 2015, p.7.

The increase of MNCs' operations whereby transfer pricing is enhanced has brought about enormous challenges in curbing transfer pricing manipulations in the country. The problem has been caused by use of tax avoidance schemes by associated MNCs.[905] As a result; profits arising from international transactions have been shifted outside the country where parent companies operate or to tax haven countries. For example, between 2001 and 2007, Tanzania lost US$830 million because of thin capitalization by Geita Gold Mine.[906] This is from one company only. Between 2001 and 2010, Tanzania also lost US$ 333 million due to manipulation of prices. [907]

Furthermore, other reports indicate that Tanzania is losing US$ 150 million each year due to trade mispricing.[908] For example, recall, in 2008, Resolute Tanzania Limited was selling gold to sister a company USD 530 per ounce, the amount that was less than half of the market price by then.[909] Such amount of money was eventually shifted outside Tanzania.

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[904] for example Geita Gold mine (GGM)a part of AngloGold Ashanti from South Africa, Songas Gas Tanzania limited from party of CDC Group plc from UK, Williamson Diamond Mines part of De Beers Group of South Africa.

[905] See discussion chapter five above. See also Bajungu C., Transfer pricing "Fairness in Multinationals Extractive Industries, a paper presented in seminar hosted by The Tax Justice Network; Agenda Participation 2000 (Tanzania), Norwegian Church Aid and KEPA, 2013. Oguttu A.W., A Critical Analysis of what Africa's Response should be to the OECD BEPS Action Plan? A paper presented at 1st Africa Tax Symposium – Zambia, 2015.

[906] Kabwe, Z.Z., Transfer pricing in Tanzania, My Experience in Tackling Tax avoidance/ Evasion through parliament, A paper presented at Tax Justice Network, Agenda Participation 2000, KEPA and Norwegian Church Aid-NCA Transfer Pricing Seminar Dar es salaam, 3rd October 2013, p. 2. See also Bomani Mining Review Report of 2006 and Masha Mining review report of 2006.

[907] Kar, D and Spanjers, J., Global Financial Integrity, Illicit Financial Flows from Developing countries: 2003 to 2012, 2014.

[908] Curtis M., et al, The One Billion Dollar Question: How Can Tanzania Stop losing So Much Tax Revenue, a Report by Tanzania Episcopal Conference, National Muslim Council of Tanzania and Christian Council of Tanzania, First Ed. June 2012 p. 17. See also Msafiri A.G., Sustainable Use of Natural Resources – Gold Mine in the Lake Zone, A paper presented at St. Augustine University of Tanzania (SAUT) main Campus Mwanza 24th October 2014, p.8.

[909] Kabwe, Z. Z., note 923, p.1.

6.3 Transfer Pricing Laws in Tanzania

The legal and regulatory framework of transfer pricing comprises the following major sources: the Constitution of United Republic of Tanzania, Tax legislation as well as their rules and tax treaties.

6.3.1 Constitution of United Republic of Tanzania (CURT) 1977

Any government requires finance to provide for public services and run the government. For that reason, governments depend on various taxes collected in their countries. Such taxes collected by government are governed by tax law by using special procedures. The fact that tax is the backbone of the country taxation becomes of quasi-constitution nature.[910] Thus, the basic principles in exercising taxing powers must be clearly established in the constitution of the country.[911] The Constitution of the United Republic of Tanzania (CURT) recognizes tax as the main source of finance for government and it provides a principle upon which tax is imposed. The provision provides that, "no tax of any kind shall be imposed save in accordance with a law enacted by parliament or pursuant to a procedure lawfully prescribed and having the force of law by virtue of a law enacted by Parliament."[912] If plainly construed, the CURT requires no person to be taxed except in accordance with the

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[910] Brennan G. and J. Buchanan, The Power to Tax: Analytical Foundations of a Fiscal Constitution, London, Cambridge University Press, 1980 as quoted from Luoga, F., *Taxation in the Advent of Democratization and Transition to Free Market Economy in Tanzania and concerns on the Rule of Law and Human Rights*, Law, Social Justice & Global Development Journal (LGD),2002, para 4.1.1 available at www.gepc.or.tz/wp.../IncomeTax-Law-in-Tanzania-Source-Book-Prof.-Luoga.pdf.

[911] Ibid.

[912] Article 138(1) of the CURT, 1977 as amended from time to time. In the case of *Commissioner General TRA v Airtel Tanzania Ltd*, The court of Appeal held that, "it is good practice in tax matters that the taxpayer be made aware as much as possible, by full citation of the enabling taxing provision, the legal basis upon which an assessment and /or a tax demand has been made…. if the relevant legal provision does exist and whether tax liability exists, then the tax should be paid" emphasis is mine.

law.[913] Therefore, the CURT confers right to taxpayers to arrange their tax affairs and pay what is required by the law. Consequently, MNCs as part of large taxpayers who substantially contribute to finance of the country are obliged to pay according to the requirement of the law. The fact that tax is the main source of finance of the country, the Constitution empowers the government only to present bills related to financial matters.[914] The bills include matters related to levy a tax or to alter taxation otherwise than by reduction.[915] Although the CURT does not clearly provide for transfer pricing laws, the principle enshrines under the CURT are also applicable to taxation of MNCs.

6.3.2 Income Tax Act, 2004

Transfer pricing legislation regulating transfer pricing was introduced in Tanzania in 2004. Prior to that, transfer pricing was largely untested and regulated through limited scattered provisions contained in anti-avoidance provisions of Income Tax Act.[916] The arms' length concept was used as a test to measure situations where related parties to a transaction by visual of their relations arrange their affairs and pay less amount of tax. The application of arms' length principle by then is well stated by Luoga that,

> *"It is an underlying assumption of income tax law that profits or gains made by a taxpayer are achieved through the interplay of market forces which are independent of the taxpayer's control. This assumption often break down where parties to a transaction do not have opposing economic interests, but have, by virtue of the particular relationship between them, a common economic interest which enables them to arrange the terms of the*

[913] Ongwamuhana K., Tax Compliance in Tanzania: Analysis of Law & Policy Affecting Voluntary Tax Compliance, Mkuki na Nyota, Dar es Salaam, 2011 p. 79.
[914] Article 99(1) of the CURT, 1977 as amended from time to time.
[915] Ibid, Article 99(2) (i).
[916] 1973.

> *transaction to produce the least amount of tax. Persons in such circumstances are said not to deal with each other "at* arm's length" and transactions between them are referred to as "transactions not at arm's length."[917]

To this extent, the Commissioner General of Tanzania Revenue Authority (TRA) was empowered to appropriately adjust any amount of transactions liable for tax if it was established that there was tax avoidance scheme.[918] The arm's length concept was also used to ascertain profit of business carried out between related non-residents.[919] However, there was no clear indication whether or not the arm's length principle was used to comply requirement of DTA which existed by then.[920]

The Income tax Act of 2004 (ITA), which came into force on 1st July 2004 repealed and replaced the Income tax Act of 1973. The main objective of ITA is to provide provisions "for the charge, assessment and collection of income tax for the ascertainment of the income to be charged and for matters incidental thereto".[921] The ITA has XI Parts: Part I provides for title, scope of application and interpretation. Part II provides for imposition of income tax. Part III income tax base in essence comprises calculation of the income base, rules governing calculation and assets and liability. Part IV provides for rules applicable to particular type of persons such as partnership, trust and cooperation. Party V deals with special industries such as insurance business, retirement savings and charitable organizations. Part VI deals with international taxation upon which source and resident principles are set, taxation

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[917] Luoga, F., note 910.
[918] Section 27, of Income Tax Act, 1973.
[919] Section 19(2) of Income Tax Act, 1973.
[920] See for example Article 9(2) of the convention between the government of Italian Republic and the Government of the United Republic of Tanzania for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.
[921] Preamble of the ITA, Cap 332 RE 2008.

of PE, controlled foreign company and trusts including foreign tax relief. Part VII provides for special procedures, which include the taxpayers' obligation, withholding tax payment procedures, installment payment procedure and income payable on assessment. Part VIII deals with non-compliance upon which offences, penalties and interest are prescribed, recovery of tax, third party liability and proceedings. Part IX is about remission, refunds and set-off. Part X provides for administration of tax by commissioner and other officers, audits together with information collection. Part XI provides for transitional provisions.

Part III is of particular interest because it provides for income tax base upon which taxes are imposed.[922] The ITA imposes tax on resident and nonresident on incomes from employment, business or investment having source in Tanzania while residents are taxed on their worldwide incomes.[923] For purpose of this work, a corporation is resident of Tanzania for tax purposes if it is incorporated or formed under laws of the United Republic or at any time during the year of income the management and control of the affairs of the corporation are exercised in the United Republic.[924] Two issues can be observed, firstly, the ITA does not provide clear difference between 'incorporation' or 'formed.' Lack of clarity on these two words may provide potentials for MNCs to declare non-residents for tax purposes. In A*frican Barrick Gold Plc v Commissioner General TRA,*[925] the appellant claimed that the Tax board erred in law and the fact in holding that appellant company is not resident for tax purposes because the words 'incorporation and formed' meant the same thing and

[922] Ibid, Section 5.
[923] Ibid, section 6 (a) and (b). For purpose of this work, income from employment is not dealt with.
[924] Ibid, section 66 (4) (a) and (b).
[925] Tax Appeal No 16, 2015.

therefore, activities done by the company did not amount to being resident. The Appeal Board stated that the said words are different because the word 'formed' is a safe habour aim to accommodate all situations for which a company may be established under the law of Tanzania and acquire residence status for tax purposes. Secondly, there is no clear guideline under circumstances management and control of the affairs are said to be exercised in Tanzania for transfer pricing purposes, the situation that may bring difficulties in determination of residence of a taxpayer.[926]Apart from residence issue, the law is silent under what circumstances an income is said to have source in Tanzania for transfer pricing purposes.[927] However, the law clearly state under which circumstances payments are regarded to have source in Tanzania.[928] Thus, the amount to be charged is profit or gains from conducting business or investment for the year of income.[929]

6.3.2.1 Application of Arms' Length Principle in Tanzania

Section 33(1) of Income Tax Act[930] provides for the arms' length principle as basis for regulating transfer prices between associated parties. The provision provides that,

> *"In any arrangement between persons who are associates, the persons shall quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have*

[926] *Barrick Gold Plc v Commissioner General TRA*, Tax Appeal No 16, 2015. In this case the appellant claim that at the time control and management of company of affairs was not exercised in Tanzania.

[927] Kenya for example clearly provides circumstances showing business is carried out in Kenya for transfer pricing purposes. See chapter 7 para 7.3.2.1.

[928] Ibid, section 69 (a) to (i).

[929] Ibid, sections, 3, 8, 9, and 20 respectively. See also Para 4.1 of TRA Practice Note 5 on Income from Business and Practice Note 6 on Income from Investment.

[930] RE 2008.

> *arisen for them if the arrangement had been conducted at arm's length."*[931]

The ITA is silent on meaning of arm's length, however, the TP Rules defines as a principle whereby commercial or financial transactions between associates is taking place on the same terms as if such transactions had taken place between independent persons under comparable conditions and circumstances.[932] In context of this definition, the independent transaction is used as a test upon which transaction between associated parties is measured or tested. The policy underlies section 33 is to address tax avoidance schemes involving manipulation of prices of goods and services under international and domestic transactions between associated parties. Thus, the function of arm's length principle is to adjust prices of goods and services to reflect arm's length price that would have been charged had the transaction conducted on normal business grounds between unrelated parties. It is in this context that ITA gives the Commissioner General (Commissioner) power to adjust prices that are not at arm's length.[933] However, adjustment in this context is only possible once the anomaly is noted as a result of transfer pricing audits.

For arm's length to apply transactions between associated parties must be arranged because of their special relations existing between them. Notably, the transaction between associated parties does not necessarily mean that the price charged for such transaction is not at arm's length. The price must be affected by arrangement

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[931] Ibid, section 33 (1). The introduction of such principle was modeled on OECD and UN models See Article 9 OECD and UN Models. In essence this was part of implementation of multilateral institutions policies. See chapter 4 for more details.
[932] Rule 3 of TP Rules 2014.
[933] Section 33 (2) of ITA R.E, 2008.

between parties because of their relationship. However, neither the ITA nor Transfer Pricing Rules explain under what circumstances the transaction between associated parties is said to be arranged. In context of tax, arrangement is defined to mean action, agreement, arrangement course of conduct, dealing, promise, transaction, understanding or undertaking involving more than one person and it includes a part of arrangement.[934] Arguably, the meaning of arrangement as provided does not directly correspond to context of transfer pricing because it does not show circumstances or elements that actually indicate presence of arrangement that affects the actual taxable amount. The words used are mere another meaning of arrangement[935] thereby missing connection to transfer pricing. The notion 'arrangement' is the corner stone of dispute between associated MNCs and the tax authority. While the associated parties are alleged not to arrange their affairs because of special relation existing between them, the revenue authorities are required to prove such arrangement, which practically becomes difficult like it was in Unilever case.[936]

6.3.2.2 Associated Parties

In context of transfer pricing, there must be transactions between associated parties for arms' length principle to apply. Generally, the ITA does not provide specific definition of associated parties for transfer pricing purposes. However, in context of ITA, parties are regarded associated in relation to corporation if are direct or indirect controls or benefits fifty percent or more of the rights to income or capital or voting

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[934] Section 3 of Tax Administration Act, Cap 399, 2015.
[935] See for example in thesaurus dictionary the word arrangement mean agreement.
[936] Income tax appeal no. 753 of 2003 KE: HC September 2005, see also chapter 4.para 4.6. See discussion chapter seven para 7.3.3. 1.

power through one or more corporation.[937] Arguably, the threshold control of fifty percent of the shareholding or voting power in the entity is very high. To this extent, it leaves important elements of connected shareholders having considerable percentage of rights to income, capital or voting power of the company.

The problem with this is that associated parties may use such loophole to escape from arm's length.[938] Although the law clearly states that in case the situation of associated parties is not covered by the ITA, one may reasonably be expected to act, other than as an employee, in accordance with the intentions of the other.[939] However, the requirement is subjective and does not give conclusive answers. Given intricacies of transfer pricing, it is not easy to measure the extent or reasonableness and intention of the parties to a transaction. Accordingly, the law does not provide any guideline in establishing the intention of the parties.[940]

Permanent establishment and its head office or other related branches are also associates for transfer pricing purposes[941] Likewise, the ITA is silent on meaning of branch, but Transfer Pricing Rules describe branch as permanent establishment (PE) as defined by Tax treaty if the transfer pricing issue is originating from tax treaty.[942]

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[937] Ibid, Section 3 (i) (bb). It should be noted that the ITA provides broad meaning of associated parties to include individual, trust, and partnership. However, for the purpose of this study only of corporation is taken in to account. In context of ITA, corporation is defined as any company or body of corporate established, incorporated under any law in force in the united republic of Tanzania or elsewhere excluding partnership. See section 3 of ITA as amended by Finance Act, 2014.

[938] For example, in African *Barrick Gold Plc v Commissioner General TRA*, Tax Appeal No 16, 2015, the company developed avoidance scheme by declared loss while distributed dividends to its shareholders.

[939] Section 3.

[940] See TRA Transfer Pricing Guideline, 2015.

[941] Section 71(6) of ITA Cap 332 R.E 2008.

[942] Rule 3 of TP Rules 2014. See also para 3 of the TRA, Transfer Pricing Guidelines, 2015.

If the issue is originating from ITA, then the meaning of PE as defined in the ITA will prevail.[943] In context of ITA, PE means,

> *"a place where a person carries on business through an agent, other than a independent acting in the ordinary course of business, a place where a person has used or installed, or is using or installing substantial equipment or substantial machinery; and a place where a person is engaged in a construction, assembly or installation project for six months or more, including a place where a person is conducting supervisory activities in relation to such a project."*[944]

In context of the tax treaty, permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on and it includes, especially 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 of natural resources. It also encompasses a building site, a construction, an assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of six months or more, furnishing of services including consultancy services by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or connected project) within the country for a period or periods aggregating to six or more months within any twelve month period.[945] The tax treaty also clearly provides for activities that cannot constitute a permanent establishment. The problem with this definition is that the meaning of PE in the treaty is wider than that of ITA. Yet, in applying arm's length

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[943] Ibid.
[944] Ibid, Section 3.
[945] Article 5 (1), (2) and (3) of the DTA between Tanzania and Canada for avoidance of double Taxation and prevention of Fiscal evasion with respect to taxes on Income and on the Capital 1995.

principle, the law requires transfer pricing regulations to be construed in consistency with OECD and UN models and their Guidelines.[946] In case of inconstancy between domestic law and international instruments, the domestic law shall prevail.[947] This requirement is perfect if ITA, as substantive law, is addressing the matter extensively. In such situation, if the ITA will prevail, the MNCs stand to benefit more because the Act does not sufficiently cover the matter. For example, a mine is not clearly stated to constitute permanent establishment under the ITA despite being leading in MNCs operations in Tanzania. Accordingly, the ITA is silent on whether or not the existing definition of PE can be applicable on electronic commerce between associated parties.

6.3.2.3 Ascertainment of Transfer Pricing Income

Generally, associated MNCs are taxed on profit from business or investment derived from Tanzania. Yet, the law is silence under what circumstances the business is said to be conducted in Tanzania for transfer pricing purposes.[948] However, ITA defines business to mean trade concerned in nature of trade, manufacture, professional or isolated arrangement with a business character.[949] It includes past, present and prospective businesses. Accordingly, a mining and petroleum operations are treated as business activities for purpose of calculating taxable income.[950] However, absence of a clear distinction may render MNCs to take advantage as recipients of business

[946] Rule 9 (1) of the TP Rule 2014.
[947] Ibid, Rule 9(2).
[948] Other countries clearly state under what circumstances the business is said to be carried, see for example section 18 (1) of cap 470 of the laws of Kenya. In the case of the *Trustee of AD Charitable Business Trust v CIT* 3 EACTC 89, it was stated that "Dividing line between what it does not amount to the carrying on business is not always easy to ascertain".
[949] Section 3 ITA RE 2008. See also Para 4.1 of TRA Practice Note No 5 on Income from Business.
[950] Ibid, section 65B (4) and 65K (4) respectively as amended by section 28 of Finance Act, 2016.

income because of large scope of deductions for expenses in respect of incomes from businesses.[951] In calculating taxable amount, the law requires any expenditure incurred by the person wholly and exclusively in production of income from the business or investment be deducted.[952] In addition, in calculating the interest amount, the law requires debt obligation incurred by the person wholly and exclusively in production of income from business or investment to be deducted.[953] Arguably, for deductions to be effected, they presuppose presence of actual cost spent on a particular aspect allowable for deductions. However, it is unclear if a taxpayer fails to produce actual cost on such expenditure. That may provide potentials for MNCs to claim deductions that are not actually spent as was in *Bulyanhulu Gold Mine Ltd v Commissioner General TRA.*[954] In this case, the tribunal disallowed deduction for expenditure of capital nature because the taxpayer failed to produce evidence. On appeal, the Court of Appeal ordered the TRA to re-assess the value of the aircraft on basis of market value and deduct expenses according to accounting principles.

Despite huge deductions available, the law clearly prohibits deductions from expenditure of capital nature.[955] Accordingly, no deduction in interest is allowed in excess of 7.3 debts to equity ratio.[956] In calculating taxable amount from mineral operations, annual charges and royalties incurred under Mining Act and mining development agreement, legally depreciated allowances, acquisition and

[951] Ibid, see deductions under sections 11, 12, 13, 14, 15, 16, 17, 18, and 19 respectively of ITA as amended by Finance Act, 2016, See also, Luoga F.M, note 10, p. 102 – 103.
[952] Ibid, section 11(2).
[953] Ibid, section 12 (1).
[954] Consolidated Civil Appeal No. 89& 90, 2015, p. 18.
[955] Section 11 (3) of ITA Cap 332 RE 2008 as amended by Finance Act, 2012.
[956] Ibid, section 12 (2) (a) as amended by section 22 of Finance Act, 2012.

rehabilitation expenses are deductable.[957] This is in addition to other deductions. Likewise, in petroleum operations, royalties and annual fees incurred depreciation allowance and decommission funds are deductable.[958] However, no deduction is allowed in agricultural development and environment, gifts, depreciation allowance for depreciable assets and long-term contracts in both mining and petroleum operations.[959] In addition, unrelieved loss, bonus payment and excess expenses incurred are not deductable.[960]

In calculating the taxable amount of permanent establishment, the law requires to be taxed separately from its owner and on amount attributable to it.[961] For example, MultiChoice Tanzania Limited is a permanent establishment of MultiChoice Africa a South African company. MultiChoice Tanzania Limited conducts business on behalf of MultiChoice Africa. For being a permanent establishment, MultiChoice Tanzania is taxed on amounts attributable to it, including amounts derived and payment received, liability owed, expenditure incurred and payment made.[962]

In addition the following arrangements between permanent establishment and its owner are recognized for calculation of income: transfer of an asset or liability of tangible, intangible, and debt obligation arising out of borrowing money used exclusively in the business of PE.[963] Moreover, sales of trading stock by the owner of the same permanent establishment and other business activities of the owner

[957] Section 65E (1) of ITA as amended by section 28 of Finance Act, 2016.
[958] Ibid, section 65N (1).
[959] Ibid, section 65E (2)(a).
[960] Ibid, section 65E (2) and 65N (2).
[961] Section 71(1) of ITA Cap 332 RE 2008.
[962] Ibid, section 71 (2).
[963] Ibid, section 71 (3) and (4).

conducted with residents of the country of the permanent establishment of the same or a similar kind as those effected through the PE are regarded as activities carried on by permanent establishment.[964] Ascertainment of income under ITA reveals that there is no specific approach in ascertaining business profit for transfer pricing purposes and therefore, calculations are made just like any other income under ITA. Unlike Tanzania, Kenya Income Tax clearly provides ascertainment of taxable amount for transfer pricing purpose.[965]The problem with this is that a transaction between associated parties contains features that might not exist in independent transactions, which may substantially affect business profit for tax purposes. Nevertheless, in context of transfer pricing where associated parties' profit is not made just like an independent part could have been made, the Commissioner is empowered to make adjustment.

6.3.2.4 Transfer Pricing Adjustment

Transfer pricing adjustment is adjustment made by commissioner where it is established that price or interests of transactions between associated parties were not made at arm's length price.[966] Accordingly, any adjustment in respect of assessment made on one of associated parties may be reflected by an offsetting adjustment on assessment of the other person up on request by the other part.[967] This is achieved by re-characterizing the source and type of income, loss, amount of payment or apportionment and allocation of expenditure including income from a domestic or

[964] Ibid, section 71 (5).
[965] See discussion chapter seven.
[966] Section 33(2) of ITA Cap 332 RE 2008 and Rule 14 (1) of TP Rules 2014. See also TRA, Transfer Pricing Guideline para 11 (2) (f).
[967] Ibid, Rule 14(2).

foreign permanent adjustment[968] *Prima facie*, the re-characterized transaction will be taken by the TRA and compared with transactions between unrelated parties or between associated and third party. However, the re-characterized (hypothetical) transaction is not actual transaction of the associated parties, which faced commercial transactions that could not have been faced by unrelated parties in a similar situation. Under such circumstances, the Commissioner imputes a hypothetical transaction into actual transaction of the associated parties and may come out with an amount that was not actually incurred. It is unclear on the extent which the re-characterized transaction actually takes into account special circumstances that associated MNCs face when transacting with each other, a pattern, which cannot be found to unrelated parties.[969] For example, associated MNCs, which distribute their activities in production, distribution and manufacturing centres have advantage in reduced transaction costs, increased information sharing, reduced risks and increased bargaining power. Such circumstances may potentially affect analysis of arm's length price. In context of ITA, special circumstances existing between associated parties are considered as basis for adjustment only.[970] Given the wide discretion of the Commissioner, there is a danger of the taxpayer being affected by such requirement.

Accordingly, it is unclear whether or not adjustment for comparability purposes is based on actual transaction of associates or on the re-characterized transaction. The adjustment for comparability purposes and (adjusted) re-characterized transactions

[968] Ibid, section 33 (2) (a) and (b) as amended by section 23 of Finance Act, 2016; Rule 4 (2)
[969] See TRA , Transfer Pricing Guidelines 2015 paras 8, 9 and 11respectively.
[970] Ibid, para 11 (1) (e).

serves different purposes.[971] Generally, transfer pricing adjustment may result in double taxation in international transactions. Consequently, the law also allows corresponding adjustment for purpose of avoiding double tax under the following conditions: First, if transfer pricing adjustment has been made in another country in which Tanzania has DTA and such transactions are subject to tax in Tanzania.[972] Secondly, if the adjustment results in taxation in another country of income or profit that is also taxable in Tanzania.[973]

6.3.3 Income Tax (Transfer Pricing) Rules 2014

Income Tax (Transfer Pricing) Rules (TP Rules) was established in 2014 and came in force on 2nd February 2014,[974] ten years after introduction of arm's length principle. The objective of the TP Rules is to give effect to transfer pricing principle in determination of transfer pricing methods. The TP Rules applies to transaction between associated MNCs operating within and outside Tanzania.[975] The TP Rules maintain meaning of associated parties as provided in the ITA. Accordingly, both ITA and TP Rules do not state clearly on transactions subject to arm's length principle for transfer pricing purposes.[976]

However, if read between lines, transactions subject to arm's length principle include the following: first, income splitting arrangement.[977] Under this category, the

[971] See discussion below on comparability factors.
[972] However, Tanzania is having very limited number of DTAs.
[973] Rule 13 (a) and (b) of TP Rules 2014.
[974] Government Notice No. 27 of 2014. The decision in the case of *Mbeya Cement company ltd v Commissioner General TRA*, Civil Appeal No. 19 played an important role in establishment of TP Rules.
[975] Rule 2.
[976] In Kenya, the law clearly provides transactions subject to arm's length principle for transfer pricing purposes. See chapter seven para 7.3.3.2.
[977] Section 34(1) and (4) respectively.

Commissioner is empowered to consider market value of any payment made.[978] Second, intercompany loan between associates by restricting interest on the debt to an equity ratio of 7:3.[979] Third, services rendered between associates,[980] financing,[981] sale and licensing of intangibles.[982] However, services, intangibles and financing are not stated in ITA.[983] The problem with this is that the TP Rules are subsidiary legislation and therefore, they may not override substantive statutory provisions. Fourth, transactions related to minerals and petroleum.[984] Fifth, arrangement made between permanent establishment and the owner.[985] However, ITA is silent on transaction related to sell or lease of tangible goods to residents because it only refers to PE and the owner. In addition, the ITA does not have any safe habour provision that may cover any other transactions between associated parties where it is not clearly stated in the statutes. Kenya clearly provides for safe habour provision to cover transactions that may be subject to transfer pricing.[986] Clarification for type of transaction subject to arm's length principle is very important to cater for any profit or loss of particular associated parties involved for transfer pricing purposes.

6.3.3.1 Determination of Arm's Length Price

The TP Rules prescribe methods to arrive at arm's length price. The methods are comparable uncontrolled price, resale price method and cost plus method commonly

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[978] Ibid, section 34 (4).
[979] Ibid, section 12. This rule is commonly known as thin capitalization.
[980] Rule 10 (a) and (b) of TP Rules.
[981] Ibid, Rule 10(3).
[982] Ibid, Rule 11.
[983] Section 33 of ITA Cap 332 RE 2008.
[984] Ibid, Section 65B (5) and (6), section 65K (5), (6) and (7) respectively as amended by section 28 of the Finance Act, 2016.
[985] Ibid, section 71 (6) (a) and (b).
[986] See chapter seven para 7.3.3.2.

known as traditional methods.[987] Other methods include profit split method and transactional net margin method.[988] The TP Rules essentially adopt transfer pricing methods as enshrined in OECD and UN models.[989] Apart from these methods, the TP Rules empowers the Commissioner to prescribe for other methods provided that the results would be consistent with arms' length principle.[990] However, neither ITA nor the TP Rules or the TRA Transfer pricing Guidelines provide any guideline on what constituted other methods. In determining arm's length price, the rules require a taxpayer to apply first, the traditional methods, where such methods do not give appropriate answers; and then resort can be made to the rest of methods.[991] Notwithstanding, this requirement a tax payer is required to apply the most appropriate methods depending on the nature of transactions and comparable circumstances. The method is said appropriate if it takes into account strength and weakness of the method, function performed by each party to a transaction, availability of information and degree of comparability with independent parties.[992] Accordingly, when transaction involves sale or licensing intangibles, CUP method should be employed and where the intangible is unique, profit split method may be

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[987] Rule 3.

[988] Ibid, Rule 5 (1). For definition of each method see Rule 3. See also Para 10 of TRA Transfer pricing Guideline 2015. To arrive at arm's length price special procedure need to be followed as set in TRA guideline. First, understanding associated parties' transaction in the context of their business. This is sought to be achieved by analyzing functions performed, risk assumed and asset used. This is followed by characterization of business based on the nature of activity and complexity of transaction. Identification of comparable transaction is performed with a view of setting level upon which transactions are compared. The determination of a controlled transactions leads to the determination of the tested party. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found" This is then followed by selecting transfer pricing method by taking in to account profit level indicator which measures the relationship between profits and sales, costs incurred or assets employed. See Para 7 of TRA transfer Pricing Guideline 2015.

[989] See discussion chapter 3.

[990] Rule 5(4) of TP Rules, 2014; See also TRA, Transfer Pricing Guidelines 2015 para 10(1).

[991] Ibid, Rules 5 (2), (3) and (4) respectively.

[992] Ibid, Rule 4(3).

used.[993]Additionally, the TP Rules prohibit a person to apply any other method, which is not listed or prescribed by the Commissioner.[994] In verifying whether the transaction was consistent with arm's length principle, the rules require the Commissioner to base on the appropriate method used by the taxpayer. In practice, associated MNCs in Tanzania prefer transactional net margin method, which is comparatively more complicated than CUP. The method is preferred because it uses the net profit as a profit level indicator which makes it easier to obtain comparables.[995]Arguably, the law contradicts by imposing hierarchal application of methods, on one hand and on the other, requiring the most appropriate method to be employed. Yet, it clearly states CUP and split profit methods to be applied in certain transactions. This situation may bring problem(s) in practical terms like it was in Unilever case whereby the taxpayer claimed to use methods as enshrined in OECD regardless of their appropriateness[996]

6.3.3.2 Transfer Pricing Comparability Factors

Comparability of transactions between associated and independent part is corner stone in obtaining arm's length price of associates. In due regard, the TP Rules require characteristics of property or services transferred, function performed, risk assumed, asset used, contractual terms of the transaction, economic circumstances and business strategies pursued by associated parties to be compared.[997] Transaction between independent parties is comparable if comparability factors are similar to that

[993] Ibid, Rule 11(2).
[994] Ibid, Rule 5 (5).
[995] KPMG Dar es salaam.
[996] See discussion in chapter seven para 7.3.3.
[997] Rule 6 (1) (a) to (e) of TP Rules 2014.

of associated parties, or no differences between comparability factors or persons entering it to transaction are likely to materially affect the price, cost charged, paid, or profit.[998] In addition, where adjustment can be made to any difference, which affects the price, then such transaction is comparable.[999] The result of transactions between associates is then compared to results obtained in uncontrolled transactions.[1000] If the price falls within the range of arm's length then, the price is said to be an arm's length.

From comparability factors, a few issues may be raised. First, the TP rules limit comparables to sufficiently available information only. However, comparability factors presuppose to be obtained from various corporation documents. In context of transfer pricing, associated MNCs are required to furnish such documents based on their transfer pricing policy.[1001] Such requirement does not exist to unrelated corporations. The only available information for such companies is related to performance of the corporations and not details on modalities of their operations. Such information is normally available in form of published or filed financial statements, with practical observance being highly consistently followed by public companies and financial institutions.[1002] Consequently, use of Tanzanian comparable pattern may be a very limited possibility and may lead to absence of Tanzania comparables. For example, transfer pricing audit done by an extractive team of TRA found that one a company was selling a rare gemstone available in

[998] Ibid, Rule 6 (2) (a) and (b).
[999] Ibid Rule 6 2(c). See also TRA, Transfer pricing Guideline 2014 para 8.3.
[1000] Rule 6(3).
[1001] Ibid, Rule 7.
[1002] See for example section 32(3) of the Banking and Financial Institutions Act, 2006.

Tanzania only to a sister company at very low prices since 2004. However, price adjustment was done in 2011 such that it affected transactions from 2009 due to lack of comparables.[1003] In due regard, a considerable amount of profit was shifted outside the country. In practice, the resort is made to foreign databases used elsewhere in the world, for example, in ascertaining the arm's length interest rate, appropriate indices such as London Inter Bank Offered Rate (LIBOR) or specific rates quoted by banks for comparable loans can be used as a reference point.[1004] Yet, such data may be very expensive to obtain, for example, to subscribe Orbis data base it costs TRA Euro 45,000/= per year.[1005]

Second, although the law requires a contractual term to be considered in comparability, the TP Rules are silent on situations where the contractual terms do not provide sufficient information for transfer pricing analysis.[1006] For example, the agreement may not include logistic services in their procurement agreement. Such added services may form substantial component of procurement processes and may have tax implication. Such discrepancies may be used to affect required transfer price between associates. Third, while comparability is regarded as corner stone for arms' length principle to apply, the law does not provide clear guideline on what should be done in absence of comparables.[1007]

[1003] Readhead, A., Transfer Pricing in Extractive sector Tanzania, 2015 p. 17.
[1004] Para 15.4 of TRA Transfer Pricing Guideline, 2015.
[1005] An interview with TRA ITU unit officials.
[1006] See also TRA, Transfer Pricing Guidelines 2015 para 9.3.
[1007] Ibid, paras 8 and 9 respectively.

6.3.3.3 Application of Arms' Length Principle to Intangibles

Literally, intangibles are valuable assets that cannot be touched. Intangible assets for transfer prices purposes include a patent, an invention, secret formula or processes, design, a model, plan, trademark, know how or marketing intangibles.[1008] From this definition, three categories of intangibles may be ascribed. First, manufacture of intangibles such as patent, design, processes or procedures, secret formula and invention. These intangibles are normally done within the corporation. Second, human competence, which entails knowledge held by various persons in the organization and their knowledge is valuable commonly known as knowhow. The third is marketing intangible, which includes marketing activities that aid in commercial exploitation of property or have an important promotional value for the property concerned.[1009] These entail external activities that may include brands, trademarks, licenses, franchise, contractual rights as well as customer and supplier relationship.

Where intangible is sold or licensed between associated parties, the owner of the intangible is required to charge the other associate at arm's length price at the value of which such intangible is expected to generate.[1010] In context of transfer pricing, the person is regarded as owner of intangible if expenses and risks associated with

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[1008] Rule 3 of TP Rules 2014.

[1009] Ibid.

[1010] Rule 11(1) (a) and (b). Section 3 of ITA defines payment made by the lessee under a lease of an intangible asset as royalty. Thus royalty is paid for use or right to use any copyright, patent, design or model, plan, secret formula or process, trademark, or the supply or acquisition of scientific, technical, industrial or commercial knowledge or information. is interesting to note that royalties cover more aspects of intangibles than definition provided in Transfer Pricing guideline such as the use of, or right to use, a cinematography film, videotape, sound recording or any other like medium; the use of, or right to use, industrial, commercial or scientific equipment; the supply of assistance ancillary to intangibles or a total or partial forbearance with intangibles. It is not clear whether such right and use of the said intangibles are property or goods for transfer pricing purposes.

development of such intangible property are borne by that person.[1011] However, if the owner of the intangible is not vested with the legal ownership then, the owner may receive arms' length consideration for the development of such intangible.[1012] With regard to marketing intangibles, where an associate who is not owner of marketing intangible and incurs cost for marketing such intangibles, and such cost are in excess to those comparable independent persons, the owner will pay such associate arm's length price for undertaking such activities.[1013] In arriving at arm's length price for intangibles, the law requires the taxpayer to use comparable uncontrolled price (CUP)[1014] method in absence of highly valuable or unique intangible, where such peculiarly exists; the profit split method is employed.[1015]

In addition, any other methods may be used as prescribed by the Commissioner provided that it has high degree of comparability between transactions.[1016] Arguably, the CUP method entails presence of a direct comparison of prices charged between associates and independent parties in a comparable situation.[1017] The apparent question is relevance of CUP method in arriving at arm's length price for intangibles. For example, PE is charged by its owner for use of patent for manufacturing a product. It is common knowledge that development of patent for a certain product normally is unique and may be developed solely for use of company.

[1011] Rule 11 (6) of TP Rules 2014.
[1012] Ibid, Rule 11 (4).
[1013] Ibid, Rule 11 (5).
[1014] CUP means a method where the price charged in transaction between associated parties is compared with the price charged between independent parties in comparable situation. Rule 3 of TP rules 2014. For more details on CUP method see chapter 3.
[1015] Rule 11 (2) of TP Rules 2014.
[1016] Ibid, Rule 11 (3).
[1017] Ibid, Rule 3.

Accordingly, the company may need to keep its secrets for their own benefits. Under these circumstances, the independent corporation may not be ready to provide such information. Such situation may lead to absence of comparables and consequently, render CUP method less reliable than expected. Even where comparables are available, re-characterization of intangible transaction for transfer pricing adjustment may pose serious challenges. Notably, TRA guideline is silent on this matter, instead is making reference to OECD Guidelines.[1018]

Notwithstanding, requirement of using CUP method for intangibles, the TP Rules also require a taxpayer to apply first, the traditional methods and where these methods do not give an appropriate answer, then resort can be made to the rest of methods.[1019] At the same time, the law obliges the tax taxpayer to select the most appropriate method, depending on nature of transaction and function performed. The problem with this requirement is that some traditional methods may not be appropriate for intangible transactions. For example, the resale price method relies on margins obtained from purchase and resale. It is unlikely that intangibles like patent and trademarks can be purchased as well as resold on a regular basis. Likewise, the cost plus method entails comparison of costs with added margins for production of the good. Royalties paid for the right to use of intangibles have little relations with cost. Royalties charged on use of rights of intangibles are not based on direct cost of production of such intangible but rather, on the right to use such intangible.[1020]

[1018] TRA, Transfer Pricing Guidelines 2015, para 13 (2).
[1019] Rules 5 (2), (3) and (4) respectively of TP Rules 2014.
[1020] *Canada v GlaxoSmithKline Inc*., 2012 SCC 52.

6.3.3.4 Application of Arm's Length Principle to Intra Group Services

The TP Rules also require transfer of services and finances between associates to be made at arm's length price.[1021] The ITA does not provide aspects that constitute services for transfer pricing purposes. However, TP Rules define intra-group services to mean "services rendered between companies in the same group."[1022] Such meaning is general and it does not give a clear indicator on scope of intra group services for transfer pricing purposes. To the contrary, TRA guideline provides a range of services that may be taken into account for transfer pricing purposes, for example, management and technical or commercial services.[1023] From legal point of view, the guideline is not a law per see and therefore, the guideline and rules cannot prevail over substantive law.[1024] Such discrepancy may provide potential to MNCs to manipulate transfer prices.

For example, in Tanzania, one of the methods used by MNCs in manipulating prices is management fee.[1025] The problem with intra-group services is that other charges may be paid directly to the other associate without implicating transfer prices in absence of proper agreement on payment of such services. Such amount or rates may be substantial to the extent of affecting transfer prices between associated MNCs. This is possible because in calculating taxable profit of permanent establishment, such charges may be deducted.[1026] In applying arms' length methods, the law requires associated parties to demonstrate that intra-group services was

[1021] Rule 10 (1) and (5) of TP Rules 2014.
[1022] Ibid, Rule 3.
[1023] TRA, Transfer Pricing Guidelines 2015 Para 14.
[1024] *ITC* 1675 62 SATC 219.
[1025] See for example *Mbeya Company Ltd v Commissioner General TRA*, Civil Appeal no 19, 2008.
[1026] Section 71 of ITA Cap 332 RE 2008.

actually rendered and had substantial economic value to the business.[1027] In ascertaining the amount for service rendered, the law excludes any charges made for shareholders or custodial activities, duplicative, incidental or on call services.[1028] Additionally, the TP Rules empower the Commissioner to declare certain service not sufficient for transfer pricing purposes.[1029] There is a danger for abuse of such powers[1030] because there is no clear guideline about services to be disregarded for transfer pricing purposes.[1031]

6.3.3.5 Arms' Length Aspect of Intra-Group Financing

The law requires interest obtained out of intra-group financing to be charged at arm's length rate. The TP Rules recognize intra-group financing to include loan, security and guarantee, advance or debt and interest bearing trade credit.[1032] To the contrary, the ITA clearly excludes debt obligation owed to residential financial institution and non-resident bank or financial institution, whose interest tax is withheld in Tanzania.[1033] In financing transactions, the arms' length applies to the rate of interest paid on intra-group loan.[1034] Generally, interest is deductible for income tax purposes before tax.[1035] Hence, the only tax possibility is withholding amount of interest levied on the nonresident creditor by the source country. In due regard, it is likely for

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[1027] Rule 10 (1) (a) TP Rules 2014.
[1028] Ibid, Rule 10 (2)(a) and (b).
[1029] Ibid, Rule 10 2(c).
[1030] Ibid, Rule 10 (2) (c). The purpose of MNCs is to make profit, any loop hole in law gives chance to maximize profit. Given the financial capacity of MNCs, and given the prevalence of corruption in developing countries like Tanzania, the chances of abuse of power is high.
[1031] See TRA, Transfer Pricing Guidelines 2015, para 14.
[1032] Rule 3.
[1033] see note 87.
[1034] Rule 10 (3) of TP Rules. Although it is not clearly stated, in Tanzania all types of intra group financing fall within definition of services.
[1035] section 11 and 12, 7.

associated MNCs to fund their associates by way of debt instead of equity.[1036] To avoid such practices, the law provides thin capitalization rules to limit the amount of debt funding in relation to equity. The law requires 7.3 as ratio of the debt to equity.[1037] Where there is change of amount of debt or equity, the amount of either of them shall be the average of balances of amount of debt or equity at the end of the month or part of the month.[1038]

In context of ITA and for the purpose of calculating taxable interest, "debt means any debt obligation excluding a non interest bearing debt obligation, debt obligation owed to residential financial institution, debt obligation owed to a non-resident bank or financial institution whose interest tax is withheld in Tanzania."[1039] Arguably these provisions may not work well in calculating taxable income or interest between associated parties. In addition, financial institutions, banks and free loans may play a significant role in manipulating transfer prices.

As noted before, most MNCs operating in EAC countries are essentially associates of large companies from developed and emerging economies. Such associates have been running their economic activities by using debt capital from parent MNCs. Accordingly, multinational transactions between associated MNCs are made in different currencies other than EAC currencies.[1040] Most parent MNCs are from

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[1036] See *Chevron Australia Holding PTY Ltd (CAHPL) v Commissioner of Taxation* [2015] FCA 1092. In this case the Court held that CAHPL had not shown that the interest paid under the Credit Facility Agreement was equal to or less than arm's length.

[1037] Section 12 of ITA Cap 332 RE 2008 as amended by Finance Act, 2012.

[1038] Ibid, section 12(4) as amended by Finance Act, 2012.

[1039] Ibid, section 5.

[1040] It should be noted that to date, EAC member state still using different currencies. However, there are discussions going on in establishing single currency in EAC.

developed and emerging economies, where they have strong currencies.[1041] Thus, there is potential for an intercompany loan, which is regarded as service to use differences on rules of conversion and interest payable on loan to shift profit from one country to another. Notably, MNCs normally earn a fixed rate of income and are protected by contractual obligations with respect to their investments. The interest received by a foreign company granting the loan would normally be subject to an exemption in the country where the receiving company is situated.[1042] However, the existing thin capitalization rules do not sufficiently address such concerns, particularly in natural resources.[1043] Accordingly, the existing contractual obligation offered to investors does not necessarily make reference to transfer pricing.

6.3.3.6 Advance Pricing Agreement

The ITA does not provide for Advance pricing agreement (APA), but the TP Rules provide for APA.[1044] The objective Advance Pricing Agreement is to ascertain, in advance, transfer prices of specified related parties' transactions over a specified period of time.[1045] There are three types of APA in Tanzania, namely, unilateral, bilateral and multilateral APA.[1046] Generally, the taxpayer is not obliged to enter into APA. However, when the taxpayer chooses to enter into APA, both the TRA and the taxpayer are bound by such agreement.[1047] The power to reject or accept the

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[1041] See Mnali J.M., Note 1, p. 11; TIC, Report on the study of Growth and Impact of investment in Tanzania,2008 p.21.

[1042] See for example section 10 2nd schedules of the Income Tax Act, 2004 where investment is exempted. The interest amount is then allowed as a deduction in the hands of the company paying the interest as required section 12 as amended by Finance Act, 2012.

[1043] EAC countries are now witnessing the good number of MNCs investing in such areas mostly likely transfer pricing practices will be enhanced Such areas are critical in generating income for country's socio and economic development and need aggressive transfer pricing laws..

[1044] Rule 12 of TP Rules 2014.

[1045] TRA, Transfer Pricing Guidelines 2015, Para 17(1).

[1046] Rule 12(3) of TP Rules 2014

[1047] TRA, Transfer Pricing Guidelines 2015, Para 17(2) .

APA is vested to the Commissioner alone.[1048] However, according to TRA officials, to date, no APA has been concluded in Tanzania. The duration of APA once concluded is five years.[1049] The law requires that once the APA is entered, Tanzania Revenue Authority (TRA) has to suspend transfer pricing adjustment for covered transaction where the transaction is consistent with the terms of agreement.[1050] Such requirement presupposes terms of agreement are implemented as required and no substantial changes of economic or comparables or characteristics of the goods transacted are capable to affect effected transaction.

Arguably, there is possibility of changes to economic circumstances that may affect concluded APA. Accordingly, sometimes, there may be inconsistence between the actual transaction and results of applying confirmed transfer pricing methods after the closing date of the return. The TP Rules do not impose requirements for the taxpayer to make necessary adjustment(s) to reflect changes of economic circumstances or actual conduct of the taxpayer in final return for the year. The TP Rules allow only adjustment made by a competent revenue authority of another country, which is consistent with arm's length principle and correspondence adjustment is made.[1051]

Although the law allows the Commissioner to cancel the APA in material breach of fundamental terms of the contract,[1052] the Commissioner does not cancel APA where

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[1048] Rule 12(4) of TP Rules 2014
[1049] Ibid, Rule 12(9).
[1050] Ibid, Rule 12 (7).
[1051] Ibid, Rule13.
[1052] It is not clear whether the cancellation of APA will be based on ordinary terms of contract or on discretional power of TRA. This is important as it may bring contradictions as to which law should apply and may lead to shift burden of proof to TRA to show breach of the taxpayer as was stated in Eaton Corporation v. Commissioner, T.C. No. 5576-12, 2012. See also Spencer K., and

there are substantial changes for economic circumstances. Notwithstanding exemption for audits and adjustment offered to confirm APA, the rules empowers the Commissioner to adjust any price or interest where he has the reason to believe such prices or interests are not at arm's length price. This requirement contradicts Rule 12(7). The law gives, on one hand, and takes, on the other hand, and therefore, it may affect the taxpayer. Additionally, the law is silent on enforcement mechanisms of APA. Arguably, APAs are not well regulated this situation may render variation in its application.

6.3.3.7 Transfer Pricing Documentation Requirement

The ITA does not provide for mandatory transfer pricing documentation requirement. Yet, it is mandatory for any taxpayer to prepare and maintain hard or electronic documents necessary to explain tax returns at least for a period of five years.[1053] To the contrary, the TP Rules make mandatory requirement for contemporaneous transfer pricing documents submitted prior to due date of filing income tax return.[1054] The required information includes organizational structure, nature of business, transfer pricing analysis including function(s) performed, asset used, risk assumed, transfer pricing methods and application of such method including any other document considered relevant by the Commissioner.[1055] Such document may be submitted to the Commissioner upon request within 30 days.[1056]

Kelleher M., An Advance Pricing Agreements Binding Commitments? *International Transfer Pricing Journal*, March/April 2013, p. 117-119.

[1053]Section 35(2) and 34 of the Tax Administration Act, Cap 147, 2015. The official language of document is Kiswahili or English.

[1054] Rule 7 (1) and (3) TP Rules 2014.

[1055] Ibid, Rule 7(2).

[1056] Ibid, Rule 7 (4). This means the taxpayer is not obliged to produce transfer pricing to commissioner unless is requested to do so.

Where an associated party fails to maintain documents, the TP Rules impose penalty of fine not less than fifty million Tanzanian shillings or convicted to a prison for not less than six months or both.[1057] To the contrary, the Tax Administration Act imposes penalty of 10 currency points for each month for which failure continues to maintain document.[1058] To the contrary, ITA imposes penalty of difference between the income tax payable for each month and part of month for which failure continues as the higher 2.5 percent or fine of one hundred thousand shillings.[1059] Apparently, there is conflicting transfer pricing documentation penalty and it is unclear about a provision that will prevail in case of conflict with the taxpayer.

6.4 Administration and Enforcement of Transfer Pricing Rules

6.4.1 Institutional Framework for Transfer Pricing

In Tanzania, all matters related to assessment and collections of revenue are vested to Tanzania Revenue Authority (TRA).[1060] The TRA was established in 1995 as a body corporate with a perpetual common seal.[1061] The TRA is vested with the following responsibilities:- administration and enforcement of laws related to revenues,

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[1057] Ibid, Rule 7(5).

[1058] Section 77 (1) and (2) of the Tax Administration Act, 2015.

[1059] Section 98(1) (a) (d) and (e) R.E 2008. It should be noted that section 80 referred in section 98(1) has been repealed by section 35 of Tax Administration Act, 2015. However, section (98 1) is not amended to reflect such changes.

[1060] See preamble of the Tanzania Revenue Authority Act, Cap 399 Revised edition 2006. It is important to note that the TRA is operating under the Ministry of Finance. Tanzania has a three-tier tax administration structure, namely; Central Government tax administration, Tax administration in Zanzibar, and Local Governments tax administration. The Tanzania Revenue Authority (TRA) administers the Central Government taxes, Zanzibar Revenue Board administers domestic consumption taxes in Zanzibar, and Local Authorities administer the various local imposed taxes. See ChatamaY. J., The impact of ICT on Taxation: the case of Large Taxpayer Department of Tanzania Revenue Authority, Developing Country Studies, ISSN 2224-607X (Paper) ISSN 2225-0565 (Online) Vol.3, No.2, 2013, 92. Available at www.iiste.org Accessed 2016.

[1061] Section 4(1) and (2) of Tanzania Revenue Authority Act, Cap 399 RE 2006. The TRA come in to operation on July 1996.

monitor and ensure collection of various specified revenues from government and private sector, promoting voluntary tax compliance and advising the government on matters pertaining to fiscal policy. In curbing any loss of tax, the TRA is responsible in determining steps to counteract fraud and any other form of tax including other fiscal evasion.[1062] In discharging its functions, the TRA has the power to identify amendment or alteration of tax laws for purpose of improving administration and compliance, among other things.[1063] In running its activities, the TRA is financed by the general government budget through an annual parliamentary budget. The structure of TRA is constituted by the Governing Board and Commissioner General.

The board is responsible for formulation and implementation of TRA policy.[1064] The Commissioner General, as Chief Executive, is responsible for executing daily operations of TRA under general supervision and control of the Board.[1065] The responsibility of collecting tax is divided in to four departments, namely, large taxpayer (LTD), domestic revenue, tax investigation and Customs and Excise Department. The large taxpayer department was established in October 2001 to provide consistent and quality service to large taxpayers, to secure revenue, to improve audit programs, to improve collections and management of tax debts, and also to act as models or pilots for testing new processes, procedures, structures and systems"[1066] Most MNCs fall under large tax payer department and therefore,

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[1062] Ibid, section 5(1).
[1063] Ibid section 5(2) as amended by section 59 of Finance Act, 2016.
[1064] Section 10 (1) and (2) and section 13 of Tanzania Revenue Authority R.E 2006. See also section 5 of Tax Administration Act, 2015.
[1065] Ibid, section 16(1) and (2) and section 17 respectively.
[1066] Chatama Y. J., The impact of ICT on Taxation: the case of Large Taxpayer Department of Tanzania Revenue Authority, Developing Country Studies www.iiste.org ISSN 2224-607X (Paper) ISSN 2225-0565 (Online) Vol.3, No.2, 2013, p.92.

transfer pricing issues are handled under the same department at the unit called International Tax Unit (ITU).

The ITU was officially established in 2011 and prior to that, transfer pricing issues were handled at large taxpayer or domestic department, depending on given circumstances. According to TRA officials the ITU is manned by less than fifteen officers composed of an economist, lawyers and accountants. The ITU also supports regional offices throughout the country. In running its activities, the ITU is entitled to its own budget of not more than three hundred million Tanzanian shillings per year. Such amount is used for purchasing data bases and it covers administrative issues. There are two main responsibilities of ITU, preparation of business plan for the department and to conduct transfer pricing audit.[1067] Such audit queries are extracted from business plan prepared by the ITU. Since its establishment, the ITU has undertaken a considerable number of transfer pricing audits in various sectors that resulted in tax adjustment of 232 billions of Tanzanian shillings that were under dispute by tax payers.[1068] Accordingly, more transfer pricing audits are likely to increase and more cases are likely to be taken to tribunals or courts of law. Apart from ITU, the tax investigation department has other three separate independent audit auditing in manufacturing, extractive industry and services. All teams have been relatively trained on transfer pricing audits and occasionally, they have been handling transfer pricing cases within their teams.[1069]

[1067] Section 45 of the Tax Administration Act, Cap 147, 2015.
[1068] An interview with TRA officials.
[1069] an interview with TRA officials

Despite considerable good performance, ITU is facing challenges in implementing its works and renders efforts to curb transfer pricing manipulation be more complicated. Other challenges include lack of local comparables and an unclear approach in situations where there are insufficient comparables. However, practice has shown that resort has made foreign databases, which are very expensive and may not be very relevant though they form an important bench mark for analysis.

According to ITU officials, ORBIS data have never been practically used since their subscription. Tax incentives offered to MNCs is another challenge and even when there are sufficient indictors of transfer price manipulation, ITU may not be able to challenge or adjust. Apart from legal issues, there is overlapping of responsibilities between ITU and other audit teams at TRA. The problem with this is that it may lead to inconsistency in application of transfer pricing laws. Shortage of staff and lack of experience in handling transfer pricing in minerals have seriously affected performance of ITU. For example, to date, no audit in mineral sector has been completed since its establishment.[1070] Lack of information is also a problem because TRA relies on information prepared by taxpayers who are sometimes not done professionally. Lack of transfer pricing policy by MNCs and sometimes they do not get cooperation from MNCs are additional drawbacks to ITU functions. Moreover, the whole process of gathering information is time consuming and expensive.

6.4.2 Transfer Pricing Dispute Resolution Mechanism

Both ITA and TP Rules are silent on enforcement of transfer pricing. To date, issues pertaining to transfer pricing compliance, enforcement and disputes are handled just

[1070] TRA interview and ibid, p. 9.

like any other income tax matters.[1071] Consequently, ITA provisions related to fraud, failure to furnish returns and underpayment of tax apply to transfer price disputes. In due regard, there are three organs responsible for solving transfer pricing disputes. At the first instance, the Commissioner is empowered to make any tax decision in relation to dispute arising from assessment and other decisions or omissions that directly affect a taxpayer.[1072] The most relevant aspect of transfer pricing disputes falls within category of assessment. Generally, the Commissioner has the power to issue an additional adjustment assessment based on the Commissioner's best judgment and information available.[1073] A taxpayer who is aggrieved by the Commissioner's decision has the right to appeal to the

Tax Revenue Appeal Board (TRAB) in accordance with Tax Revenue Appeal Act provisions.[1074] In context of transfer pricing, where it is established that a taxpayer did not comply with arm's length principle is guilty of underpayment of tax and is liable to a penalty of one hundred percent of the underpayment of the tax.[1075] TRAB[1076] is the second institution responsible for handling appeals on objected assessment decision by the Commissioner.[1077] Appeals to TRAB are made pursuant to requirement provided in The Tax Revenue Appeal Act.[1078] During the hearing, the onus of proving that the assessment or decision in respect of which an appeal is made

[1071] Interview with TRA officials at KRA offices Nairobi Kenya 2014
[1072] Section 50 (1) and (3) of the Tax Administration Act, Cap 147, 2015.
[1073] Ibid, section 48.
[1074] Ibid, Section 53.
[1075] Rule 4 (5) of TP Rules, 2014.
[1076]Established pursuance to section 4 of the Tax Revenue Appeal Act, RE 2006.
[1077] Ibid, section 16, see also section 53 (1) of the Tax Administration Act, 2015.
[1078] Ibid, section 14 and 15 respectively.

lies to the appellant.[1079] Any person who is aggrieved by the decision of TRAB has the right to appeal to Revenue Appeal Tribunal (tribunal).[1080] The proceedings of the TRAB and Tribunal are of judicial nature and that their decision is enforceable and executed just like degree or orders of the court of law.[1081]

Any taxpayer who is aggrieved by the decision by TRAB or Tribunal has the right to appeal to the Court of Appeal on point of law only.[1082] Accordingly, the provisions of the Appellate Jurisdiction Act[1083] and rules made there under shall apply *mutatis mutandis* to appeals from the decision of the Tribunal.[1084] The decision by Court of Appeal is final. The tax dispute resolution mechanism in Tanzania reveals that there is no special mechanism established for addressing transfer pricing disputes.

The fact that, to date, no transfer pricing cases have been decided by TRAB, the Tribunal or Court of Appeal, it may be hard to say that transfer pricing will be handled in a very special way. It is likely that it will be handled just like any other tax dispute. However, at least four transfer pricing cases have been filed and are still at the TRAB. Due to the fact that transfer pricing disputes are complex in nature involving various disciplines, it remains to be seen the manner actors will handle transfer pricing disputes.

[1079] Ibid, section 18(2) (b).
[1080] Ibid, section 8 and section 11 respectively. The procedure for appeal and onus of proof are the same as those made under TRAB.
[1081] Ibid, section 18 (1) and section 24 (3).
[1082] It should be noted that the appeal from tribunal are not taken to the High court because both have concurrent jurisdiction on tax matter.
[1083] Appellate Jurisdiction Act, 1979 cap 141 of the laws of Tanzania.
[1084] Section 25 of the Tax Revenue Appeal Act, RE 2006.

6.5 Base Erosion and Profit Shifting Action Plan in Tanzanian Context

As noted before that the existing arm's length principle, to a great extent, has encountered serious challenges in curbing transfer pricing manipulation, Base Erosion and Profit Shifting Action Plan (BEPS Action Plan) was thought as a rescue. The rationale behind BEPS is to ensure that profit by MNCs is taxed where economic activities generating that profit are performed or where the value of intangible is created. Analysis of transfer pricing law reveals that, to a certain extent, BEPS Action Plan has been taken into account.

For example, comparability factors and analysis, requirement and payment of ownership of intangibles and documentation requirement under TP Rules seem to be borrowed from BEPS guidelines on application of arm's length principle. Accordingly, the fact that the TP Rules are construed in manner consistency with OECD model and Guidelines as supplemented and updated from time to time, BEPS Action Plan is applicable in Tanzania.

6.6 Conclusion

The presented analysis and examination of transfer pricing laws in Tanzania reveal inadequacy of law in curbing transfer pricing manipulations. The arm's length principle still remains as a sole solution in curbing transfer pricing manipulation. While the existing transfer pricing laws are premised on arm's length principle, they lack clarity and in some instances, they contradict each other. Accordingly, where clear provisions exist, they are not implementable, either because of lack of pre-requisites, requirement such as comparables or lack of experience and knowledge of transfer pricing by tax officers. Although the arms' length is applicable to extractive

business there is no clear guideline on how such transactions should be handled in transfer pricing context. The absence of decided transfer pricing cases in courts and tribunals are indicators of such discrepancies. Although there are few cases, which have been filed, it remains to be seen whether or not decision of such cases by tribunal and court will reduce if not eliminate existing discrepancies. Such discrepancies are likely to hinder Tanzania desire to obtain right share of tax from MNCs investments for economic development.

CHAPTER SEVEN

TRANSFER PRICING LEGISLATION IN KENYA

7.1 Introduction

A favourable situation created by the government of Kenya has been a catalyst in attracting more MNCs in the country. Consequently, MNCs have been contributing more than seventy percent to government revenue. However, such revenue has been characterized by looming risk of losing the right share of tax from associated MNCs' operations in Kenya through transfer pricing. In an effort to protect its tax base, Kenya has enacted a transfer pricing law whereby arm's length principle is a corner stone. However, inadequacy of the law and complexities involved in arriving at arm's length price has remained a major obstacle. While more efforts are geared towards attracting MNCs, there is need to remove risks associated with MNCs' investment with a view of achieving the country's desire to fund its expenditure through tax revenue. This chapter analyses adequacy of transfer pricing legislation in curbing transfer pricing manipulation in Kenya.

7.2 Overview of Social, Economic and Political Context

Kenya gained its independence on 12th December, 1963 from British. After independence, Kenya inherited colonial legal system and economy that reflected colonial interests.[1085] The economy of Kenya was largely centered on agriculture with a limited range of secondary industries.[1086] The history of foreign investment in

[1085] Ndege P.O., Colonialism and Its Legacy in Kenya, Lecture delivered during full bright Hays Group Project Abroad programme, Moi University Main Compus, 5th July to 6TH August 2009. p. 4-6.
[1086] Ibid, p. 6.

Kenya can be traced back prior to independence. Kenya was a settler as well as crown colony and it was integrated by the British such that not only many British settlers settled but also they meant to stay forever. Consequently, Kenya received more investments.[1087] British colonialists used the law as a tool for the purpose. Using their colonial legislature, the British colonialists made some laws that influenced the pattern of investment in East African countries. For example, the laws made granted long land holding rights to settlers in Kenya and dispossessed Africans off their lands and vested the same to settlers or investors. In due regard, it discouraged Africans from competing with British investors in cash crops production. Such laws greatly attracted foreign investors to invest in Kenya.

After independence, Kenya continued to be the most favoured destination of foreign investment in the EAC region. That was due to relatively high level of economic development, market size growth and openness of the foreign direct investments, while other neighbor countries such as Tanzania and Uganda had relatively closed regimes.[1088] The large capital flow in Kenya was driven by expansion in the agriculture sector, fiscal and monetary policies such as overvalued exchange rates, import tariffs, quantitative restrictions including import licensing.[1089] Thus, sustainable budget deficit and import substitution industrialization strategies also

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[1087] Kahama C.G., et al., The Challenge for Tanzania's Economy. Tanzania Publish House, Dar es Salaam, 1994, p. 17.

[1088] Abala D.O., *Foreign Direct Investment and Economic Growth: An Empirical Analysis of Kenyan Data*, DBA African Management Review, Vol.4 No.1 2014, PP 62-83, P.64. This is because countries like Tanzania and Uganda opted for socialism policy while Kenya opted for market oriented policies in the garb of socialist principle. See Nellis J., The Evolution of Enterprise Reform in Africa: From State - owned Enterprises to Private Participation in Infrastructure – and Back? NOTA DI LAVORO 117.2005, p 3. Available at http://ssrn.com/abstract=828764. Accessed January 20 2016.

[1089] Ibid, p. 273.

contributed.[1090] Whilst post-independence government of Kenya managed to attract foreign investment for economic development, the taxation system inherited from colonial powers remained quite substantially unaltered.[1091] Such pattern informs narrow coverage of existing tax instrument, poor tax administration and tax collection efforts.[1092] Notwithstanding, great inflow of foreign investment in Kenya between 1980s and 1990s the economy of the country deteriorated and level of foreign investments dropped. There are two reasons for such pattern: first, at that time, the country experienced bad governance, high corruption level, inconsistence in implementation of economic policies and structural reform that led to poor public services and infrastructure.[1093] Second, economic policy reforms of Tanzania and Uganda in processes of implementing liberalization of their economy.[1094] Despite backdrop of foreign investment in Kenya, various measures were taken by the government of Kenya to improve foreign investment in the country. They included establishment of Export Processing Zone (EPZ), manufacturing under bond (MUB) and accession to the African Growth and Opportunity Act (AGOA) in 2001.[1095] Other measures included establishment of investment law geared to attract foreign investment.[1096] The remarkable development made by the government of Kenya was establishment of Kenya Vision 2008 to 2030. The objective of the 2030 vision is to

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[1090] Ibid.

[1091] Warris A., *Taxation without principles: A Historical Analysis of the Kenyan Taxation System,* Kenya Law Review, Vol 1: 272, 2007, pp 272 – 304 p. 273; See also Masoud B.S., Legal Challenges of Cross Border Insolvencies in Sub –Saharan Africa with Reference to Tanzania and Kenya: A Frame work for Legislation and Policies, PhD Thesis, Nottingham Trent University, United Kingdom, 2012, p.196.

[1092] Ibid.

[1093] Abala, Note 1088, p. 65.

[1094] Ibid, see also chapter 6 and 3.

[1095] World Bank. Connecting to Compete: Trade Logistics in the Global Economy, Washington D.C. 2012, p.

[1096] See for example The Investment Promotion Act, 2004 cap 485Bas revised 2009. An Act provide for promotion and facilitation of investment and other assistance and in obtaining tax incentives and for related purposes. See section 15(2) (iii).

transform Kenya in a newly industrialized global competitive and prosperous middle income country.[1097]

Consequently, the government of Kenya continued to attract, maintain and retain foreign investments. The rationale behind was their contribution to economic development providing employment, technology, for example, in communication sector like introduction of mobile transactions such as M-Pesa money transfer, facilitating transfer of capital and investments together with increasing foreign exchange earnings and tax revenue.[1098] It is estimated that Kenya is having more than 100 MNCs operating in the country.[1099] Such MNCs are ranging from communication sectors, for example, Safaricom and Airtel, manufacturing such as British American tobacco, Bamburi cement and banking like Barclays, to mention a few. Such MNCs are part of the large tax payers in Kenya contributing 70 to 80 percent of the revenue. However, Kenya Revenue Authority (KRA) has no specific data on the extent of contribution of MNCs alone operating in Kenya due to complications in identifying actual transactions between associated MNCs.[1100] All these culminated in an increase in MNCs' operations in Kenya whereby transfer pricing is practiced. However, while foreign investments have been seen important for developing the country's economy, they are also sources of vulnerable to such

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[1097]Kenya Bureau of statistics, Foreign Investment Survey, Preliminary Report 2015, p.1 available at www.knbs.or.ke.

[1098] Shihata I. F., Legal Treatment of foreign Investment, The World bank Guideline, Martinus Nijhoff Publishers 1993, p.9-12. See also Nyamori B., note 46 p.153; Kenya Bureau of statistics, Foreign Investment Survey, Preliminary Report 2015, p.1 available at www.knbs.or.ke. Accessed 2015.

[1099] Interview with TRA officials Nairobi Kenya December 2014. See also KRA: Large Taxpayers Office, available at <http://www.revenue.go.ke/index.php/domestic-taxes/large-taxpayersoffice/about-lto/vision.

[1100] Ibid.

economy. This is because transfer pricing manipulation has been eroding tax base of Kenya.

For example, transfer pricing audit made by KRA discovered loss of 25 billion Kenya shillings (Kshs.) due to abuse of transfer pricing rules.[1101] That is achieved by either under-pricing or overpricing of goods and services between associated MNCs or by declaring losses.[1102] It is also established that for 10 years between 2004 and 2013, Kenya lost Kshs.11. 5 billion transfer pricing related tax annually.[1103] Consequently, associated MNCs' transactions have become under serious investigation by the government in order to curb transfer pricing manipulation. This is sought to be achieved by sharpening transfer pricing laws.

7.3 Transfer Pricing Laws in Kenya

The legal and regulatory framework of transfer pricing comprises three major sources, namely, the Constitution of Kenya, legislation and their rules and tax treaties.

7.3.1 The Constitution of Kenya 2010

The Constitution of Kenya clearly empowers nation government to impose taxes and charges on income tax, value added tax (VAT), customs duties and other duties on

[1101] Andae G., Tax Evasion Sting recovers sh. 25 Billion from Multinationals, Business daily, July 14, 2014.

[1102] Ibid, The amount which is equivalent to half the budget Kenya has allocated to 47 counties in the in 2014 financial year to tackle unemployment, the broken health system and to revamp infrastructure.

[1103] Global Financial integrity report 2014 and 2015 which reports that Sub –Saharan Africa is losing a lot of money mainly due to trade invoice mispricing. 2015 report p. 43.

import and export goods as well as excise tax.[1104] It provides authority to collect revenue to support the economy's efforts towards generating, serving and investing adequate funds to sustain needs for the country as well as promote sustainable national development.[1105] The fact that, to a great extent, the economy of Kenya depends on its internal revenue, the Constitution provides for principles of public finance. It requires openness, accountability and public participation in financial matters.[1106] It also requires public finance system to promote an equitable society by sharing the burden of taxation fairly.[1107] Accordingly, the revenue raised should be nationally equally shared and expenditure should promote equitable development.[1108]

The constitution declares that the primary source of revenue for national is taxation. The power to impose tax lies with parliament exercised through legislation.[1109] Accordingly, it prohibits any tax or licensing fee to be imposed or waived or varied except as provided under legislation.[1110] However, where the relevant legislation provides for waiver or variation, proper record and reason for waiver or variation are recorded and reported to Auditor General.[1111] Generally, the Constitution of Kenya adheres to principles of good taxation.

[1104] Article 209 (1) of the Constitution of Kenya 2010.
[1105] Kenya National Development Civic Education, Ministry of Justice, National Cohesion and Constitutional affairs, 2012 p.158.
[1106] Article 201 (a) of the Constitution of Kenya 2010.
[1107] ibid, Article 201 (b) (1).
[1108] Ibid, Articles 202(1) and 203 respectively.
[1109] Ibid, Article 209.
[1110] Ibid, Article 210.
[1111] Ibid, Article 210(2) (a) and (b).

7.3.2 The Income Tax Act 2010

The Income Tax Act (ITA) of Kenya was passed on 2010.[1112] It repealed and replaced the 1973 ITA. There are three objectives of the ITA, firstly, it provides for charges, assessment and collection of income. Secondly, it provides for ascertainment of income to be charged. Thirdly, it provides for administration of charge, collection and ascertainment of the same.[1113] The ITA has xiv parts, part I provides for commencement and interpretation. Party II deals with imposition of income tax, part III is about exemption from tax, part iv is on ascertainment of total income, party v is geared towards personal reliefs and part vi is on rates, deductions and set-off and double taxation relief. Part vii provides for persons assessable, part viii is about returns and notices, part ix is for assessments, part x deals with objections, appeals relief and relief for mistakes, part xi provides for collection recovery and payment of tax, part xii is about offences and penalties, part xiii is on administration and part xiv deals with miscellaneous provisions.

Generally, the ITA imposes tax on both residents and non-residents on income accrued from Kenya.[1114] For the purpose of this work, a company is regarded a resident of Kenya if it is incorporated under the laws of Kenya or management and control of affairs of the body is exercised in Kenya for that particular year of income.[1115] Accordingly, the company is resident of Kenya if it is declared by the

[1112] Cap 470 RE 2014.
[1113] See preamble of the ITA R.E 2014.
[1114] Ibid, Section 3 (1).
[1115] Unlike OECD and UN model and their guidelines, the ITA deviated from the world 'effective management' which normally brings confusion.

Minister in the government gazette for any year of income.[1116] The income taxed is profit obtained from business carried out, service rendered, a right granted for use or occupation of who has, and habitually exercises, authority to conclude contracts in the name of that person and property in Kenya for whatever period.[1117] In addition, interest, dividends[1118] and natural resources are also taxed.[1119] MNCs also can be taxed on net gain derived from an interest in a corporation if the interest derives twenty percent or more of its value directly or indirectly from immovable property in Kenya.[1120] Therefore, any income arising out of stated activities are also taxable to associated MNCs.

7.3.2.1 Application of Arm's Length Principle in Kenya

Part IV of the ITA is of particular interest because it provides for ascertainment of income and arm's length principle for transfer pricing between associated parties. Section 18(1) provides for ascertainment of business profit or gain in relation to a non-resident who carries on business in Kenya. A person is said to carry on business in Kenya for transfer pricing purposes if such business is carried on from land or water, a product or produce, sells or delivery outside Kenya, including contract of sale made outside Kenya and utilization of the product or produce outside Kenya.[1121] The profit or gain is also derived from Kenya where a bank, which is a permanent

[1116] Section 2 of ITA, Cap 470 R.E 2014. However, the law is silence on criteria for the Minister to declare a company as a resident.
[1117] Ibid, section 3 (2) (a). Business profit is deemed to be derived from Kenya even if the business which gave rise of it is partly carried on in and partly carried out of Kenya; see section 4(a) of ITA.
[1118] Ibid, section 3 (2) (b).
[1119] Ibid, section 3(h).
[1120] Ibid, section 3(2) (g), 3 (3) (c) and section 5A.
[1121] Ibid, section 18(1).

establishment of a nonresident person holds outside Kenya any deposits, assets or property acquired from its operations in Kenya.[1122]

Section 18 (3), in particular, provides for the arm's length principle. The provision provides that,

> "*Where a non-resident person carries on business with a related resident person or through its permanent establishment and the course of that business is such that it produces to the resident person or through its permanent establishment either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person or through its permanent establishment or from that business shall be deemed to be the amount that might have been expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length.*"[1123]

This section sets arms' length principle as the basis for associated MNCs to be taxed. From the wording of section 18(3), the rationale behind is to ascertain the business profit or gains of associated MNCs by using independent persons as a benchmark. The policy underlying arm's length principle, in particular, section 18(3) is the need to hinder cross-border transactions between associated parties that have undesirable effect of shifting taxable income from Kenya.[1124] But neither the ITA nor Transfer Pricing Rules provide for meaning of arm's length principle. However, the TP Rules define arm's length price to mean the price payable in a transaction between independent enterprises.[1125] For the purpose of regulating transfer pricing, the

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[1122] Ibid, section 18(2).
[1123] Ibid, section 18(3). .
[1124] Nyamori note 46 p. 155. See also, Mbiuki J.M., The Legal and Institution Frame work of Transfer Pricing in Kenya: A Case Study of Unilever Case and its Aftermath, A Thesis Submitted in partial fulfillment of the requirements for a award of a Master of Laws (LL.M) Degree of the University of Nairobi, 2009, p. 29.
[1125] Rule 3 of TP Rules 2006.

persons are associated[1126] to each other if "either person participates directly or indirectly in the management, control or capital of the business of the other; or a third person participates directly or indirectly in the management, control or capital of the business or both."[1127] Accordingly, any individual, who is associated by marriage, is a blood relative or has an affinity to an individual involved in the management, control or capital of the business of the other is considered to be an associated party.[1128] The threshold for control is 25 percent of the shareholding or voting power in the entity.[1129] Accordingly, it recognizes bank as a permanent establishment of the non- resident person established outside Kenya but deposits assets or property acquired from its operations in Kenya.[1130] Permanent establishment is defined as a fixed place of business and includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, a building site, or a construction or installation project that has existed for six months or more where that person wholly or partly carries on business.[1131] However, the ITA is silent on aspects that do not constitute permanent establishment for transfer pricing purposes.

In ascertaining business profit derived from Kenya for transfer pricing purposes, the law clearly prohibits any deductions for expenditure incurred outside Kenya in respect of remunerations for services rendered by non-resident directors of non-resident company in excessive of five percent or twenty five thousand Kenya

[1126] It is important to note that ITA has used the word 'related' throughout , but for the purposes of consistence of this work, the word 'associated 'is used.
[1127] Section 18 (6) (a) and (b) of ITA R.E 2014.
[1128] Ibid, section 18 (6) (c).
[1129] Ibid, paragraph 32(1) of part IV of the second schedule.
[1130] Ibid, section 18(5).
[1131] Ibid, section 2(a). The definition of permanent establishment is *imparimateria* with UN model.

shillings, whichever is high.[1132] Accordingly, no deduction in excess of one hundred and fifty thousand Kenya shillings shall be allowed.[1133] In addition, no deduction is allowed on executive and general administrative expenses except to the extent that the Commissioner may determine that expenditure to be just and reasonable.[1134] However, the ITA does not provide any guideline as to when the expenditure is deemed to be reasonable and just. The terms just and reasonable are vague and may be used inappropriate manner. The ITA also prohibits deductions in respect of non-resident person carries business in Kenya through permanent establishment in interest or royalties or management or professional fee purported to be paid to the nonresident person.[1135] In implementing requirement of arm's length principle as provided under section 18(3), the law empowers the Minister of Finance to issue guideline for determination of arm's length price of a transaction.[1136]

In ascertaining taxable income of permanent establishment, the law requires be taxed on profit attributable to it only. However, the KRA is of the opinion that permanent establishment as an independent entity may have an opportunity to make profit from transactions that its foreign related parties had undertaken in Kenya. The rationale behind is that by virtue of relationship between permanent establishment and its head office as well as other permanent establishments, it may pass off the opportunity to those associated while playing a key role in generating income. In this context,

[1132] Ibid, section 18(4) (a).
[1133] Ibid.
[1134] Ibid, section 18(4) (b). Unlike Kenya, the law does not clearly provide for ascertainment of business profit for transfer pricing purposes.
[1135] Ibid, Section 18(5) as amended by section 9 (b) of the Finance bill 2014, provided that for the avoidance of doubt, the expression "non-resident person" shall include both the head office and other offices of the non-resident person.
[1136] Ibid, Section 18 (8) (a), however, as of October 2016 no transfer pricing guideline has been issued.

where MNCs carry out business in Kenya through permanent establishment they are also taxed on profits that relate to the permanent establishment but arise from activities conducted outside Kenya.[1137] Furthermore, where a permanent establishment situated in Kenya makes payment to any other person in management or professional or training fee, royalty, interest, and use of property, it is considered to be income derived or accrued from Kenya.[1138]

In ascertaining total income for the year of income, no deduction is allowed for capital expenditure, or any loss, diminution or exhaustion of capital.[1139] Notwithstanding any deductions, no deduction expenditure incurred in production of income deemed under section 10 of ITA to have accrued in or to have been derived from Kenya where that expenditure was incurred by a nonresident person not having a permanent establishment in Kenya.[1140] Accordingly, no deduction in respect of interest, royalties or management professional fees paid or purported to be paid by permanent establishment to nonresident persons including head office and other unrelated offices of such non- resident.[1141] However, any exchange loss or gain in respect of foreign exchange loss and gain with respect of net assets including liability is disregarded.[1142]

[1137] Ernest and Young 2013, p.2.
[1138] Section (10, a –f) of ITACap 479 R.E 2014.
[1139] Ibid, section16.
[1140] Ibid, section 16 (2) (f).
[1141] Ibid, section 18(5).
[1142] Ibid.

7.3.2.2 Transfer Pricing Adjustment

Where it is established that a transaction between associated MNCs produces no taxable income or less than what could have been expected to the parties dealing with each other independently, the Commissioner is empowered to adjust such income. However, section 18 is silent on modalities of transfer pricing adjustments.[1143]Consequently, general anti-avoidance provisions of the ITA become applicable.[1144] The provision provides that,

> "*Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for a year of income or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction."*

For the Commissioner to invoke this provision, two conditions must exist, firstly, the main purpose or one of the purposes of the transaction must be avoidance or reduction of liability to tax. Secondly, the exercise of the Commissioner's power must be just and reasonable.[1145] The fact that there is no specific provision of transfer pricing adjustment, it is likely transfer pricing adjustments are done in context of general anti-avoidance tax. The problem with this approach is that transfer

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[1143] Unlike Kenya, In Tanzania the law clearly provides for modalities for transfer pricing adjustment. See chapter six para 6.3.2.4.

[1144] Section 23 of Cap 470, ITA, R.E 2014. The policy underlies section 23 is that taxpayer ought not to pay less tax thanwhat could have expected for being induced by tax avoidance motive but rather should be in accordance with the intention of the law.

[1145] *Commissioner of Income Tax v C.W Armstrong*, KE, CA, 1962.

pricing adjustment entails specific procedures that must be followed, unlike other ordinary adjustments. This can be substantiated by the fact that any additional tax arising out of transfer pricing adjustment is subject to additional penalties of twenty percent for late payment and two percent interest rate per month on tax amount remaining to be paid.[1146] Yet, the taxpayer is also liable for tax avoidance penalty equal to double the amount that would have been avoided.[1147]

The Tax Procedure Act also imposes tax avoidance penalty to any taxpayer who knowingly makes false or misleading statement or omits from statements any information made to an authorized person.[1148] Seventy five percent of the tax shortfall for if the statement was made deliberately or twenty five percent in any other case.[1149] Such penalty will be increased for ten percent if it is the second application and twenty five percent for the third application.[1150]However, it is unclear whether errors could be considered false declarations and criteria to determine if an act is deliberate.[1151] Although the Tax Procedure Act is silent on transfer pricing, the Act is applicable by analogy to transfer pricing because the Act clearly states that in absence of specific procedure under tax law, the provision of TPA shall apply.[1152] The law also is silent as to whether or not transfer pricing adjustments can be passed through financial statements or through income tax computation. However, a taxpayer is allowed to make self-adjustment if by reason of

[1146] Section 72D and 94 (1) of ITA R.E 2014
[1147] Section 85 of the Tax Procedure Act, 2015.
[1148] Section 84(1) and (8) of TPA, 2015.
[1149]Ibid, section 84 (2) (a) and (b).
[1150] Ibid, section 84(3) (a) and (b).
[1151] PWC, Kenya's New Tax Procedure Act seeks to harmonize and consolidate tax administration, Tax Insights from International Tax Services, March 2016. p.2.
[1152] Section 2 (2) of Tax Procedure Act, 2015.

some mistake of fact or errors leading to excessive assessment by applying to the Commissioner within seven years.[1153] In addition, the law is silent on corresponding adjustment.

7.3.3 Income Tax (Transfer Pricing) Rules 2006

Income Tax (Transfer Pricing) Rules (TP Rules) were established in 2006 and came into force on 1st July, 2006.[1154] The TP Rules came out following decision in Unilever case whereby the court, in reaching its decision, relied on OECD rules because by then Kenya had no detailed transfer pricing rules. There are two objectives of TP Rules, first, to provide guidelines for associated enterprises in determining the arm's length price for transactions of goods and services between them.[1155] Second, to provide administrative regulations for transfer pricing documents submitted to the Commissioner General (Commissioner).[1156] The TP Rules applies between associated MNCs operating within and outside Kenya.[1157]

Also applies between permanent establishment and its head office in which permanent establishment is treated as a distinct as well as separate from its head office or other related branches.[1158] The TP Rules define associated parties for transfer pricing purposes to mean one or more or third person enterprises participating directly or indirectly in management, control or capital of the other

[1153] Section 90 of ITA R.E 2014.
[1154] Legal Notice No. 67 of 2006.
[1155] Rule 3(a) of the TP Rules 2006.
[1156]Ibid, Rule 3(b).
[1157] Ibid, Rule 5(a).
[1158] Ibid, Rule 5(b).

enterprise.[1159] To the contrary, the ITA defines related parties to include an individual who participates in management, control or capital of the business is associated by marriage, consanguinity or affinity.[1160] Arguably, even in absence of control, entities may still be deemed related because control is not the only criterion.[1161] ITA widely defined related persons, a pattern, which ensures that transfer prices can be adjusted not only to MNCs related but also to individuals who are related in a particular business. To the contrary, the TP Rules clearly exclude individuals.[1162] Accordingly, the TP Rules define associated enterprises and not associated persons for transfer pricing purposes as provided under enabling Act and the scope of application of TP Rules is limited to related enterprises.[1163] Ordinarily, in case there is conflict between rules and enabling Act, the enabling Act will prevail over rules. However, exclusion of related individual under the rules may bring problems in its implementation.

TP Rules provide for transactions, which are subject to adjustment under arm's length principle. They include the sale or purchase of goods or lease of tangible assets, the transfer, purchase or use of intangible assets, provision of services; lending or borrowing of money and any other transactions, which may affect profit or loss of the enterprises involved.[1164] The TP Rules provide a wide range of transactions that are subject to transfer pricing adjustment, in particular, it gives a wide room for KRA to adjust such transfer pricing. Although the TP Rules recognize

[1159] Ibid, Rule 2.
[1160] Section 18(6) of ITA.
[1161] Deloitte, Global Transfer Pricing Country Guide 3, Kenya, 2015, p. 133.
[1162] See definition of related enterprises regulation 2.
[1163] Rule 5 of the TP Rules 2006.
[1164] Rule 6(a)–(f).

services, tangible and intangible assets including goods, neither the TP nor the ITA provides for definition of such terms for transfer pricing purposes like it is done by other countries.[1165] The absence of proper definition of such terms may render uncertainty in application of arm's length principle to such transactions.

7.3.3.1 Determination of Arm's Length Price

To arrive at arm's length price, the TP Rules provide methods to be applied. They include Comparable Uncontrolled Price (CUP) resale price method; cost plus method profit split method and the transactional net margin method.[1166] Essentially, these methods are replica of OECD methods.[1167] In applying these methods, the taxpayer is free to choose any method it deemed fit for a particular transaction.[1168] Accordingly, no issued guidelines describe procedures to be followed while determining arm's length price. In this context, it is not an offence for the associated MNCs to select any method in determining arm's length price even if the most relevant method is available. Notwithstanding, this requirement, a tax payer is obliged to apply the most appropriate methods, depending on nature of transactions or class of transactions or related persons or function performed.[1169] Arguably, the

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[1165] See for example transfer Income tax (Transfer Pricing Rules) of Tanzania 2014. Definition means interpretation given by any written law to a word or expression. See section 3 of the Interpretation and General Provisions Act, Cap 2 of the laws of Kenya, Revised Edition 2014. See also, Kiunsi H.B., Money and Politics in Tanzania: An Evaluation of The Election Expenses Act in the 2010 General Election, Elixir Criminal Law 51 (2012) pp 10841-10849, p. 10845 stating the rationale behind defining word or expression is to provide certainty to its meaning, or to limit its ordinary meaning or to extend its ordinary meaning, and in some cases merely to avoid repetitions.

[1166] Rule 7 (a) – (d) read together with Rule 8(1) of the TP Rules 2006.

[1167] According to KRA officials there are two reasons for this, first, at the time TP Rules were established only OECD model was available and it was viable option. Second, OECD Model provides for international standard of arm's length principle.

[1168] Rule 4 of TP Rules 2006.

[1169] Ibid, Rule 8(2).

law contradicts by imposing no hierarchal application of methods, on one hand, and on the other hand, requiring the most appropriate method to be employed.

Generally, KRA prefer CUP method where comparables are available and in the absence of comparables, it renders determination of arm's length price via CUP difficult.[1170] The problem is exacerbated by lack of local comparable data base although it subscribed pan-European data base like Amadeus.[1171] To the contrary, associated MNCs in Kenya prefer spilt profit margin method, which is comparatively more complicated than CUP. It is believed that MNCs take advantage of the law because it is silent on the range of profit margins.[1172] The TP Rules deviates from OECD by allowing any other method prescribed by the Commissioner to be used in case the arm's length price cannot be determined by using methods prescribed in the TP Rules.[1173] Yet, neither the TP rules nor the ITA provide what constitutes other methods. It is also unclear whether or not that other methods eventually will lead to arm's length price or will be something else more or equivalent to arm's length methods. However, according to KRA officials, the practice has shown that formulary apportioned method has been used in such cases. The problem with this method is that no law regulates the same. Therefore, there is risk of such methods to be applied arbitrarily as well as may affect both the taxpayer and KRA.

[1170] An interview with KRA officials.
[1171] Ibid,
[1172] Ibid.
[1173] Rule 7(e) of TP Rules 2006.

7.3.3.2 Transfer Pricing Comparability Factors

Application of any method in determining arm's length price depends on comparable available, but the TP Rules are silent on factors to be compared.[1174] However, in context of TP Rules, a transaction is comparable if there are no material differences or reasonable accurate adjustment that can be made to eliminate material difference.[1175] Comparability of transaction for transfer pricing purposes presupposes presence of local comparable data. Kenya, like any other developing countries, is lacking local comparables.[1176] Consequently, use of Kenya comparables may be very limited and may lead to absence of comparables. In practice, MNCs in Kenya have been using commercial foreign databases such as Amadeus and Orbis as benchmark studies.[1177] The problem with foreign comparables is that they may not be very relevant and they may be expensive.

Accordingly, the TP Rules are silent on whether or not foreign data are accepted provided that no material differences or can reasonably be adjusted. Yet, in practice, KRA occasionally challenges use of foreign comparables on basis of non-inclusion of country adjustment.[1178] However, no guideline on how adjustment can be made when foreign comparable is used.

[1174] Unlike Kenya, Tanzania clearly provides comparability factors . see Rule 6 of TP Rules 2014 of Tanzania.
[1175] Rule 2 of TP Rules 2006.
[1176] See discussion in chapter 6, para 6.4.3.2.
[1177] Deloitte, note 71. See also KPMG, Global Transfer Pricing Review, Kenya, 2015, p.4.
[1178] Ibid.

7.3.3.3 Application of Arm's Length Principle to Intangibles, Services and Intercompany Financial Transactions

The TP Rules require transfer of services, intangibles and finances between associate MNCs to be made at arm's length price.[1179] In Kenya, there are no clear guidelines on application of arm's length principle to such transactions. To start with services, in practice, the KRA requires the tax payer to demonstrate that intra group services were actually rendered based on the agreement if any.

However, there is no guideline as to when the services are said to be actually rendered.[1180] In practice, the KRA requires taxpayer to show that service was needed and there is no duplication of activities and that the fee was properly charged.[1181] This is sought to be achieved by providing evidence of such transactions. While such requirements may be valid, if they are not regulated may not compel a taxpayer to comply. Likewise, the law does not provide any guideline on range of services to be taken into account for transfer pricing purposes. The problem with this is that it may render difficult to ascertain the amount of tax to be charged. This is obvious despite prohibition of deduction on services rendered by the nonresident directors of the non-resident company.[1182] Yet, the law empowers the Commissioner to determine whether or not administrative expenses between associates are reasonable and just.[1183]

[1179] Ibid, section 10 and Rule 3 (a), and 6 (c), (d) and (e) of TP Rules, 2006.
[1180] In Tanzania for example there is clear guideline showing circumstances that the service was actually rendered. See TRA, Transfer Pricing Guidelines, para 14.
[1181] Omond, F., Transfer Pricing –An East African Perspective, A paper presented in IBFD 1st Africa Tax Symposium, June 2015 Livingstone Zambia, p. 16.
[1182] Section 18 (4) (a) R.E 2014.
[1183] Ibid, section 18 (4) (b).

With regard to intangible, in practice, the KRA requires the taxpayer to show the owner of the intangible and if it is registered in Kenya. Accordingly, it evaluates the value of intangible and contribution of Kenya to the value of intangible.[1184] Arguably, both ITA and TP Rules are silent under circumstances a person can be regarded as owner of intangible. Sometimes the owner of the intangible may not be vested with the legal ownership but contributed substantially in developing such intangible but no guideline on arm's length payment. Accordingly, the law is silent about aspects that constitute intangibles for transfer pricing purposes. Moreover, it does not provide guideline method to be applied in intangibles in absence of comparables or where intangible is of high value.[1185]This is necessary because of a variety of intangibles that may present different problems.

With regard to intergroup financing, generally, the KRA has not been focusing much on this area. There are few explanations for this such that, to a great extent, the law in Kenya has restricted interest and deemed interest deduction in ascertaining taxable income. For example, the law does not allow deduction of interest to a company if the ratio of all liabilities in which the interest is charged exceeds three times the sum of revenue reserves and issued and paid up capital.[1186] The 3:1 ratio applies to other companies except for extractive industries (mining, petroleum and geothermal) in which 2:1 ratio of debt to equity applies.[1187] Accordingly, the law does not allow any deduction of interest paid by permanent establishment to non-resident person for

[1184] Omond, F., note 92.
[1185] Unlike Kenya, in Tanzania, the law requires be transferred by using CUP method. see Rule 11(2) of TP Rules 2014 of Tanzania.
[1186] Section 16(j) (i) commonly known as 3.1 ratio.
[1187] Deloitte, International Tax, Kenya Highlights 2016 available at

transfer pricing purposes.[1188] In context of ITA, debt means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which a company is paying financial charge, interest and discount premium. However, there is no clear guideline on what constitutes intergroup financing for transfer pricing purposes. Absence of a clear guidelines on such transactions may be potential for associated MNCs to manipulate prices and hence, jeopardize KRA efforts for collecting tax for viable development.

7.3.3.4 Transfer Pricing Documentation Requirement

Neither the ITA nor the TP rules make mandatory transfer pricing documentation requirement. However, when person avers application of arm's length principle, the TP Rules require that the person should develop transfer pricing policy and provide documentation to evidence their analysis.[1189] Required transfer pricing documentation includes those related to selection of transfer pricing method and their reasons for selection including their application, the global organizational structure of the MNC, details of transaction under consideration, assumptions, strategies and policies applied in selecting the method plus any other information as may be necessary for such transaction.[1190] Notwithstanding such requirement, the tax payer is not under obligation to produce such document with other tax returns but rather, can produce upon the request by the Commissioner thirty days upon request.[1191]

[1188] Ibid, section 18 (5).
[1189] Rule 10.
[1190] Rule 9 (2)(a) to (f).
[1191] Rule 10 (i).

Arguably, the existing TP Rules do not compel associated MNCs to produce transfer pricing documents but rather, maintain documents. The ITA requires the tax payers to maintain their records for ten years.[1192] To the contrary, the Tax Procedure Act requires the tax payer to maintain any tax document as required by law in either English or Kiswahili for a period of five years.[1193] Notwithstanding these requirements, the law requires corporate taxpayers to notify KRA any changes in their business structure, in particular, changes in shareholders, beneficial ownership as well as cession or sale of business within thirty days of such changes.[1194] Despite existing conflicting requirements, there is no specific penalty for non-compliance with the documentation requirement.[1195] Consequently, 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.[1196]

7.4 Administration and Enforcement of Transfer Pricing Rules in Kenya

7.4.1 Institutional Framework for Transfer Pricing

Generally, administration and enforcement of tax matters are vested with Kenya Revenue Authority (KRA). The KRA was established in 1995 and became effective on 1st July, 1995.[1197] Essentially, KRA is a body corporate with perpetual succession and common seal. The main function of the KRA under general supervision of the minister responsible for finance is to collect and receipt of all government

[1192] Section 55(2) of ITA R.E 2014.
[1193] Ibid, Section 23 (1) (a) and (c).
[1194] Ibid, section 54B, (a) and (b) (i), (ii) (v).
[1195] Unlike Kenya, Tanzania clearly provides penalty for non compliance of TP rules. see Rule 7(5) of TP Rules 2014 of Tanzania.
[1196] Rule 11 and 12 of TP Rules 2006. It worth to note that, following establishment of the Tax procedure Act, this requirement might be affected as some of the provision have been repealed and other amended.
[1197] Section 3 of Kenya Revenue Authority Act, RE 2016.

revenues.[1198] In performing a given function, the KRA is also responsible in administering and enforcement of tax laws. Other responsibilities include advising government on administration and collection of revenue and to perform any other duties that may be assigned by the minister in revenue collection.[1199] The KRA is manned by Board of Directors and KRA management under the Commissioner General.The Board, under chairman as presidential appointee, is responsible for approval and review of the policy and monitoring of performance of the KRA.[1200] The function of the Commissioner General is to oversee daily operations of the KRA in collection of government revenue.[1201] In performing its responsibilities, the KRA is divided in to two main department, namely, domestic tax payer, which consists of domestic taxes and large tax payer office (LTO) and custom and excise. The LTO is of particular interest because it deals with taxpayers, whose annual turnover is from 750 million and above.[1202] As a result, most MNCs are within the LTO. The LTO was established in 2006 as full-fledged department with objective of administering domestic tax matters affecting large tax payers. One of the responsibilities of LTO is administration of taxes to all companies with their subsidiaries falling under LTO. It is in this context that KRA has established transfer pricing unit (TP Unit). The TP Unit was established in 2009. The TP Unit is manned by less than twenty staffs and is responsible for handling transfer pricing audits. Selection for transfer pricing audit is based on risk profile such as consecutive losses, use of tax haven countries, intercompany loan, management fee, large investment deductions and disclosure in

[1198] Ibid, section 5(1).
[1199] Ibid, section 5(2).
[1200] Ibid, section 6(1) and 6(6).
[1201] Ibid, Section 11(2) and Section 5 of Tax Administration Act, 2015.
[1202] http://www.revenue.go.ke/lto/lto.html

tax return as well as financial statements.[1203] The major focus area includes management fee, tangible goods, intangible and royalties and financial arrangement. Since its establishment, considerably, there is increase in transfer pricing audits that resulted into transfer pricing adjustment to Kenya billion shillings. Accordingly, more cases currently are under audit and some cases have been decided at tribunal level and a few at high court appeal stage.[1204]

Despite considerable good performance, the TP Unit is facing challenges in implementing its works. The existing TP Rules do not provide for a clear guidelines on transaction related to service, intangibles, royalties and intercompany financial arrangement. Such situation has led to less related transaction audits. Apart from legal challenges, absence of reliable local comparables, poorly prepared documents and lack of information of foreign associated parties are other challenges.[1205] In addition, the TP Unit has low number of transfer pricing experts compared to transfer pricing audits, which are likely to occur.

7.4.2 Transfer Pricing Dispute Resolution Mechanism

The existing transfer pricing laws do not provide for specific mechanisms for transfer pricing disputes. Such disputes have been handled just like any other tax matter. In most cases, transfer pricing disputes arise from additional assessment by the Commissioner if he considers that the taxpayer under-declared his income.[1206] If the tax payer is aggrieved by the decision of the Commissioner, he has the right to

[1203] www.kra.ke.go large tax payer office.
[1204] Omond F., Transfer Pricing- An East African Perspective, a paper presented in Zambia, June 2015.
[1205] An interview with KRA officials.
[1206] Section 73 and 77 of ITA R.E 2014, and section 28 of Tax Procedures Act, 2015

appeal to Tax Appeal Tribunal (TAT)[1207] within thirty days upon receipt of the decision by the Commissioner.[1208] The function of TAT is to hear appeals filed against any decision of the Commissioner.[1209]

The Tax Appeal Tribunal (TAT) is composed of the chairman and not less than 15 but not more than 20 members. For a person to become TAT member she/he should be the holder of degree in law, business, finance, economics, insurance or related discipline from university or institution recognized in Kenya,[1210] among other qualifications. This requirement is very useful when dealing with transfer pricing cases because such disputes are not premised on taxation only but rather, a combination of the said disciplines. Empirical evidence shows that absence of such qualifications may provide potentials for revenue authority to lose cases. For example, a study by European Commission revealed that before establishment of Tax Appeal Tribunal, local committee members were lacking specialist experience in tax and transfer pricing, a situation, which rendered difficult to come up with well reasoned, researched precedents.[1211] Likewise, in Unilever case, the Judge was

[1207] Section 3 of the Tax Appeals Tribunal Act, 2013 which came in to force on April 2015 by Legal Notice No. 32 of 20th March 2015.

[1208] Ibid, Section 12 and 13 (1) (a) respectively. Prior to establishment of TAT, appeals on decision of commissioner including transfer pricing disputes were filed either to Local Committee or Tribunal. See Mbiuki note 1124, p 70; Ado, M., Transfer Pricing Disputes In Kenya: Advance Pricing Agreements the Way Forward? Master's programme in European and International Tax Law, Lund University, 2015, p.16.

[1209] Section 3 of Tax Appeals Tribunal Act, 2013 and Rule 2 (a)–(f) of the Tax Appeals Tribunal (Procedure) Rules, 2015.

[1210] Ibid, section 4 (3) (b) (ii). However, unlike repealed section 82 of ITA, the Tax Appeals Tribunal Procedure Rules does not include degree in Taxation as one of the qualification for the members.

[1211] EU Commission Transfer pricing and Developing countries, Kenya (2011):, Appendix D: Country Study-Kenya, p. 16.

concerned with failure from local committee to include reasons for their decisions.[1212]

The proceedings of the TAT is of judicial nature and that it carries out its writs processes, orders and rules just like any ordinary court of law.[1213] The burden of proof lies with appellant[1214]and it has the power to engage expert evidence.[1215] The TAT also has power to grant parties to settle matters out of TAT at any stage during the proceedings.[1216] The decision of TAT is made in writing and the law requires such decision to be reasoned.[1217] It is interesting to note that the TAT clearly excludes application of the Civil Procedure Act.[1218] This is very important because it may help to reduce technical issues used by lawyers in civil cases. However, any part aggrieved by Tax Appeal Tribunal decision has the right to appeal to High Court of Kenya within thirty days after decision of the TAT under High Court rules.[1219] Where any part is aggrieved by the decision of High Court, he has the right to appeal to Court of Appeal.

Although the Tax Appeal Tribunal has kept all tax disputes under one roof and taken in account significantly pertinent issues that might be potential in solving transfer disputes, it is likely to face some challenges from taxpayers. There are two reasons for this, first, the Constitution confers on the High Court unlimited jurisdiction in all

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[1212] Unilever case , In which the Judge stated, "Unfortunately 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…" See also Ado, M., note 104.
[1213] Section 24 of Tax Appeal Tribunal Act, 2013.
[1214] Ibid, section 30.
[1215] Ibid, section 23.
[1216] Ibid, section 28.
[1217] Ibid, section 29(5) and (7).
[1218] Ibid, section 14.
[1219] Ibid, Section 32.

civil and criminal matters.[1220] For that reason, some taxpayers may directly institute tax cases to the High Court, seeking for prerogative orders before passing to ordinary tax disputes mechanism.[1221] For example, in *Keroche Industries v Kenya Revenue Authority & 5 others* [1222] it was stated 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.*"[1223]

Unfortunately, the Tax Appeal Tribunal does not pose any requirement that all tax disputes should first be filed to TAT before proceeding to High Court. Since the TAT is still new, it remains to be seen whether or not tax related cases will first be taken at TAT before the High Court. Secondly, tax including transfer pricing appeals from TAT lies to High Court and Court of Appeal. However, unlike TAT, the High Court is likely to lack specialist knowledge on transfer pricing issues. This is because there is no pre-requisite for bench of Judges to have prior knowledge in taxation, finance, marketing and economics, which are important aspects in determining transfer pricing cases. Accordingly, currently, under hierarchy of Kenyan court system, there is no high court tax division designed to handle such issues. The requirement for such division seems to be desirable by the court itself. In *Republic v*

[1220] Article165 and Article 2 respectively of the Constitution of Republic of Kenya 2010.
[1221] Ado note 104, p16, Mbiuki, note 1124, p. 72, see also EU P.34.
[1222] 2007.
[1223] Keroche's case p.34

Kenya Revenue Authority Ex-Parte Abdalla Brek Said T/A Al Amri Distributors & 4 others,[1224] the court stated that,

> "*The court avails itself of this opportunity to call for the establishment of a specialized 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' benefit and, on the other hand, in the interests of the Public at large who eventually benefit for the proceeds of taxation."*

In such circumstances, transfer pricing cases are likely to be handled just like any other civil cases in which Civil Procedure Act and other High Court Appeal rules are applicable. One issue is crystal clear. While TAT ousted application of Civil Procedure Act in its proceedings, such provisions are likely to be applied in High Court proceedings to the same dispute and therefore, it may represents the same problem, which TAT aimed to avoid.

7.4.3 Court Interpretation and its Impact to Transfer Pricing Law

Transfer pricing disputes poses serious challenges when determined by the court of law. This part focuses on decision of the High Court of Kenya and its influence on transfer pricing regime in Kenya. To illustrate this point, the study uses the High Court's decision of *Unilever Kenya Ltd v Commissioner of Income Tax*.[1225]

The facts of the case were as follows:- Unilever Kenya Limited (UKL) and Uganda Unilever Limited (UUL) are both subsidiaries of Unilever group of companies incorporated in United Kingdom (UK). Both subsidiaries are related companies under the laws of Kenya. In August 1995, UKL and UUL entered into a contract

[1224] 2015
[1225] Income tax appeal no. 753, of 2003 KE: HC September 2005.

agreeing that UKL will manufacture and supply goods to UUL. However, UKL charged UUL lowered prices than it charged its domestic buyers and importers not related to UUL. The Commissioner of Income Tax raised assessment against UKL in respect of sales made by UKL to UUL and found that they were not made at arm's length price.

As a result, such arrangements produced less tax than would have been produced if transactions had been carried out by an Independent Corporation. Hence, the Commissioner assessed UKL for additional tax. Two main issues were of concern. First, "whether t the transaction between UKL and UUL was so arranged to produce less profit."[1226] Second, "whether in the absence of specific guidelines from the KRA on this issue, the OECD Guidelines and methods prescribed there under for calculation of an arm's length price are a proper, reasonable and objectively acceptable bases for the determination of arm's length price as required by section 18(3)".[1227] In this case, the HC ruled in favour of the tax payer, the UKL.

In reaching decision whether the OECD Guidelines was applicable in absence of Kenyan guidelines, the HC agreed with UKL that in absence of Kenyan guidelines to determine what constitutes arm's length price, the UKL was justified to resort to OECD Guidelines because they are internationally accepted principles of international business so long as they are not in conflict with Kenyan law.[1228] In his words, the Judge stated that,

[1226] Ibid, p.3.
[1227] Ibid, p. 4.
[1228] Ibid, p.12 and 13.

> *"We live in what is now referred to as a 'global village.' We cannot overlook or sideline what has come out of the wisdom of tax payers and tax collectors in other countries. And especially because of the absence of any such guidelines in Kenya, we must look elsewhere. We must be prepared to innovate, and to apply creative solutions based on lessons and best practices available to us. That is indeed how our law will develop and our jurisprudence will be enhanced. And that is also how we shall encourage business to thrive in our country."*[1229]

This decision offers an important insight in transfer pricing jurisprudence in Kenya. First, the court also had dilemma for fear from discouraging investors if they had to decide against MNCs. This can be inferred from the judge's statement that "…and that is also how we shall encourage business to thrive in our country." Second, the judgment influenced KRA to establish transfer pricing rules modeled in OECD one year after the judgment.[1230] Arguably, the court interpreted Kenyan law in light of the OECD.

However, the provisions of the OECD are standard-based (*ex post*) as opposed to rule-based (*ex ante).*[1231] Eduardo posits that the full meaning of the OECD provision can be provided by case law only or something functionally equivalent to case law.[1232] This shows that precise meaning of the OECD standard-based will be found in decentralized domestic court case laws with public good character.[1233] In this context, courts normally have wide room to construe provision of tax treaty to take

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[1229] Ibid.

[1230] See Income Tax Act (Transfer Pricing Rules) 2006 of Kenya.

[1231] For difference between rule based and standard based see Baistrocchi, E., The use and interpretation of tax treaties in the emerging world: Theory and implications, in British Tax Review, 2008 Issue 4 p. 386.

[1232] Ibid.

[1233] In other words case law is a public good character if it sets good precedent to be referred future cases when similar circumstances happen. See Baistrocchi, E., note 639 p.388 . Stating that, case law is a public good (rather than a private good) if it allows a representative person to predict the probable outcome of a future court's decision.

into account strategic consideration.[1234] In reaching decision of the two issues the court used standard-based rather than rule-based of Section 18(3).[1235] The judge, whether knowingly or unknowingly, interpreted section 18 (3) as if he was interpreting OECD model provision. This was so because the judge specifically referred to OECD principle by stating that,

> "*I have no doubt in my mind that OECD principle on income and capital and the relevant Guidelines such as 'transfer pricing' principles, the CUP method adopted for calculation of what ought to be the income, the cost plus return method as well as resale minus method are not just there for relaxing reading ... would be fool- hardy for any court to disregard any international accepted principles of business.....To do otherwise would be highly short-sighted.*"[1236]

This statement implies that the OECD standards are stronger than domestic laws and judges are ready to opt for OECD rather than substantive laws of the country. Additionally, the OECD standards were made applicable even in absence of tax treaty to OECD non-members like Kenya. It is also true that section 18 (3) is a replica of Article 9 of the OECD model. Nevertheless, it was supposed to be construed in rule-based. As Bosire pointed out that while resort could have been made to foreign jurisprudence, ultimately, it is a substance of Kenyan law to be construed and applied.[1237] The court's interpretation in favour of OECD makes existing domestic transfer pricing laws ineffective. The main implication of the judgment is that the court reaffirmed use of OECD and its transfer pricing Guidelines

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[1234] Ibid, The good example of such kind of interpretation can be found in the *Union of India and Azadi Bachao Andolan* (2003) SC 56ITR INDIA in which the court interpreted the India-Mauritius tax treaty in light of the India-US tax treaty.

[1235] ITA, RE 2014.

[1236] Judge Alnashir Visram in Unilever case p.13.

[1237] Nyamori B., An Analysis of Kenya's Transfer pricing Regime, International Transfer pricing Journal , March/ April 2012, p.157.

in Kenya. The biggest impact is that it influenced Kenya to establish transfer pricing rules, which replica of OECD transfer pricing Guidelines. This was partly to remedy concern by the KRA that the OECD model was not part of Kenyan law and partly to reaffirm desire for MNCs to apply OECD, which for a great part allows them to obtain more taxing rights than host countries.[1238]

The Unilever case also has brought insight on difficulties involved by revenue authorities in proofing before the court of law an alleged manipulation of transfer prices. In this case, it was not disputed that UKL and UUL are related parties within the meaning of section 18(3) of Income Tax Act of Kenya. The argument by KRA was that transacted between them were arranged as to produce less profit. Produced evidence showed that UKL had designed a scheme to cheat on its incomes with the view of reducing its tax liability.[1239] UKL sold its products to Tanzania and Somalia higher than those sold to UUL and that price to UUL was set without considering market force. In addition, transfer pricing policy of Unilever group of companies was offending Section 18(3).[1240] Whether the transaction was so arranged, the court held that there was no such arrangement between UKL and UUL.[1241] In reaching the decision, the judge stated that, "the business so arranged must be such as to show less income to enable the tax authority to challenge it and that there was no evidence of tax cheating or tax fraud."[1242] According to judge, only evidence tendered by KRA was with regard to method used for computation of arm's length price. Thus,

[1238] See discussion chapter five at para 5.3
[1239] Unilever case p.11.
[1240] Ibid.
[1241] Ibid p.13.
[1242] Ibid.

according to the judge, the method used by UKL was lawful and permissible so long as there was no fraudulent trading with a view to evade tax.[1243]

The statement by the court shows that even where revenue authorities have strong indication or rather, evidence showing that actually in the course of business, the transaction was so arranged it is difficult to prove before the court of law. The difficult is inherited from the long and cumbersome procedure involved in arriving at arm's length price, which involves economic, accounting, marketing and law as well as information technology. Accordingly, the whole process is done solely by the taxpayer and the revenue authority comes into play when there is suspicious that the arms' length was not adhered to. Given complexities involved in setting up arm's length price, sometimes judges may not easily understand such transaction and actually, they detect malice arrangement between associated MNCs. Such situation may discourage revenue authorities to take transfer pricing cases to the court of law.

This can be evidenced by the recent development in Kenya that established an alternative dispute resolution mechanism in which transfer pricing disputes are channeled.[1244] Accordingly, such kind of decision may pull away legislators from crafting transfer pricing laws commensurate with domestic tax demands. One year after the decision, Income Tax (Transfer Pricing Rules) 2006 were officially established.

[1243] Ibid p.13.
[1244] An interview with KRA officials, department of big tax payers held on November 2014, Nairobi.

7.5 Base Erosion Profit Shifting Action Plan in Kenyan Context

As noted before that the existing arm's length principle, to a great extent, has encountered serious challenges in curbing transfer pricing manipulation, BEPS Action plan was thought as a rescue. The rationale behind BEPS is to ensure that profit by MNCs is taxed where economic activities generating that profit are performed or where the value of intangible is created. On the basis of existing transfer pricing laws as examined in this chapter, there is no any inclusion or reference to Base Erosion Profit Shifting Action Plan 2013. Accordingly, the KRA has not stated its position on implementation or adoption of the plan.

7.6 Conclusion

The presented analysis and examination of transfer pricing laws in Kenya reveal inadequacy of law in curbing transfer pricing manipulations. The arm's length principle still remains as a sole solution in curbing transfer pricing manipulation. While existing transfer pricing laws are premised on arm's length principle, they lack clarity and in some instances, they contradict each other. Accordingly, where clear provisions exist, they are not implementable, either because of lack of pre-requisites, requirement in practice, such as comparables or lack of experience and knowledge of transfer pricing by tax officers. Nobly, the law is silent on transaction related to extractive sectors. The situation is exacerbated by lack of specific transfer pricing penalties and specific transfer pricing adjustment. In addition, lack of clear guidance on services, finance and intangibles, which provide high risk on manipulation, are likely to hinder Kenyan desire to finance its expenditure through local taxes.

CHAPTER EIGHT

CONCLUSION AND RECOMMENDATIONS

8.1 Introduction

This chapter presents conclusion of the study which essentially sums up insights of the study, provide recommendations and suggestions for future research.

8.2 Main Insights of the Study and Key Findings

The study has carried out in depth examination and analysis on transfer pricing laws in particular legal challenges that EAC countries face in applying arms' length principle. The study sought to address potentials of losing revenue from international transactions between associated MNCs emerging from the increase of foreign investments in the regional. The main focus of the study was the examination of adequacy of EAC transfer pricing laws and international standards in curbing manipulation of transfer prices between associated MNCs operating in the region. The study was guided by the following research questions;-

(i) Do existing transfer pricing rules and standards in EAC adequately curb transfer pricing manipulation?

(ii) To what extent are the general principles and guidelines of OECD and UN Model relevant in curbing transfer pricing manipulation in EAC countries?

(iii) What strategies should be considered and employed in formulating an effective transfer pricing regime for EAC?

The study has demonstrated that the existing transfer pricing laws are inadequate in curbing such malpractice. The traditional doctrinal legal research methodology were

mainly employed and supplemented by empirical and comparative methods. Tanzania and Kenya are used as case study for EAC countries. The literature review revealed that although substantive literature has been developed, such scholarly writing is missing from EAC perspective. The preoccupation of this study was to provide comprehensive transfer pricing literature from EAC perspective.

The theoretical and concept of transfer pricing analysis and discussion made in chapter two reveals that transfer pricing theories have been developed exclusively and addressed from profit maximization and minimization of tax point of view. Consequently, suggested transfer pricing methods reflects maximization of profit. It is further found that the existing transfer pricing manipulation originates from transfer pricing theories. And that the existing manipulation of prices between associates MNCs originates from managers of entities who are afraid to be evaluated on basis of their profit performance. To date same managers are still concealing relevant information not only for purpose of evaluation but rather for purpose of lessening tax liability. Furthermore it was found that manipulation of transfer pricing is not only done by infringing the purpose of the law, but rather the whole processes is done on bases of accounting, economic, marketing and taxation. Therefore to handle such situation it requires combination of such disciplines and lawyers.

To counteract transfer pricing theories, the study reveals that market price under arm's length principle is viable option to regulate transfer prices from legal and economic point of view. The study found that arm's length is capable of counteracting transfer pricing theories with a view of allocating right share of income for both taxpayer and governments. This is because arms' length principle takes in to

account transfer prices comparability requirement, separate account evaluation and transfer pricing methods as advanced by such theories and counteract them. The Arms' length principle obliges related parties be evaluated as independent party and compare their transaction and prices to non related parties so as to arrive at market price which is real transfer price. A review of transfer pricing standards under international instrument in chapter three reveals that arms' length principle is a cornerstone for any taxation of profit between associated MNCs. Countries are required to craft their domestic laws based on this principle. However, transfer pricing instrument reveals that originally, the transfer pricing laws were established to avoid double taxation as primary concern and not to deter MNCs from manipulation of transfer prices.

Accordingly such rules were developed all along based on experience and practice of developed countries and therefore not necessarily reflecting needs for developing countries like EAC. The experience was based on problems faced in exporting capital and their desire to maximize profit and minimization of tax. Such experience has never felt by EAC countries for a great extent because all along have been capital importers. Hence, the standards developed based on solving their problems by limiting source countries in which MNCs operates to tax. Consequently, issues of concern for EAC and other developing countries were not taken in to account.

For example transfer pricing standards all along have been silent in relation to natural resources such as minerals, gas and oil. This might be because at the time of establishment these were not material concerns. Additionally, international transfer pricing standards did not take in to account the difficulties involved in implementing

arm's length principle for developing countries like EAC. The rules also all along have been not sufficiently addressing changes brought by technology in electronic transaction between associated MNCs. Presentation and discussion of EAC transfer pricing regional instrument under chapter four found that arm's length and other transfer pricing standards as enshrined in EAC regional instrument affirms use of such principle to regulate transaction between associated parties in EAC.

The study further found that transfer pricing standards as enshrined in EAC instruments lack clarity and clear guideline on handling transfer pricing issues. Such discrepancies lead to non uniform application of the arms' length principle in the region giving advantage to MNCs. The study observed that the increase of foreign investment in the regional in which EAC increasingly integrated in to world economy, influenced existing transfer pricing standards in the region. It was found that EAC countries have been caught in between desire to attract foreign investment and desire to obtain revenue out of MNCs transaction within the regional.

However, the desire to attract more investors seems to outweigh desire to obtain revenue out of such investment. This is substantiate by the fact that all along EAC countries have been changing and improving policy and laws to attract foreign investments and less efforts in tax laws to keep pace with such increase of investments. This demonstrates the extent to which EAC countries have bound themselves in obligation that potentially affect and shape their policy choices in tax law in particular transfer pricing. This show that the existing transfer pricing laws of EAC are not adequately addressing transfer pricing manipulation.

The discussion and analysis of relationship between transfer pricing standards and manipulation of transfer prices through aggressive transfer pricing has found the following. First, Transfer pricing standards provides potentials for transfer pricing manipulation and therefore associated MNCs stand to benefit more than revenue authorities in absence of aggressive transfer pricing laws. Second, the arms' length principle and other standards is vulnerable to transfer pricing manipulation because associated MNCs have been using loopholes found in transfer pricing laws to manipulate prices. Third, manipulations of transfer prices are done under auspices of aggressive tax planning by using same transfer pricing standards. Forth, the BEPS Action plan which brought to rescue the existing transfer pricing laws is still premised on arm's length reaffirms arm's length principle as an ideal in regulating transactions between associated parties. same principle has been employed over and over again with slightly modification within the ambit of arms' length principle.

BEPS Action Plan came to capture tax which could be shifted to other countries through transfer pricing manipulation. The study further reveals that, to date arm's length principle remains as sole solution in curbing transfer pricing manipulation. It was further found that, currently there is no alternative to arm's length principle because formulary apportionment sought to be alternative to arms' length price, was found to be not sufficiently addressing transfer pricing manipulations.

The analysis and discussion of transfer pricing laws in Tanzania under chapter six found that the existing transfer pricing laws lack coordination and clarity in some instances. Although arms' length principle is enshrined in various tax laws actual implementation of arm's length principle remains unimplemented to a great extent

on account of factors provided in respective chapters. The study found that the failure is due to limited provision of arm's length principle as provided under section 33 of ITA. Although more requirements are provided under Transfer pricing rules, legally speaking rules cannot override enabling Act.

Other factors include conflict of the provision of the law governing transfer pricing, lack of local comparables and lack of clear guideline in absence of comparables, lack of clear mechanism to handle transfer pricing disputes, lack of capacity and experience by revenue officials in handling transfer pricing issues and lack of clear mechanism in transfer pricing audits. In addition, lack of provisions for ascertainment of taxable income for transfer pricing purpose and lack of clear transactions subject to transfer pricing among others. These discrepancies leads to conclusion that the existing transfer pricing laws as enshrined in Tanzania is inadequate in curbing transfer pricing manipulation between associated MNCs. The analysis and discussion of transfer pricing laws in Kenya under chapter seven found that the existing transfer pricing laws lack coordination and clarity in some instances. Although arms' length principle is enshrined in various tax laws actual implementation of arm's length principle remains unimplemented to a great extent on account of factors provided in respective chapters.

The study found that although section18 of ITA to a great extent covers arms' length principle, Kenya still faces challenges in curbing transfer pricing manipulations. Such challenges are caused by factors as conflicting provision of the transfer pricing law, inadequate of provision and clear transfer pricing rules governing intra company service, intangibles and finances. Other factors include lack of clear auditing

mechanism, lack of local comparables and clear guideline in absence of comparables, low number of transfer pricing experts in handling transfer pricing issues, lack of special transfer pricing disputes mechanisms, lack of comparability factors, lack of specific transfer pricing penalties, lack of clear modalities of transfer pricing adjustment for arm's length price and failure of the law to clearly state and regulate other methods capable to arrive at arm's length price among other factors. These discrepancies leads to conclusion that the existing transfer pricing laws as enshrined in Kenya is inadequate in curbing transfer pricing manipulation between associated MNCs.

8.3 Recommendations

Basically, the EAC countries require comprehensive tax reforms that recognize special nature of transfer pricing between associated MNCs. Such countries need transfer pricing provisions that expedite determination of transfer pricing in capturing the right share of tax to both government and MNCs. This approach is necessary because EAC countries still rely solely on arm's length principle in curbing transfer pricing manipulation. Consequently, such reforms must be based on arm's length principle as a bench mark without departing from international practices.

Generally, the study recommends amendments of transfer pricing law in Tanzania and Kenya countries. Such amendment should aim at capturing the right share of tax arising from business profit by associated MNCs. This is sought to be achieved by counteracting MNCs and transfer pricing theories while taking into account economic situation of EAC countries. Understanding economic situation is

important in setting up transfer pricing law between associates. This is important because it will help to understand the competitive advantage potentially for maximizing profit and minimizing cost prompted to invest in such countries and counteract manipulation of them. Equally important, capacity of EAC countries outbound investment should be taken into account so as to establish any potential likely to minimize tax liability. The suggested amendment of the transfer pricing law in Tanzania and Kenya should take in account the following aspects:

Firstly, there is need for clear clarification on ambiguous concepts and phrases. The law should be amended to provide clear definition of transfer pricing concept and clarification of all ambiguous words as well as phrases. The definition of legal transfer pricing is important in explaining and identifying circumstances, which a taxpayer did or did not transact at arm's length price. The concept will also help in identifying special circumstances between associated parties, which are unavailable to unrelated parties. This is particularly necessary in making comparability for purpose of comparing comparables and characterization of transaction for adjustment purposes. Consequently, when the transfer pricing concept used will clearly eliminate possibility of providing two conflicting results and enhance certainty of law.

Secondly, there is need for hierarchal application of transfer pricing methods. The law should clearly state certain types of transactions should not rely on traditional methods that are irrelevant.[1245] Accordingly, there is a need to establish the best choice rule in selecting transfer pricing method. The best choice should guide

[1245] It should be noted that the study could not suggest specific method to a specific transaction because it involves calculations which require combination of accounting, mathematics, economist and taxation which is beyond this study.

taxpayers to choose one method that will provide the best arm's length results. The rule should take into account relevance of the method to be chosen to a particular transaction and advantage and disadvantage of the method chosen. Additionally, selection of the best method rule should not only depend on comparables available only but also should depend on nature of goods and services under transaction. Where the taxpayer is not complied with the rule, the law should clearly provide relevant penalty for non-compliance.

The penalty should either compel the taxpayer to use the best method or fine, which will deter the taxpayer from committing such offence in future. An exception should be provided to peculiar goods and services under transactions that may require specific method(s) to be followed. For example, Tanzanite and other precious gemstone are available in Tanzania only. As a result, in order to obtain comparables, it may be difficult. In this context, specific method(s) should be clearly stated based on policy and reliable research by revenue authorities.

Accordingly, the law should clearly state other methods that may be prescribed by the Commissioner where traditional transfer pricing methods fail to provide desired results. This is necessary because if there are other methods that can yield results equivalent to arm's length price, such method(s) ought to be regulated by the law so as to avoid arbitrary application and uncertainty of the law. Thirdly, in regard to comparability factors, the law should clearly provide requirements for use comparables from African continent before embarking on foreign comparables. This is thought to be achieved by establishing domestic, regional and continental data bases. Such databases should be updated from time to time so as to keep pace with

any changes in business arena. The common denominator factor is that African economic situations are more or less the same and therefore, they are sharing common features. Notably, such commitments require resources, both human and financial.

However, national bureau of statistics of countries in collaboration with revenue authorities can be utilized in developing data bases as benchmarking information. For that reason, foreign databases may be used as a last resort. Where there is no possibility of comparables, revenue authorities may do away with comparability aspect and adopt a fixed margin. However, this is subject to serious research. In addition, the law should clearly state the modality to be followed where there is no comparable. Fourthly, elimination of tax incentive and tax holidays: the law should be amended to clearly limit the extent of tax incentive and tax holidays offered to foreign investors. This is necessary in eliminating any risks of transfer pricing manipulation during period of tax holidays. In related matters, the law should clearly provide for requirement of application of arm's length principle in any international agreement where one part to an agreement is expecting to transact with a related party for transfer pricing purposes.

Fifth, the law should clearly empower transfer pricing units full mandate in handling transfer pricing issues. Thus, any other government institutional audits from any aspect of transactions including mining, gas and petroleum should be obliged to submit any transfer pricing audit query to TP Units. This requirement is important in providing consistency in application of the law. Sixth, the law should require tax advisers to be regulated by a board of authority. This is necessary in curbing tax

avoidance schemes aiming at manipulating transfer pricing between associated MNCs.

Seventh, capacity building for tax officials: there is need for revenue authorities to build transfer pricing capacity both human resources, financial and working tools. In this context, transfer pricing unit officials should be well equipped by acquiring knowledge based on continuous processes of learning while taking into account new tactics of aggressive planning, technology changes, new products and business methods. This is thought to be achieved by using institutes of tax administration and higher learning institutions in respective countries. Accordingly, working tools and financial resources should be sufficiently made available to transfer pricing units. The TP Units should be composed of officials from various expertise such as tax, law, economics, accounting and marketing. Capacity building should be extended to enforcement instruments such as tribunals and courts of law. This is envisaged to be achieved by conducting regular transfer pricing seminars, workshops and training, short-term and long-term courses. The invitation of transfer pricing experts in handling transfer pricing cases may also be used. In near future, it is important to consider establishment of a High Court Tax Division.

Eighth, enhancing tax compliance**:** the government, through tax authorities, has to strengthen tax policy to promote tax compliance to taxpayers. Negative attitude towards MNCs in profit shifting should change and handle MNCs just like any other taxpayers.

Ninth, building economies of EAC: the economies of countries under the study need to be improved, which, in turn, will enhance growth of domestic MNCs. In addition,

fair treatment should be considered to domestic MNCs so as to put both investors on equal footing. The enabled domestic MNCs may have outbound investment not necessarily to developed countries but at least at regional level and in Africa. Countries' desires to obtain foreign investment should not outweigh desire to obtain tax out of profit by associated MNCs. EAC countries should make diligent research and be aware of gains obtainable by agreeing on sharing resources and avoid any chances that will lead to lose their right share of tax.

Accordingly, revenue authorities must be in a position to foresee future prices for goods and services between associated MNCs. In due regard, such authorities must not focus on transactions, which they believe are of high risk, but rather, the whole transactions should be thoroughly analyzed. Tenth, Actions 8,9,10 and13 of Base Erosion and Profit shifting Action plan 2013 may be customized and adopted. Eleventh, there is need to adopt formulary apportionment for MNCs operating within countries. There is a need for revenue authority to conduct serous studies to see whether or not formulary apportionment should be used to domestic MNCs. However, any recommendation for use of such method should be well regulated by the law.

Apart from general recommendations for Kenya and Tanzania, the following are specific recommendations for individual countries. In Tanzania, Section 33 of Income Tax Act, should be amended to include the following:- One, meaning of business and under circumstances the business is said to be carried on by resident or nonresident for transfer pricing purposes should be clear. Two, relevant transfer pricing transactions that are subject to adjustment should be clearly stated. Three,

ascertainment of income for transfer pricing should clearly state inclusion and deduction allowed. Four, relevant intercompany financial services should be stated and ratio of interest deduction as enshrined in BEPS action plan may be customized and adopted. Five, relevant intercompany services for transfer pricing purposes should be stated and defined. Associated parties for transfer pricing purposes should be provided.

Six, clear elements of transactions, which the Commissioner is empowered to disregard should be clearly stated so as to avoid irrational use of power. Seven, penalties and APA should be clearly provide in ITA rather than being in the TP Rules only. Accordingly, such APA should be regulated and guidelines should be issued to that effect. Eight, the TP Rules should be amended and clearly state interpretation of provisions of transfer pricing law to be construed in a manner consistent with enabling Act and not as per OECD and UN models. Such amendment will harmonize well with requirement that in case of conflict between regulation and, enabling Act and international instrument, the enabling Act shall prevail. Ten, the term meaning of permanent should be amended to take into account electronic commerce.

In Kenya, the law should be amended to provide the following: first, clear guidelines on intercompany financial services for transfer pricing should be stated. Second, the relevant intercompany services for transfer pricing purposes should be stated and defined. Third, advance pricing agreement (APA) should be introduced and regulated well in Kenyan law. Fourth, the law should provide clear factors to be taken into account for comparability purposes.

8.4 Suggestions for Future Research

Future research may be taken by considering the following: first, similar research can be conducted in the same countries by suggesting alternative to arm's length as means to curb transfer pricing manipulations within countries. Second, a similar research may be taken in other EAC countries other than Kenya and Tanzania.

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